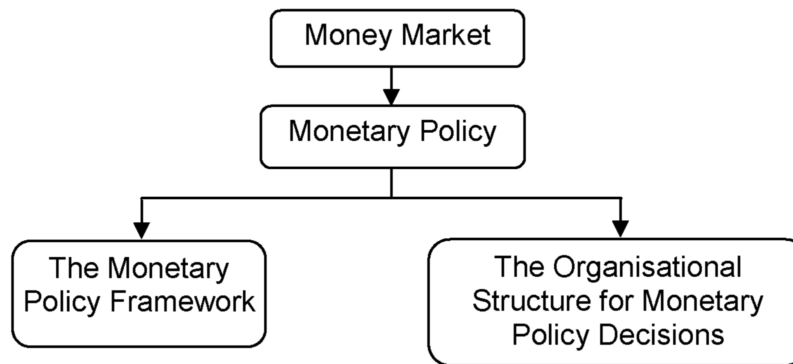
# 7. MONETARY POLICY




**Q.No.1. Define Monetary Policy. Elucidate different components of the monetary policy framework. (B) (SM)**

**Monetary policy:**

Monetary policy refers to the use of monetary policy instruments which are at the disposal of the central bank to regulate the availability, cost and use of money and credit to promote economic growth, price stability, optimum levels of output and employment, balance of payments equilibrium, stable currency or any other goal of government's economic policy.

Monetary policy encompasses all actions of the central bank which are aimed at directly controlling the money supply and indirectly at regulating the demand for money.

**Monetary policy framework has three basic components:**

**i)** The objectives of monetary policy,

**ii)** The analytics of monetary policy which focus on the transmission mechanisms, and

**iii)** The operating procedure which focuses on the operating targets and instruments.

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**Q.No.2. What are the objectives of Monetary Policy in India? (A) (SM)**

**Objectives of Monetary Policy in India:**

The objectives of monetary policy generally coincide with the overall objectives of economic policy and they provide explicit guidance to policy makers. They are

1. Maintaining price stability (a necessary precondition for sustainable growth)
2. Ensuring adequate flow of credit to the productive sectors of the economy
3. Economic growth

**Multiple objectives which are equally desirable in the recent years are**:

1. Rapid economic growth,
2. Debt management,
3. Moderate long-term interest rates,
4. Exchange rate stability
5. External balance of payments equilibrium

Considerations of financial and exchange rate stability have assumed greater importance in India recently on account of increasing openness of the economy and the progressive economic and financial sector reforms.

**Conflicts:**

*The need for simultaneous achievement of several objectives brings in the possibility of conflict among the different monetary policy objectives. For example, there is often a conflict between the objectives of holding down both inflation and unemployment; a policy targeted at controlling inflation is very likely to generate unemployment.*

*As such, based on the set national priorities, the monetary policymakers have to exercise appropriate trade-offs to balance the conflicting objectives.*

**SIMILAR QUESTION:**

**1. What are the objectives of monetary policy in India?**

**A.** Refer above answer

**Q.No.3. What are the explicit objectives of monetary policy of a developing economy? (B) (SM)**

**Explicit objectives of monetary policy of a developing economy**: According to the needs of developing countries, the explicit objectives of monetary policy are:

**a)** Maintenance the economic growth,

**b)** Ensuring an adequate flow of credit to the productive sectors,

**c)** Sustaining a moderate structure of interest rates to encourage investments, and

**d)** Creation of an efficient market for government securities.

**Q.No.4. State Monetary Transmission Mechanism and its forms? (A) (SM)**

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**Monetary Transmission Mechanism**: The process or channels through which the change of monetary aggregates affects the level of product and prices are known as 'monetary transmission mechanism'.

**i)** It describes how policy-induced changes in the nominal money stock or in the short- term nominal interest rates impact real variables such as aggregate output and employment.

**ii)** The four different mechanisms through which monetary policy influences the price level and the national income are:

- **a)** The interest rate channel
- **b)** The exchange rate channel,
- **c)** The quantum channel (e.g., relating to money supply and credit), and
- **d)** The asset price channel i.e. via equity and real estate prices.

**SIMILAR QUESTIONS:**

**1. Illustrate the analytics of monetary policy**

**A.** Refer above answer

**2. Define 'monetary transmission mechanism'.**

**A.** Refer the definition

**3. Explain the different mechanism of monetary policy which influences the price-level and national income? (N18 - 3M)**

**A.** Refer above answer

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**Q.No.5. Explain the traditional Keynesian interest rate channel of monetary transmission mechanisms. (B) (SM)**

**Traditional Keynesian Interest Rate Channel:**

According to the traditional Keynesian interest rate channel,

**a)** A contractionary monetary policy- induced increase in interest rates increases the cost of capital and the real cost of borrowing for firms with the result that they cut back on their investment expenditures.

