Monetary Policy and Its Impact on Indian Economy: A Critical Analysis

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Abstract: *Monetary Policy is a Policy made by the central bank (RBI) to control money supply in the economy and thereby to fight both inflation and deflation. It helps maintain price stability and achieve high economic growth. To Combat Inflation RBI reduces Money Supply (Tight/Dear Money Policy). To Combat Deflation RBI increases Money Supply (Easy/Cheap Money Policy). There are certain quantitative and qualitative tools of monetary policy adopted to achieve specified goals. This paper tries to study all the tools and critically analyze their impact on the growth of the Indian economy since 2011-2016. The objectives and the various issues concerned with this policy, their indicators and targets are being succinctly discussed here.*

Key-words: *Monetary Policy, Price stability, Economic growth.*

Introduction: The monetary policy explains how the central banks manage the money supply for the healthy economic growth. The money supply consists of credit, cash, and market for mutual funds. The most important of these is credit which includes loans, bonds, mortgages, and other agreements to repay. RBI implements monetary policy using certain tools. These are Quantitative Tools and Qualitative Tools. Quantitative Tools are Reserve Ratios (CRR,SLR) , OMO(Open Market Operations) and Rates(Repo , Reverse Repo , Bank Rate etc).

Objectives of Monetary Policy

1. Full Employment: It is the foremost objective of monetary policy.
2. Price stability: The other policy objective is to stabilize the price level. The fluctuations in the prices bring uncertainty and instability in the economy.
3. Economic growth: It is the process whereby the real per capita income of a country increases over a long period of time.
4. Balance of Payments: To maintain in the equilibrium in the balance of payments.

Instruments of Monetary Policy:

There are several direct and indirect instruments that are used in the implementation of monetary policy.

- **Repo Rate:** The (fixed) interest rate at which the Reserve Bank provides short-term (overnight) liquidity to banks against the collateral of government and other approved securities under the liquidity adjustment facility (LAF). The LAF consists of overnight and term repo auctions. Progressively, the Reserve Bank has increased the proportion of liquidity injected in the LAF through term-repos (up to 56 days) at variable rates. The repo help to develop inter-bank term money market, which in turn can set, market based benchmarks for pricing of loans and deposits, through that improve transmission of monetary policy.
- **Reverse Repo Rate:** The (fixed) interest rate (currently 50 bps below the repo rate) at which the Reserve Bank absorbs short-term liquidity, generally on an overnight basis, from banks against the collateral of government and other approved securities under the LAF. The Reserve Bank also manages variable interest rate and conducts repo auctions, when necessary.
- **Marginal Standing Facility (MSF):** A facility under which scheduled commercial banks can borrow additional amount money for averment from the Reserve Bank by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a limit (currently two per cent of their net demand and time liabilities deposits) at a penal rate of interest, currently 50 basis points above the repo rate. This provides a safety valve against unanticipated liquidity shocks to the banking system. The MSF rate and reverse repo rate determine the corridor for the daily movement in the weighted average call money rate.
- **Bank Rate:** It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers. This rate has been aligned to the MSF rate and, therefore it changes automatically as and when the MSF rate changes alongside policy repo rate changes.
- **Cash Reserve Ratio (CRR):** The share of net demand and time liabilities that banks must maintain as cash balance with the Reserve Bank.
- **Statutory Liquidity Ratio (SLR):** The share of net demand and time liabilities that banks must maintain in safe and liquid assets, such as, unencumbered government securities, cash and gold. Changes in SLR often influence the availability of resources in the banking system for lending to the private sector.
- **Open Market Operations (OMOs):** These include both outright purchase/sale of government securities for injection/absorption of durable liquidity, respectively.
- **Refinance facilities:** Sector-specific refinance facilities aim at achieving sector specific objectives through provision of liquidity at a cost linked to the policy repo rate. The Reserve Bank has, however, been progressively de-emphasizing sector specific policies as they interfere with the transmission mechanism.
- **Market Stabilization Scheme (MSS):** This instrument for monetary management was introduced in 2004. Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-dated government securities and treasury bills. The mobilized cash is held in a separate government account with the Reserve Bank.

Research Methodology

The type of Research is Descriptive in nature. All the tools of monetary policy is studied to analyze its implementation and impact on economic growth of the country.

Time period – A five year monetary policy is studied from 2011 t0 2016 to see the impact on economic growth.

Data collection – Secondary data is being considered for the analysis. Data is taken from the RBI's web site, News papers articles, journals and magazines etc.

