**SEMESTER 6th (UG)**

**Subject: BUSINESS ENVIRONMENT**

**UNIT V - MONETARY POLICY**

**INTRODUCTION**

Monetary Policy refers to the use of monetary instruments under the control of the central bank to regulate magnitude such as interest rates, money supply and availability of credit. The primary objective of monetary policy is to maintain price stability while keeping h. mind the objectives of growth. The responsibility to conduct monetary policy is given to the Reserve Bank of India under the Reserve Bank of India Act, 1934.

In a developing country like India, the monetary policy is significant in the promotion economic growth. The various instruments of monetary policy includes variation in bank rates, other interest rates, selective credit controls, supply of currency, variations in reserve requirements and open market operations.

**D.C. Rowan has defined Monetary Policy as "discretionary act undertaken by the authorities designed to influence**

**(a) the supply of money**

**(b) the cost of money or rate of Interest and**

**(c) the availability of money."**

**According to Prof. Harry Johnson, "A policy employing the central banks control of the supply of money as an instrument for achieving the objectives of general economic policy is a monetary policy."**

**FEATURES OF MONETARY POLICY**

1.Monetary Policy of India is an **active policy** as the RBI uses all the measures of credit control.

2. Monetary policy adopted by the RBI is **flexible** in nature. During Inflation, RBI follows tight monetary policy and reduces money supply whereas during depression RBI increases the money supply by following liberal monetary policy.

3. The Reserve Bank of India uses **multiple monetary instruments** to control credit as per the need of the economy. It uses both quantitative and qualitative measures to regulate money supply.

4. RBI always tries to reduce rate of inflation or keep it with in a sustainable limit. While on the other hand, the government of India focus to accelerate the GDP growth of the country. These **contradictory objectives** are achieved only through monetary policy.

5. The monetary policy adopted by the RBI is both **investment and saving oriented**. To encourage Investment in backward areas, the RBI provides concessional loans. At the same time, the RBI also keeps the rate of interest on deposits reasonably high to attract savings.

6. Monetary policy **regulates the level and structure of interest rates** directly in organised sector and indirectly in unorganized sector.

**TYPES OF MONETARY POLICY**

**1. Expansionary Monetary Policy:** Its aim to increase money supply to lower unemployment, boost private sector borrowings & stimulate economic growth. RBI increase money supply by lowering interest lowering reserve requirements like CRR & SLR purchasing government securities.

**2. Contractionary/Dear Monetary Policy :** Its aims to reduce money supply to control Inflationary pressure. RBI decreases money supply & contracts credit by Increasing interest rate, increasing CRR & SLR & by selling government securities.

**OBJECTIVES OF MONETARY POLICY**

The Chakravarty Committee appointed by the Reserve Bank of India in 1982 has emphasized that price stability, economic growth, equity, social justice, promoting and nurturing new monetary and financial institution have been the important objectives of monetary policy in India. Following le the broad objectives of Monetary policy in India.

1.**Achieving Price Stability :** For sustainable growth the prime condition is price stability. To maintain price stability, inflation needs to be controlled. A high degree of inflation raises the cost of living and hurts the poor most. Inflation also has an adverse effect on Balance of Payment by making exports costlier.

However, a certain rate of inflation is inevitable in a developing economy. Thus price stability means reasonable rate of inflation. In consultation with the Reserve Bank, the government of India has notified 4% Consumer Price Index inflation as target for the period between 2016 to 2021.

**2. Accelerate Economic Growth** **:** One of the dominant objectives of the monetary policy is to accelerate the process of economic growth with a view to raise the national income. The RBI ensures the regular supply of money and credit for the economic growth of country through its monetary policy.

**3. Controlled Expansion :** Another main objective of the monetary policy is the controlled expansion of money supply for growth with reasonable price stability in the country.