**b)** An expansionary monetary policy induced decrease in interest rates decreases the cost of capital for firms and cost of borrowing for households.

**SIMILAR QUESTION:**

**1. Explain the transmission of monetary policy outcomes through interest rate channel?**

**A.** Refer above answer

**Q.No.6. Explain the exchange rate channel of monetary transmission mechanisms. (B) (SM, MTP2 N18 - 3M)**

**Exchange Rate Channel:**

The exchange rate channel works through expenditure switching between domestic and foreign goods.

Appreciation of the domestic currency makes domestically produced goods more expensive compared to foreign-produced goods. This causes net exports to fall; correspondingly domestic output and employment also fall.

Depreciation of the domestic currency makes domestically produced goods more cheaper compared to foreign-produced goods. This causes net exports to rise, correspondingly domestic output and employment also rise.

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**Q.No.7. Explain the Credit channel of monetary transmission mechanisms. (A) (SM)**

**Credit Channel:**

Credit channel operates by altering access of firms and households to bank credit. The procedural effect is as follows.

**a)** Most businesses and people mostly depend on bank for borrowing money.

**b) Monetary Contraction:**

Through "open market operation" when RBI sells securities it leads to contraction in the supply of bank reserves and then to a contraction in bank credit.

Thus banks cut back their lending - firms cut back their investment spending - aggregate output and employment gets declined.

**c) Monetary Expansion:**

Through "open market operation" when RBI purchases securities it leads to expansion in the supply of bank reserves and then to an expansion in bank credit.

Thus banks rise their lending - firms rise their investment spending - aggregate output and employment gets increased.

**Q.No.8. Explain the Balance sheet channel of monetary transmission mechanisms. (B) (SM)**

**Balance Sheet Channel:**

As a firm's cost of credit rises, the strength of its balance sheet deteriorates.

**a)** A direct effect of monetary policy (interest rate) on the firm's balance sheet:

With an increase in interest rates it leads to an increase in the payments of the firm (i.e. repayment of its floating rate debts).

**b)** An indirect effect of monetary policy (interest rate) on the firm's balance sheet:

With an increase in interest rates it reduces the capitalized value of the firm's long-lived assets.

**c)** These together aggravate the decline in output and employment.

**d)** Hence an induced short-term interest rate not only acts immediately to depress spending (through the traditional interest rate channel), but also with a time-lag, it raises each firm's cost of capital through the balance sheet channel.

**Q.No.9. Explain the standard asset price channel of monetary transmission mechanisms. (C) (SM)**

**Standard asset price channel:** The standard asset price channel suggests that asset prices respond to monetary policy changes and consequently affect output, employment and inflation.

**a)** A policy induced increase in the short-term nominal interest rates makes debt instruments more attractive than equities in the eyes of investors leading to a fall in equity prices.

**b)** If stock prices fall after a monetary tightening, it leads to reduction in household financial wealth, leading to fall in consumption, output, and employment.

**SIMILAR QUESTION:**

**1. How do asset prices respond to monetary policy?**

**A.** Refer above answer

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**Q.No.10. Narrate the operating framework in implementation of monetary policy? (B) (SM)**

The operating framework relates to all aspects of implementation of monetary policy. It primarily involves three major aspects, namely,

1. **Choosing the operating target**: The operating target refers to the variable (for e.g. inflation) that monetary policy can influence with its actions
2. **Choosing the intermediate target**: The intermediate target (e.g. economic stability) is a variable which the central bank can hope to influence to a reasonable degree through the operating target and which displays a predictable and stable relationship with the goal variables.
3. **Choosing the policy instruments:** Among the various tools that a central bank can use to influence money market and credit conditions and pursue its monetary policy objectives

**SIMILAR QUESTION:**

**1. What is meant by the term 'monetary policy instruments'? (MTP1 N18 - 3M)**

**A.** Refer 3rd point

**Q.No.11. Explain the operating procedures and instruments of monetary policy. (A) (SM)**

**Operating Procedures:**

The day-to-day implementation of monetary policy by central banks through various instruments is referred to as 'operating procedures'.

For implementing monetary policy, a central bank can act directly by using its regulatory powers or indirectly by using its influence on money market conditions as the issuer of reserve money.

**a) In general, the direct instruments comprise of:**

- **i)** The required CRRs and SLRs prescribed from time to time.
- **ii)** Directed credit which takes the form of prescribed targets for allocation of credit to preferred sectors (for e.g. Credit to priority sectors), and
- **iii)** Administered interest rates where in the deposit and lending rates are prescribed by the central bank.