Monetary policy

2011-12

- Short term lending rate (repo) hiked by 50 bps to 7.25%.
- Reverse repo to be fixed 100 bps lower than the repo rate.
- Cash reserve ratio (CRR) and bank rate left unchanged at 6 pc each.
- Interest rates on savings bank deposits hiked to 4% from 3.5%.
- Economic growth projected lower at 8% for FY'12.
- WPI inflation projection lowered to 6%.
- Objective was to contain inflation by curbing demand-side pressures.
- Favours aligning of fuel prices with international crude prices to avert widening of fiscal deficit.
- Banks got a new overnight borrowing window under Marginal Standing Facility at 8.25%.
- Likelihood of oil prices moderating significantly is low.
- Malegam committee recommendations on MFI sector broadly accepted.
- Bank loan to MFIs on or after April 1, 2011, was treated as priority sector loans.
- Short-term borrowing rate (reverse repo) up by 50 bps to 6.25%.

2012 - 13

- Short term lending rate (repo) lowered by 0.50 per cent to 8 per cent.
- Cash reserve ratio retained at 4.75 per cent.
- GDP growth for 2012-13 projected at 7.3 per cent.
- Bank rate cut by 0.50 pc to 9 per cent.
- Deposit growth pegged at 16 per cent, credit growth at 17 per cent.
- Govt. borrowing may decrease credit flow to private sector.
- Liquidity conditions moving towards comfort zone.
- Tightens norms for lending against gold by NBFCs.

2013-14

- Key short-term lending rate (repo) cut by 0.25 per cent to 7.25 per cent Cash reserve ratio kept unchanged at 4 percent
- FY14 GDP growth pegged at 5.7 percent, down from govt's estimates
- Inflation to remain range-bound around 5.5 pc in FY14
- CAD is the biggest risk to the economy
- RBI proposes doubling of limits on priority sector lending to MSMEs to Rs 5 cr
- Banks asked to stop differential treatment to home-branch and non-home branch customers
- RBI says probe into Cobrapost's sting operation calls for a better regulatory compliance by banks
- Banks not carrying out customer due diligence as required while marketing and distributing third-party products
- RBI proposes restricting gold imports only to meet genuine needs of exporters of gold jewellery

- Banks asked to set up mechanism to monitor and review implementation of Direct Benefit Transfer

2014-15

- Short-term lending (Repo) rate unchanged at 8%
- Cash reserve ratio (CRR) unchanged at 4%
- SLR cut by 50 bps to 22.5% to unlock banking funds
- Reiterates CPI inflation target of 8% by January 2015 and 6% by 2016
- Decisive election results should help bring in gradual recovery of growth
- Farm sector outlook clouded by forecast of delay in monsoon
- Export credit refinance facility cut to 32% from 50%
- Foreign Portfolio Investments (FPIs) allowed in currency derivative market
- Indians as well as non-residents can carry up to Rs 25,000 while leaving country

2015-16

- Short-term lending rate (repo) unchanged at 7.5 per cent Cash Reserve Ratio unchanged at 4 per cent Retains Statutory Liquidity Ratio at 21.5 per cent
- Forecasts CPI inflation at 5.8 pc by March 2016
- CPI inflation to dip to 4 pc in August 2015
- Future rate cuts will depend on interest rate reduction by banks
- India better prepared to deal with volatility post US Federal Reserve rate action
- State cooperative banks to be allowed to set up off-site/ mobile ATMs without prior approval from RBI
- RBI to formulate scheme for market making by primary dealers in semi-liquid and illiquid G-Secs.

Findings

In India, the monetary policy lays more emphasis to control Inflation.

Effects of Inflation: It affects the purchasing power of consumers as they can now buy only a lower number of goods with the same amount of money. Many analysts call it an invisible tax. In short inflation is a phenomenon that devalues everything by its touch and thus has severe debilitating effects.

Measurement of Inflation: Inflation for a particular period can be measured on a year on year (YOY) basis with respect to a base year. As with any Index, the sample of items considered and their weight ages are of prime importance. Inflation can also be measured at e Whole sale Price Index (WPI), which measures inflation at the wholesale level. Consumer Price Index on the other hand measures inflation at the consumer level. Of late, RBI has indicated that it is watching CPI more closely. Inflation can also be seen from the supply side and demand side.

Supply side inflation: It is caused when there is a rise in prices due to inadequacies in supply. For example, food prices in India are expected to increase due to drought. (Since new crops fail, there is not enough supply of food grains). Thus supply side inflation occurs when supply of goods falls below their demand.