**4. Control Business Cycles :** Monetary policy's aim is to coffin)l the business cycles i.e. boom or depression. During boom period, through monetary policy, the RBI contracts credit and reduces the money supply to control inflation. On the other hand during depression, the RBI increases the money supply to encourage private investment and aggregate demand in the economy.

**5. Interest Rate Stability :** Another objective of monetary policy is to maintain interest rate stability. As fluctuations in interest rates makes future uncertain and affects consumers' willingness to buy durable goods such as houses, motor cars etc.

**6. Stability of Financial Market :** The central bank is the ultimate source of funds in the money market. Through monetary policy, the RBI tries to promote a more stable financial markets. Through its role as lender of last resort, the RBI pump funds and prevent financial panic particularly by bank failures.

**7. Stability in Foreign Exchange Market :** A rise in the value of rupee makes Indian industries less competitive with those in abroad. Decline in the value of the rupee stimulates inflation in India. Stablising extreme movements in the value of rupee in foreign exchange market is thus viewed as worthy goal of monetary policy.

**8. Employment Generation :** Another objective of monetary policy is to create employment opportunities. For example with the help of expansionary monetary policy, the RBI can stimulates business activities that leads to the expansion of job market.

**9. Allocation of Credit to Priority Sectors :** Another important objective of monetary policy is to ensure availability of more funds to the priority sectors like agriculture, small industries and export units at concessional rates.

**10. Maintaining Balance Between Conflicting Goals :** The goal of price stability often conflicts with the goal of interest rate stability, and high employment in the short run. For example when the economy is expanding and unemployment is falling, both inflation and interest rates may start to rise. If the RBI tries to prevent a rise in interest rate by purchasing government securities and thus causing interest rates to fall, the resulting open market operations will increase the money supply and thereby will increases inflation.

Thus, important objectives of monetary policy are to make a balance between the conflicting goals and ensure both reasonable price stability along with economic growth.

**INSTRUMENTS/TECHNIQUES/TOOLS/MEASURES OF MONETARY POLICY**

To achieve the objectives of monetary policy the Reserve Bank has adopted the following measures :

1. **Measures for Expansion of Currency and Credit :**

In India during the planning period, the aim of monetary policy of Reserve Bank has been that of continuous expansion of currency credit to meet the needs of the planned development of the economy. This continuous expansion has been achieved by using following measures.

**1. Revision of Open Market Operations** : In October 1956, the open operations policy of the Reserve Bank was revised and it started giving discriminatory support to the sale and purchase of government securities. Initially, the bank made large purchases of government securities. In the subsequent years the bank's sale of government securities exceeded its purchases. But this excess sales method was discontinued between 1964 and 1969 with a view to expand currency and credit in the economy.

**2. Liberalisation of the Bill Market Scheme** : The Reserve Bank has liberalised the bill market Scheme, as a result, the commercial banks receive additional funds from the Reserve Bank to meet the credit requirements of the borrowers. Since 1957, the Reserve Bank has included the export bills also in the bill market scheme, so as to help the commercial banks to provide credit to exporters also.

**3. Financing Facilities to the Priority Sectors** : Even though, the general policy of the Reserve Bank is to control credit expansion, still It continues to provide credit facilities to priority sectors such as small scale industries and cooperatives. The Bank has been providing short term finances to the rural cooperatives also.

**4. Refinancing and Rediscounting Facilities** : The Reserve Bank also follows a policy of selective refinance and rediscount facilities. In this recent years, the banks are permitted to refinance equal to one percent of their time and demand liabilities. This is done at the rate of 10% per annum. Refinance facilities are available for providing food procurement credit as well as export credit. The scheduled banks can also get their bills of exchange, promissory notes and hundis rediscounted with the Reserve Bank, but the maximum duration of these bills should not be more than 3 months.

**5. Establishment of Various Financial Institutions** : The Reserve Bank has played the main role in the establishment of various financial institution in the country, through which the Reserve Bank provides medium term and long term credit facilities for development.

