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THE GLIMPSE OF MONETARY POLICY OF INDIA

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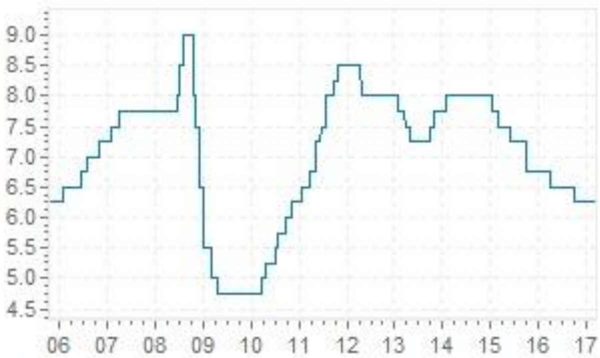
Abstract

monetary policy in India saw many ups and downs since the year 1935. There was period when private sectors and commercial banking were limited. The nationalisation of banks helped great in administration of monetary policy. There were made many changes in terms as well as the features in monetary policy in post liberalization years. This article presents small glimpse of Indian monetary policy that stand firm with time and never shied away from accepting changes from time to time.

Under Section 49 of the Reserve Bank of India Act, 1934, the Bank Rate has been defined as "the standard rate at which the Reserve Bank is prepared to buy or re-discount bills of exchange or other commercial paper eligible for purchase under the Act". The Bank Rate was used as a signal rate but in later half of the century, it lost the importance as instrument of monetary policy. Former RBI governor C. Rangarajan reactivated it in April 1997. Again it got modification in 2003 and became 6% but then lost the relevance because repo rate and the reverse repo rate were designed as most important instrument of monetary policy.

Graph Indian interest rate RBI - long-term graph



RBI lends money to Banks against collateral bonds. Therefore banks need availability of bonds in excess of the regulatory requirement, known as SLR (statutory liquidity ratio). Banks are required to maintain at least 24% of their deposits as government Securities &

bonds. SLR was introduced by section 24(2A) of Banking Regulation Act 1949. SLR remained very high above 35% of total net time and demand liabilities during the period 1981to1993. During 1996- 2012, it came down between 23 to 25%. Narsimhan committee in mid 1990's recommended to bring it down from 38.5% to 25%. SLR has acted as a golden instrument of credit control and it works as buffer against the shocks that may bring failure of banking services in country.

History of SLR changes shows that SLR was used for limited or undermined role in controlling the credit flow by banks. However SLR has mostly benefited the government by financing the deficits from time to time. This has been the major role that provision of SLR has played. CRR is important ratio that RBI varies to control money supply in economy. It is permanent tool in hands of RBI to control liquidity in banks. RBI Act has reserved the value of CRR between 15 % and 3%. As private sector picked up pace in Indian economy in post liberalization period, a greater need of increased availability of liquidity was felt across the various sector of economy. Narsimham committee Report on banking sector suggested to reduce CRR. Therefore it has been reduced significantly from 15% in 1990s to 4% in 2016. CRR remained generally below 6% only since November- 2001 except a small gap August 2007- October 2008, when CRR generally remained high and varied between 7- 9%. The Period '1993 - December-1996' is marked by very high CRR (10 to 15%).

From 2013, the RBI tightens the rules pertaining to CRR requirements (daily basis) by increasing minimum daily CRR balance to 99% of fortnight basis. Earlier it was necessary to maintain at least 70% of the fortnightly CRR requirement on daily basis. Banks complain that it has become very expensive as well as tough task to maintain new requirements on daily basis. CRR now has ceased to be an instrument of monetary control in India since mid-1990s. In 1990s, additional CRR requirement also called incremental CRR was introduced at times of pressure. Incremental CRR of 10% was levied on various Non-resident deposits at one time when they flooded Indian market. This was aimed to restrict NRI deposits during that time. Similarly RBI declared an incremental CRR of 100% from 26th November for a fortnight to absorb flood of currency deposits following Demonetization of 500 & 100 rupee notes in November-2016. Under financial sector reforms, Interest rates (lending & deposit) were deregulated in 1990s. Deregulation was mostly completed by October 1997. However interest rates on small loans (rupees 2 lakh or less), rupee export credit, and the savings bank deposits remained regulated. 'Base Rate' system was incorporated by the RBI replaced the Benchmark Prime Lending Rate (BPLR) in 2010. interest rates on small loans up to 2 lakh rupees was also deregulated and except saving bank deposit interest rate, all other rupee lending rates became deregulated. Deregulation of interest rates aimed best possible 'asset-liability management' on banks' side.

