



MONETARY POLICY, METHODS OF CREDIT CONTROL AND AUTONOMY OF CENTRAL BANKS IN INDIA

Management

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ABSTRACT

In India, the objectives of monetary policy evolved for maintaining price stability and ensuring adequate flow of credit to the productive sectors of the economy. With progressive liberalization and increasing globalization of the economy, maintaining orderly conditions in the financial markets emerged as an additional policy objective. Thus, monetary policy in India endeavours to maintain a judicious balance between:

- Price stability
- Economic growth
- Financial stability.

KEYWORDS :

MONETARY POLICY IN INDIA

The case of price stability as the prime objective of monetary policy rests on the assumption that volatility in prices creates uncertainty in economic decision making. Rising prices affect savings adversely while they make speculative investments more attractive. The most important contribution of the financial system to an economy is its ability to augment savings and allocate resources more efficiently

Monetary Policy in India

Operating procedure refer to the day to day management of monetary conditions consistent with the overall stance of monetary policy. It is in essence the 'nuts and bolts' of monetary policy. It involves four activities, viz.,

- The choice of the operational target;
- The nature, extent and the frequency of different money market operations by the central bank;
- The use and width of the corridor for very short-term market interest rates; and
- The manner of signalling policy intentions.

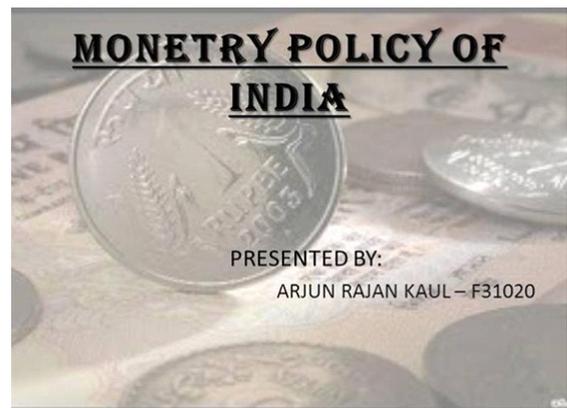
About Monetary Policy

Monetary policy is the process by which monetary authority of a country, generally a central bank controls the supply of money in the economy by exercising its control over interest rates in order to maintain price stability and achieve high economic growth.

In India, the central monetary authority is the Reserve Bank of India (RBI), is so designed as to maintain the price stability in the economy.

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The operating procedure is explained in detail below:



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1) Issues and Options: The liquidity adjustment facility (LAF) has emerged as the key element of the present operating procedure of monetary policy. It has generally helped in steering the desired trajectory of interest rates in response to evolving market conditions.

2) Monetary Transmission: At the heart of the operating framework is the nature of monetary transmission. The pertinent question is whether the interest rate channel of monetary transmission is working. Monetary transmission is substantially more effective in a deficit liquidity situation than in a surplus liquidity situation.

3) Policy Rate: The present LAF framework is such that the operating policy rate alternates between the repo rate and the reverse repo rate, depending on the prevailing liquidity condition. In a surplus liquidity condition, the reverse repo rate becomes the operating policy rate. In a deficit liquidity situation, the repo rate becomes the policy rate. Going by international best practices, it is unconventional to have two policy rates.

4) Bank Rate: The RBI in its tool kit has the Bank Rate which is essentially a discount rate. Under Section 49 of the RBI of India Act, the Bank Rate has been defined as "the standard rate at which it [the

Reserve Bank] is prepared to buy or re-discount bills of exchange or other commercial paper eligible for purchase under this Act". While the Bank Rate was an important instrument of monetary control, its importance declined once the LAF system was instituted and progressively refinance facilities were provided at the repo rate. It is now used for calculating penalty on default in the cash reserve ratio (CRR) and the statutory liquidity ratio (SLR) as required by the RBI Act and BR Act.