Some of these institutions are :-

(i) ICICI—Industrial Credit and Investment Corporation of India.

(ii) IDBI—Industrial Development Bank of India.

(iii) IFCI—Industrial Finance Corporation of India.

(iv) IRCI—Industrial Reconstruction Corporation of India.

(v) SFCs—State Financial Corporations.

(vi) ARDC—Agricultural Refinance and Development Corporation.

(vii) NA BARD—National Bank for Agriculture and Rural Development.

**6. Deficit Financing :** To continuously increase the supply of money in the country, the Reserve Bank has adopted the system of deficit financing for financing the budgetory deficit of the government. For this the Reserve Bank has made changes in its reserve requirements and made the reserve system more flexible.

The changes made by the Reserve Bank are :

(i) The proportional reserve system which required keeping of 40% reserves in gold an foreign securities has been dropped by the Reserve Bank.

(ii) The minimum reserve system has been modified by the Reserve Bank. Now the bank need to keep only gold worth Rs 115 crores. The requirement of keeping foreign securities of the value of Rs. 85 crores can be waived during extreme contingencies. Thus, in extreme contingencies the bank need to keep just Rs.115 crores of reserves in t lace of Rs. 200 crores.

**7. Anti-inflationary Fiscal Policy** : In the Seventh five year plan, it was preferred that there should be an anti inflationary Fiscal policy in place of anti inflationary monetary policy. This plan laid much emphasis on the positive, promotional and expansionary role for the monetary policy. In the seventh plan the amount of deficit financing given by the Reserve Bank to the government had been fixed at a minimum level, which was just sufficient to generate the additional money supply needed to meet expected increase in the demand for money. If such a fiscal policy continues, it will relieve the Reserve Bank of its anti inflationary responsibilities so that it can pay more attention to the provision of credit facilities for the development of trade, industry and commerce in the country.

**8. Allocation of Credit :**According to this measure, the allocation of credit will be done in accordance with the priorities laid down in the plans. Still the major part of the credit goes to the public sector through statutory requirements and other means. For the priority sector a certain minimum of credit at concessional rates of interest is ensured through selective credit control and the differential rate of interest scheme. The Reserve Bank does not give credit to the private industries directly. These industries can get credit facilities through the public financial institutions.

**(B) Measures for Credit Control.**

Apart from meeting developmental and expansionary requirements of the economy, the Reserve Bank has also been assigned the responsibility to ensure that money supply is with in manageable limits as unlimited expansion of money and small credit results in inflation and ultimately affects the poor.

**Measures for Credit Control**

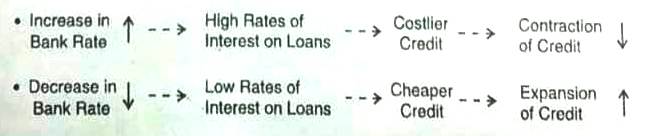
**Qualitative/Selective Measures**

**Quantitative/General Measures**

Designed to regulate the flow of moo I^ specific sectors of economy & not applicable to whole economy.

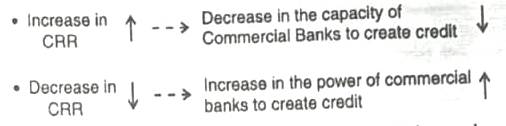
**I. Quantitative/General Measures :** Its designed to regulate the total quantity of credit created by the banking system & affect the economy in general. The Reserve Bank adopts the following methods to control qurantum of credit.

**1. Bank Rate :** Bank rate, also known as discount rate is a powerful tool used by RBI to control liquidity and money supply in the market. It is the rate of interest charged by the Reserve Bank of India against loans offered to commercial banks. Bank rate directly affects the end users i.e. customers, as high bank rate means high lending rate. When banks pay high interest rate to obtain loan from RBI, they in return also charge high interest rates from customers to break even. Bank rate is usually higher than Repo rate. The current bank rate is the same as marginal standing facility rate i.e. 5.65% (upto 7 August 2019).