The Chakravarty Committee on Indian banking & monetary system (1984) reviewed the Indian monetary system and it found that the time had come to establish 'interest rate' as important tool while applying monetary policy in order to ensure effective use of credit and short-term monetary management. The main idea was to let the various sectors of economy decide how much and when the credit is required on basis of current interest rate and it required Rationing of credit to be done away with. Judicious choice of interest rate should be done by central bank after taking into account the current and future demand of liquidity. Committee found that under inflationary pressure, overuse of quantitative controls on credit had resulted deformity in process of credit sanction at lowest level. The committee also suggested that absolute fixing and implementing monetary target mechanically will harm the economy and a flexible, indicative approach should be followed. Committee also recommended greater use of 'Open market Operations' by RBI and government and that should include encouraging expansion of retail market for Government Securities and treasury bills (short term finance). There should be higher level of incidence of sale & purchase of securities and treasury bills with freedom. Most important suggestion was that the 'Valuation' of SLR holdings by banks should be done on basis of purchase price and not on 'Market Value'. Interest rate variation also varies the SLR holding value and it generated problems.

Narasimham Committee on banking and finance (1991) had the view that the SLR instruments were misused continuously by government for public financing like financing various government deficits in fiscal preview. It strongly advocated the use of SLR requirement only as prudential requirement as it was originally intended under RBI Act.

Committee also proposed the fresh idea of reducing the cash reserve ratio from its present high level in 1980s. It preached that interest rates should be deregulated and market forces should be allowed to take front seat. This will facilitate broader and greater use of 'Open Market Operations' and lessen the role of CRR.

The most important aim of monetary policy includes:

(1) To stimulate demand by increasing money supply also called expansion of liquidity

(2) To Control inflation

(2) To stablisation of exchange rate

Earlier monetary policy used to employ direct instruments – fixation of deposit and lending rates for commercial banks and selective credit controls. After the economic reforms initiated in starting years of 1990s, RBI modified the approach (accepting guidelines advocated by Chakravarty & Narasimham committee) and turned on more flexible approach of adjusting ‘interest rates’ to stimulate lending and investment. Inflation control and growth revival requires just opposite application of policy. It becomes problematic when both inflationary pressures and lower growth have to be tackled simultaneously. For example there had been series of debates between government, RBI and industries in 2015 but central government chose to hike interest rate with an aim of controlling inflation instead of lowering interest rate to revive the economy.

In real world it is quite difficult to achieve the desired results from monetary policy. For example an independent monetary policy is just unmanageable in case of fixed exchange rate and free capital flow. Practically a country can achieve any two conditions among the three i.e. free capital flow, fixed exchange rate system & independent monetary policy. If interest rates is hiked, inflation can be limited but increased interest rates generally lures foreign capital which in turns appreciates Indian rupee vis a vis dollar. Appreciation of rupee is highly adverse for export growth and thus central bank will have to buy ‘dollars’ from the market. Increase in domestic currency results form that step and market forces will push down the interest rate. End result is against the aim that central bank wanted to achieve in first place.

As we have seen above that CRR & SLR were the primary tools of RBI for limiting the availability of liquidity in system. From mid of 1990s, these tools lost their importance and Open Market Operations took the front seat in liquidity controlling. When Central bank buys government bonds, liquidity increases in market and interest rate comes down. This encourages government and private sector to borrow larger funds at lower interest. The OMO practice also does not cause much immediate effect on currency for e.g. steep Appreciation of rupee does not occurs. RBI sell government securities to suck out extra liquidity from the market and it in turn increases interest rates lower the inflation and appreciate the already falling rupee. RBI has a challenging task of assessing the liquidity position in system time to time and to decide the overall amount of use of OMOs. A major concern in Indian scenario has been the financing of state’s fiscal deficits through the market borrowing using OMOs time to time. Ideally this remains a wrong practice and fiscal operation of state’s should be excluded from Monetary policy especially OMOs.