Constituents of the Corridor: The prescription of the Bank Rate by itself will not make it active unless there is liquidity facilities linked to the Bank Rate. It is recommended to have the institution of a collateralized Exceptional Standing Facility (ESF) at the Bank Rate up to one per cent of the Net Demand and Time Liabilities (NDTL) of banks carved out of their required SLR portfolio. This facility is not entirely new. In the recent episode of liquidity tightness, the RBI has been providing additional liquidity up to 1 to 2 per cent of NDTL but on an ad hoc basis at the repo rate. The advantages of this facility are four-fold. First, it will provide an upper bound to the policy rate corridor. Second, it will provide a safety valve against unanticipated liquidity shocks. Third, it will help stabilize the overnight interest rate around the repo rate in a liquidity deficit situation. Fourth, it will enhance the liquidity attribute of the SLR portfolio without compromising its prudential nature.

Width of the Corridor: First, it should not be so wide as to induce volatility in short-term money market rates. Second, it should not be so narrow that it retards the development of the short-term money market by taking away the incentive from market participants to deal among them before approaching the central bank.

Operating Target: The overnight call money rate has been the operating target of monetary policy as the monetary transmission is the fastest to this segment. However, in the past few years, the turnover in the uncollateralized (inter-bank money market) segment has declined sharply, while that in the overnight collateralized market segment, viz., the Collateralized Borrowing and Lending Obligations (CBLO) and market repo, and has increased.

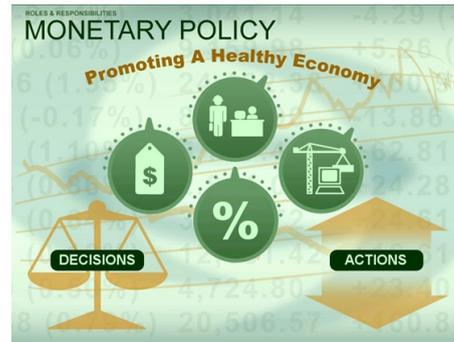
8) Timing and Frequency of LAF: The RBI is currently conducting LAF twice a day. This has provided flexibility to market participants and has helped contain volatility in the overnight market.

9) Instruments for Liquidity Management: In order to keep the liquidity in the LAF window at the optimal level of (+)/(-) one per cent of NDTL for effective monetary transmission, the RBI needs to have instruments at its disposal to manage excessive liquidity deficit/surplus conditions. The role of the LAF window is to deal with frictional liquidity deficit/surplus.

10) Collateral: The RBI holds Special Bonds (oil bonds), apart from government securities, in its portfolio. Oil bonds are treated as non-SLR securities. With effect from July 27, 2010, government securities obtained under reverse repo are not reckoned for the purpose of SLR of banks.

11) Liquidity Forecast: To ensure that the operating target does not deviate from the policy rate, liquidity forecast plays a crucial role. Liquidity forecast in the RBI is made on a weekly basis up to four weeks ahead. A quick back-testing analysis of these liquidity forecasts shows that the liquidity projections during the past two years have been satisfactory.

12) Dissemination of Liquidity Forecast: Several central banks disseminate liquidity forecasts, such as the ECB (weekly), Bank of England (daily), Bank of Japan (daily and monthly), Bank of Canada (daily) and Reserve Bank of Australia (daily). The dissemination of forecasts is intended primarily to facilitate the liquidity management of banks.



Sources google images

Maintenance of the CRR: An area of uncertainty in liquidity forecast is the pattern of CRR maintenance by banks. At present, banks, on average, are required to maintain 100 per cent of the required CRR during the fortnight with a daily minimum maintenance of 70 per cent.

Seamless Movements of Funds and Securities: Interest rate in the uncollateralized segment is expected to be higher than that in the collateralized segment due to the credit risk involved in the former. However, interest rates in the overnight inter-bank call money market deviate from the operating policy rate significantly even if the interest rate in the collateralized segments, i.e., the CBLO and market repo, remains close to the operating policy rate. There are two reasons for this:

- a) Difficulty in providing sufficient collateral by some banks
- b) Settlement of securities and funds under different segments occurring at different times, necessitating the use of intra-day liquidity or the need for additional securities.