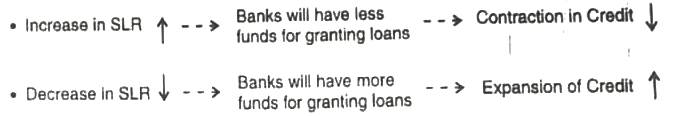
**2. Cash Reserve Ratio (CRR) :** The average daily balance that banks are required to keep aside in the form of liquid cash with the Reserve Bank of India is called Cash Reserve Ratio. CRR is fixed % of total demand and time liabilities of banks, determined by RBI. For example If CRR is 100/n then the maximum amount a bank can lend is equal to 90% of total reserves. CRR is the most direct and effective method of credit control. RBI Controls lending capacity of Banks in India through CRR.

RBI is empowered to vary the CRR between 3% to 15% of total demand and time liabilities. In 1993, CRR was very high i.e. 14%. Since April 2013, CRR is 4%.



**3. Statutory Liquidity Ratio (SLR) :** Apart from cash reserve requirements, all commercial banks are required to maintain a minimum rate of their demand and time liabilities in the form of liquid assets like gold, cash and government securities, at the end of every business day. This ratio is called Statutory liquidity Ratio (SLR). Changes in SLR often influences the availability of resources in the banking system for lending to the private sector.

The maximum SLR that the Reserve Bank of India can set is 40% p.a. However the current SLR (upto August 2019), is set at 18.75 % p.a.



**4. Open Market Operations (OMO) :** OMO is the sale and purchase of government security and treasury bills by the Reserve Bank of India. RBI uses this monetary rod to smoothen liquidity conditions and regulate money supply in the economy. RBI carries out the open market operations through the commercial banks and does not directly deal with public.

**5. Liquidity Adjustment Facility (LAF) :** LAF is a monetary policy tool which allows the commercial banks to borrow money from the RBI in case of shortage or deposit excess funds with the RBI in case of excess liquidity on an overnight basis against the collateral of government securities.

Liquidity Adjustment Facility includes both

(a) Repurchase option i.e. REPO.

(b) Reverse Repurchase option i.e. Reverse REPO.

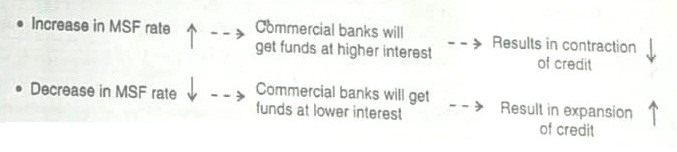
**(a)Repurchase option / Repo Rate :** Repurchase option is when commercial banks borrow money from the RBI to meet short term needs by selling securities to the RBI with an agreement to repurchase the same at predetermined rate and date. The rate charged by the RBI for this transaction is called the repo rate.

• Increase in Repo Rate Commercial banks get funds from RBI at higher interest Results in contraction of credit

• Decrease in Repo rate Commercial Banks get funds from RBI at lower interest Expansion of credit Repo rate is usually higher than reverse repo rate.

**(b) Reverse Repo Option / Reverse Repo Rate :** Reverse Repo rate is the interest rate given by the Reserve Bank of India on deposit made by commercial banks with it. When commercial banks have excess funds on overnight basis, they can deposit the same in the central bank and earn **`Reverse Repo Rate.'** Increase in Reverse repo rate also contracts credit as commercial banks will deposit more funds with RBI to earn higher interest.

**6. Marginal Standing Facility (MSF) :** Through liquidity Adjustment Facility, banks are permitted to borrow only a certain percentage of its deposits. In case the banks require more funds beyond the limit under LAF, they can access another window called Marginal Standing Facility (MSF). MSF refers to the penal rate at which banks can borrow money from the Reserve Bank of India over and above the limit under LAF window. MSF being a penal rate is always fixed above the repo rate.