Liquidity adjustment facility (LAF), introduced by RBI during June-2000, is a monetary policy window through which banks can adjust their day to day liquidity mismatches. After valid incorporation of LAF, Bank Rate was sent to cold bag as an instrument of monetary management and resulted abandoning of discounting/rediscounting of bills of exchange by the Reserve Bank. Repo or repurchase option is a collaterised lending at interest rate called repo rate that involves selling securities to RBI to meet short term differences with repurchase-agreement at predetermined rate and date. Reverse repo operation is required when RBI borrows money from banks by lending securities with a aim to absorb the extra liquidity in system.

On recommendations of an RBI's Internal Group RBI has revised the LAF scheme on March 25, 2004 and Oct 29, 2004. Now auctions of transferable central government dated-securities and treasury bills (Reverse Repo and Repo auctions) are conducted on a daily basis, except Saturdays. All commercial banks (except RRBs) and Public Departments having current account and SGL account with RBI can participate and Minimum bid size is Rs. 5 crore and in multiple of Rs.5 crore. Repo and reverse repo rates are fixed by RBI as per demand of economy. Repo and reverse repo rates used to remain independent till new monetary policy released on 3.5.2011. This policy statement stated that reverse repo rate would be linked to repo rate. At that time, the reverse repo rate was fixed 100 basis points below repo rate. The liquidity adjustment facility corridor had become the difference between repo & reverse repo rate.

The difference between the two rates i.e. repo rate and the reverse repo is described as liquidity corridor, technically called as LAF. The overnight call money market includes commercial banks that lend to each other for fulfilling temporary asset-liability mismatches. The overnight call money market rates mostly fluctuate between the upper and lower limit of Liquidity corridor. But many times overnight call- rates cross the upper end of the corridor (repo rate). LAF corridor generally varied between 100 and 300 basis points. During April 2001 to March 2004 and June 2008 to early November 2008, LAF corridor remained quite high i.e. between 150 to 250 & 200 to 300 basis points respectively. November 2008 onwards the LAF corridor remained quite narrow. This corridor is used to limit the volatility in short-term interest rates.

Marginal Standing Facility (MSF) rate was effectively introduced in may-2011. MSF offers interest rate above repo rate and hence is a penal interest rate. MSF is last resort of borrowing for banks. MSF is the rate at which scheduled banks could borrow funds overnight from Reserve Bank of India (RBI) up to some per cent (generally 1% or 2%) of their net demand and time liabilities (NDTL) against government securities. Initially the facility was provided on all working days in Mumbai, excluding Saturdays between 3.30 P.M. and 4.30 P.M. Initially the rate of interest under this facility was 100 basis point above repo rate but in july-2013 it was increased to 300 basis points (i.e. 3%) above the repo rate and in future would be decided by the Reserve Bank from time to time. This scheme aims to reduce interest rate volatility overnight and to improve monetary transmission. A margin of 5% & 10% was applied in respect of Government of India dated securities and Treasury Bills & SDLs respectively. MSF rate make upper band of the **interest corridor** with repo rate at the middle and reverse repo as the lower band. For controlling liquidity, "policy rate" is used by RBI and it include repo/ reverse repo rate and the MSF rate , which is always tied to repo rate (some fixed percentage above repo rate), gets automatically adjusted too.

In January 2015, RBI introduced new concept of 'Liquidity Coverage Ratio' also known as LCR based on recommendations of international Basel-III committee with an aim to maintain sufficient liquidity with banks to meet outflow in future during any stress period of 30 days. In this respect India is better placed and only need to fulfill LCR norms is to vary the CRR & SLR ratios. Liquid asset has to be maintained at least 60% of net cash outflow over 30 day period and the minimum limit will be gradually increased to 100% by year 2019. Thus over the period SLR requirement will be reduced in future so that more liquidity is diverted towards new LCR- commitment.

RBI timely bring changes in policy rate corridor according to market situation for e.g. in April 2016, RBI narrowed the policy rate corridor from 100 basis points to 50 basis points by reducing MSF rate by 75 basis points and increasing the reverse repo rate by 25 basis points. Aim was to ensure finer alignment of weighted average call rate (WACR) with the repo rate. The repo rate became 6.5% while MSF became 7% and Reverse Repo Rate increased to 6%. RBI take positive decisions time to time such as now (2016) banks' acquired government securities under LAF (Liquidity adjustment facility) will be included while calculating their SLR requirement. Bonds/ securities that banks used to pledge with RBI (Repo window) are included under SLR definition but those acquired from central bank under reverse repo deal were not taken into account while assessing SLR requirements. Thus this decision surely will prove beneficial to banks and more funds will be available to bank for credit purposes.