Changes in Operating Procedure of Monetary Policy in India

Consistent with the objectives and policy framework, the operating procedure of monetary policy in India has also witnessed significant changes. The choice of targets, instruments and operating procedure was circumscribed to a large extent by the nature of the financial markets and the institutional arrangements.

During the monetary targeting period (1985-1998), while M3 growth provided the nominal anchor, reserve money was used as the operating target and cash reserve ratio (CRR) was used as the principal operating instrument.

Besides CRR, in the pre-reform period prior to 1991, given the command and control nature of the economy, the Reserve Bank had to resort to direct instruments like interest rate regulations and selective credit control. These instruments were used intermittently to neutralize the expansionary impact of large fiscal deficits which were partly monetized.

The administered interest rate regime kept the yield rate of the government securities artificially low. The demand for them was created through periodic hikes in the Statutory Liquidity Ratio (SLR) for banks.

The Narsimham Committee (1998), however, noted that the money market continued to remain lopsided, thin and volatile and the Reserve Bank also had no effective presence in the market. Therefore, it reiterated the need to transform the call money market into a pure inter-bank market and recommended the Reserve Bank's operations to be market-based.

Following these recommendations, the Reserve Bank introduced the Liquidity Adjustment Facility (LAF) in June 2000 to manage market

liquidity on a daily basis and also to transmit interest rate signals to the market. Under the LAF, the Reserve Bank's policy reverse repo and repo rates set the corridor for overnight market interest rates. Thus, Open Market Operations (OMOs) including LAF emerged as the dominant instrument of monetary policy, though CRR continued to be used as an additional instrument of policy.

With the introduction of prudential limits on borrowing and lending by banks in the call money market, the collateralized money market segments developed rapidly.

Maturities of other money market instruments such as commercial papers (CPs) and certificates of deposits (CDs) were gradually shortened to seven days in order to align the maturity structure.

Managing large and persistent capital inflows in excess of the absorptive capacity of the economy added another dimension to the liquidity management operations during the 2000s. Although, initially the liquidity impact of large capital inflows were sterilized through OMOs and LAF operations, given the finite stock of government securities in the Reserve Bank's portfolio and the legal restrictions on issuance of its own paper, additional instruments were needed to contain liquidity of a more enduring nature.

This led to the introduction of the Market Stabilization Scheme (MSS) in April 2004. Under this scheme, short-term government securities were issued but the amount remained impounded in the Reserve Bank's balance sheet for sterilization purposes.

Interestingly, in the face of reversal of capital flows during the recent crisis, unwinding of such sterilized liquidity under the MSS helped to ease liquidity conditions.

In response to the measures taken to develop the money market, over the years the turnover in various market segments increased significantly.

All these reforms have also led to improvement in liquidity management operations by the Reserve Bank as evident from the stability in call money rates, which also helped improve integration of various money market segments and thereby effective transmission of policy signals.

The rule-based fiscal policy pursued under the Fiscal Responsibility and Budget Management (FRBM) Act, by easing fiscal dominance, contributed to overall improvement in monetary management.

Notwithstanding such improvements at the short-end of the financial market spectrum, the transmission of the policy signals to banks' lending rates has been rather slow given the rigidities in the system, particularly the preference for fixed interest rate on term deposits. Against the backdrop of ample liquidity in the system more recently, as banks have reduced their deposit rates, the effective lending rates would have shown further moderation.

Monetary Policy Formulation Processes

The process of monetary policy in India had traditionally been largely internal with only the end product of actions being made public. The process includes a wide range of inputs involving the internal staff, market participants, academics, financial market experts and the Bank's Board.

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