**II. Qualitative / Selective Measures :**

The Banking Regulation Act, 1949 has given extensive power to the RBI to apply selective credit control measures. The following are the different methods of selective credit control adopted by the RBI.

**1. Marginal Requirements on Loan :** A loan is sanctioned against collateral security. Margin means that proportion of the value of security against which loan is not sanctioned. For example if margin requirement is 20% then bank will give loan up to 80% of the market value of security. Margin requirements varies from 20% to 80%. The Reserve Bank can control the credit by increasing the margins and expand credit by reducing the margin requirements.

**2. Discriminatory Interest Rates (DIR):** Through DIR, RBI ensures credit flow to certain priority or weaker sections by charging concessional rate of interest. Through this method, the RBI not only direct the flow of credit to useful channels but also prevent the flow of credit in to undesirable channels.

**3.Regualtion of Consumer Credit :** The consumer credit schemes which are adopted by the banks require that a certain percentage of consumer durable goods is in cash. The balance amount is financed by the bank through bank credit which is repayable in monthly instalments over a period of time. The Reserve Bank control credit by increasing credit by reducing the down payment and increasing the number of the down payment and reducing the number of instalments. On the other hand it expand credit by reducing the down payment and increasing the number of instalments.

**4. Credit Authorization Scheme (CAS) :** This scheme was introduced in 19:5:Under this scheme, commercial banks were asked to obtain prior approval of RBI for credit of Z 1 crow or more to any single party. Later this limit was raised to Rs.6 crore in 1986. However this scheme was discontinued in 1987.

**5. Credit Monitoring Arrangements (CMA) :** Since July 1987, a system of post sanction scrutiny called Credit Monetary Arrangements (CMA) has been introduced by the Reserve Bank of India. The RBI has been monitoring and scrutinizing all bank credit exceeding Rs. 5 crore to any single party for working capital needs and Rs. 2 crore in the form of term loans. The main purpose of CMA is to keep a close watch on the flow of credit to borrowers and bank should give large borrowings on the basis of credit appraisal and actual requirements of the borrowers.

**6. Moral Persuasion :** Under moral persuation, RBI issues periodical letters to banks to exercise control over credit in general or advances against particular commodities. Periodic discussions are held with the authorities of commercial banks in this respect. However the effectiveness of this method depends on the willing cooperation extended by the commercial banks.

**7. Ceiling on Loans :** The RBI has fixed ceiling on loan for any single project at Rs. 500 crore. Banks can sanction maximum loan of Rs. 500 crore for a single project.

**8. Directives :** The RBI through directives also tries to control flow of credit for unproductive purposes. Directives are given regarding the purpose for which loans may or may not be given.

**9. Direct Action :** This method is too severe and is therefore rarely followed. It may involve refusal by the RBI to rediscount bills or cancellation of license, if the banks fail to comply with the directives of the Reserve Bank of India.

**Difference between BANK RATE and REPO RATE**

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| **BANK RATE** | **REPO RATE** |
| 1.Bank rate is charged against loans offered by the RBI. | 1. Repo Rate is the rate at which the RBI lends to commercial banks by purchase government securities. |
| 2. No collatral is required I.e. commercial banks can borrow from the RBI at bank without providing any security | 2. Securities, bonds, agreements and collateral is involved when Repo rate is charged. |
| 3. Increase in Bank rate directly affects the lending rates offered to the customers, thus making loans costlier for borrowers. | 3. Increase in Repo rate is usually handled by the banks and doesn’t affect customers directly. |
| 4. Bank rate caters to long term financial requirement of commercial banks. | 4. Repo rate focuses on short term financial needs of banks. |
| 5. Bank Rate is usually higher than repo rate. | 5.Repo rate is always lower than bank rate. |
| 6. At present , Bank rate is 5.65% (upto 7 August 2019) | 6. At present , Repo rate is 5.40% (upto 7 August, 2019) |