Recently RBI constituted a committed headed by deputy governor –Mr. Urjit Patel and the committee suggested abandoning of CMBs in phased manner which are the liquidity management tools of cash management bills. This comes under preview of OMOs. Mostly

CMBs are floated by finance ministry with a target of managing government's temporary deficits and mismatches. In middle of year 2013, rupee was depreciating and at that time RBI sold CMBs to siphon off extra rupees from the market. Hence finance ministry rejected the proposal with a reason that CMBs are much a requirement of RBI & Government. It is also argued that OMOs cannot be altered much such as phasing out CMBs until government fully take over the fiscal role of debt management from central bank. In budget 2007-08, finance Minister Mr. P Chidambaram proposed to set up an autonomous Debt Management Office (DMO) in ministry of finance. In October 2016, finance ministry set up a 'public debt management cell' (PDMC) which aimed to manage government borrowings and liabilities (cash management) and at deepening government bond &security market. PDMC is an interim arrangement and will be upgraded to a statutory 'Public Debt Management Agency' in about 2 years.

Many people raised question that why only CRR was hiked to 100% in November-2016, for all incremental liquidity that get deposited in banks and other means were not tried. It was believed that surplus liquidity with banks at that time (Rupees 3.5 to 4 trillion) would come closer to maximum absorption capacity of RBI and RBI already had Rupees 7.5 trillion of government sectors before the demonitisation drive. However liquidity absorption measures like selling bonds under 'Market Stablisation Scheme' would have taken much time to get actuated and achieving results. RBI already announced that limit of MSS Bonds issuance was set Rs 300 Billion and that also would not had sufficed to absorb such a huge liquidity.

On April 6th 2017, RBI announced narrowing of policy rate corridor that instead of using CRR hike or OMOs for managing the huge excess liquidity. This is new change in monetary policy issued by RBI after the demonetization. This means that RBI has taken bold step of not gulping the extra liquidity directly with its permanent monetary tools of CRR & OMOs. Reverse repo rate has been increased to bring at 6% level along with the unchanged repo rate (third time in a row) of 6.25%. MSF rate has been turned down to 6.25%. Thus repo rate has become equal to MSF rate that means no penal rate exist at present. This will limit the overnight call rates. The extra liquidity in the banking system started declining with progression of successive remonetisation. Liquidity peaked to Rupees 6,014 billion in February-2017 but it came down to Rupees 4,806 billion in March. The money expanded in market progressively. Increasing reverse repo rate helps banks to get more interest from RBI. However exorbitant or injudicious lending by banks into unproductive or risky compartments should be checked in. it high liquidity always stand another risk of rising level of inflation after the demand pick up.

Experience during recent recession in last few years showed that monetary policy, many times was not capable of reviving the economy. For example, in case of cutting interest rates, it proved failure as it was unable to boost demand. Economy comes under liquidity trap because banks don't want to lend and consumers are unwilling to spend. This was the case of UK where Interest rates were slashed from 5% to 0.5% in March 2009, but recession in UK remained at its place. Even quantitative easing like creating money by central bank may be ineffective if banks shrink or stop credit extension to various sectors in economy. Government spending kick starts demand in the economy because jobs are created and liquidity directly comes in the market. This is most important factor to revive the economy. In a liquidity trap, expansionary fiscal policy will not cause crowding out because the government is making use of surplus saving to inject demand into the economy. In a deep recession, the liquidity trap may set in and it can be broken by expansionary fiscal policy that brings confidence if the monetary policy fails to create demand.

At last, the most problematic aspect of Indian economy has been to control inflation and at the same time to promote growth. What is the best choice to limit inflation in India? In mid of 2014 RBI governor sh. Raghuram Rajan told that 'interest rate' is the best tool available with central bank to control price rise. He further told "RBI do not use rupee as the way of managing inflation. RBI tries not to rely on a particular level of rupee to help on inflation front." Along with that he stressed that government should bring vast improvements so that agriculture sector growth could rise. The above statement is very important in view that role of policy always changes and new things come up as the economy goes ahead. Pressures, whether internal or external, brings changes and help central bank to seek more correct use of different instruments with time and in long term the experience brings the difference in economy.

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