Demand Side Inflation: This arises when the rise in prices is caused by an increase in demand. For example, many analysts believe that the worldwide increase in commodity prices has been due to an excessive demand especially from China.

Control of Inflation

It can be controlled by increasing supply and/or reducing demand. Increasing the supply of goods normally falls within the purview of the Government. This is exactly why the fiscal policy of the Govt. (also known as the Union Budget) is important. The reduction in demand can be achieved by monetary actions of the Central Bank of the country (RBI in case of India).

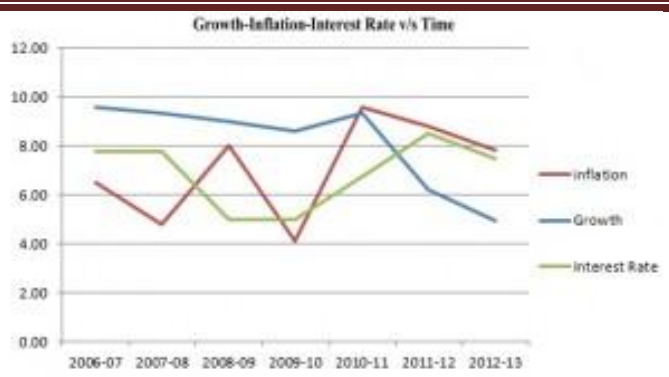
Repo & Reverse Repo Rate: Repo rate is the rate at which RBI lends money to banks &injects liquidity into the economy. Currently RBI uses the repo rate as the benchmark rate. Reverse repo rate is the interest rate paid by RBI to commercial banks when it sucks out liquidity from the system. Normally the reverse repo rate is 1% lower than the repo rate.

Reserve Requirements (CRR & SLR): CRR stands for Cash Reserve Ratio and SLR stands for Statutory Liquidity Ratio. All commercial Banks have to maintain CRR & SLR as a % of deposits. They can only lend the remaining balance after meeting these requirements. For example, if reserve requirements are 30%, then of every Rs.100/-received by banks as deposits, banks can only lend Rs. 70/- (Rs.100 minus Rs.30). CRR is maintained by banks as cash deposits with RBI while SLR is maintained as investments in Government Securities and Treasury Bills (Govt. debt). Thus, RBI can control money supply and influence interest rates via CRR & SLR.

Effect of change in reserve requirements: RBI seeks to control demand side inflation by increasing interest rates. One of the way of achieving this increase is by increasing CRR or both SLR. Consequently banks will have lower funds for lending and may therefore increase interest rates on their loans. Similarly, when RBI seeks to decrease interest rates, it could reduce CRR o both SLR. Commercial banks would then have more funds to lend and thereby reduce their lending rates.

Recent Monetary Actions by RBI: In the recent past RBI has adopted a hawkish tone on inflation. It has increased reserve rates to 27% (till the latest policy) and the repo rate to 8% in an effort to control inflation. This was done through a series of steps initiated by the previous Governor Mr. Subbarao and also through the current out group.

Consequences of these actions: The actions of RBI did control inflation to a certain extent. It also had some unintended effects. The higher interest rates led to consumers cutting down their consumption. Also firms shelved their expansion plans. Consequently, Indian economy grew at a 5% for the 2nd year in succession. This increase in interest rates has been described as one of the factors that have cause a slowdown.



Conclusion

Interest rates have great influence on both the growth and inflation. Higher the interest rate, higher is the cost of capital and this contributes to slowdown in investment in the economy. Lower the interest rate, higher is the supply of money in the economy and greater purchasing power of individuals. This will result in increase in the price of goods, since there is more demand and less supply of the goods. Manipulating interest rates thus creates a variation in growth and inflation in the economy.

In 2012, the inflation in comparison compared to previous year increased its pace to 8.80% and as a result, the growth suffered. Central Bank in 2012-13 had to therefore increase Repo rate to control inflation.

The global economic activities have slowed and risks remain high, most recently on account of uncertainty over policies of systemic central banks. On the domestic front, macroeconomic conditions remain weak, along with supply constraints, lackluster domestic demand and weak investment sentiment.

Due to the remarkable economic growth of India during the recent years as compared to the other nations, there is an increase in foreign currency inflow which has caused the demand to multiply. Inflation has moderated as projected, however the depreciation in the rupee value of imbalances in the commodity markets pose a big challenge. Given that food prices are still high, the figures on inflation will be influenced by the efforts to break the persistent food inflation and also to examine the impact of the Food Security Bill on the inflation.

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