**b) The indirect instruments mainly consist of:**

- **i)** Repos
- **ii)** Open market operations
- **iii)** Standing facilities, and
- **iv)** Market-based discount window.

SIMILAR QUESTIONS:

**1. Explain the role of instruments of Operating Procedure in implementation of monetary policy?**

**A.** Refer above answer

**2. What is the distinction between direct and indirect instruments of monetary policy?**

**A.** Refer a) and b)

**3. Define Operating Procedures**

**A.** Refer the definition

**Q.No.12. Define the term Cash Reserve Ratio as an instrument of monetary policy. (A) (SM)**

**Cash Reserve Ratio (CRR):**

CRR refers to the fraction (or portion) of the total net demand and time liabilities (NDTL) of a scheduled commercial bank in India which it should maintain as cash deposit with the RBI. The CRR has to be maintained by banks as cash with the RBI.

- **i)** The RBI set the ratio in keeping with the broad objective of maintaining monetary stability in the economy and this applies uniformly to all scheduled banks in the country irrespective of its size or financial position.
- **ii)** Non-Bank Financial Institution (NBFIs) are outside the purview of CRR.
- **iii)** The RBI does not pay any interest on the CRR balances maintained by the scheduled commercial banks (SCBs) with effect from the fortnight beginning March 31, 2007.
- **iv)** The failure of a bank to meet its required reserve requirements would attract penalty in the form of penal interest charged by the RBI.
- **v)** The CRR as on $8^{th}$ July, 2017 was 4 %

**CRR acts as an important quantitative tool aiding in liquidity management**

- **i)** CRR in recent years stood as an important quantitative tools aiding in liquidity management. Higher the CRR with the RBI, lower will be the liquidity in the system and vice versa.
- **ii)** RBI reduces the CRR to expand credit during recession in the economy.
- **iii)** RBI increases the CRR to contract credit during inflation in the economy.

SIMILAR QUESTION:

**1. Write notes on Cash Reserve Ratio (CRR). Explain the operation of CRR. (RTP M18)**

**A.** Refer above answer

**2. Account for cash reserve ratio as a monetary policy instrument (MTP1 M18 - 3M)**

**A.** Refer Introduction to CRR

3. **How do changes in Cash Reserve Ratio (CRR) impact the economy? (M18 - 2M)**

A. Refer 2nd point

4. **Define CRR. How is CRR used as a policy instrument? (MTP2 N18 - 3M)**

A. Refer above answer

**Q.No.13. Define Statutory Liquidity Ratio (SLR) as an instrument of monetary policy. (A) (SM)**

**Statutory Liquidity Ratio (SLR)**

As per the Banking Regulations Act 1949, all scheduled commercial banks in India are required to maintain a stipulated percentage of their total Demand and Time Liabilities (DTL) / Net DTL (NDTL) in one of the following forms:

1. Cash
2. Gold, or
3. Investments in un-encumbered Instruments
   - The SLR requires holding of assets in one of the above three categories by the bank itself.
   - The banks which fail to meet its SLR obligations are liable to be imposed penalty in the form of a penal interest payable to RBI.
   - As per the Second Bi-Monthly Monetary Policy Statement 2017-18 of the RBI on June 7th 2017, it has been decided to reduce the SLR from 20.5% to 20% from June 24, 2017.

Investments in un-encumbered Instruments includes:

a) Treasury-bills of the Government of India.

b) Dated securities including those issued by the Government of India from time to time under the market borrowings programme and the Market Stabilization Scheme (MSS).

c) State Development Loans (SDLs) issued by State Governments under their market borrowings programme.

d) Other instruments as notified by the RBI (i.e. securities issued by PSEs).

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**SIMILAR QUESTION:**

1. **What are the eligible securities for SLR?**

A. Refer from introduction to 3rd point

**Q.No.14. How the SLR functions as a powerful tool of monetary policy for controlling liquidity in an economy? (A) (SM)**

The SLR is also a powerful tool for controlling liquidity in the domestic market by means of manipulating bank credit.

a) During high liquidity (or inflation) a rise in the SLR, reduces the credit creation capacity of banks.

b) A reduction in the SLR during recession, raises the credit creation capacity of banks.

c) The SLR requirement also facilitates a captive market for government securities.

**SIMILAR QUESTION:**

1. **Explain the functioning of SLR? (RTP N18)**

A. Refer above answer

2. **How do changes in Statutory Liquidity Ratio impact the economy?**

A. Refer above answer

**Q.No.15. State Liquidity Adjustment Facility (LAF) as an instrument of monetary policy. (A) (SM)**

**Liquidity Adjustment Facility (LAF):**

From June 2000, the RBI has introduced Liquidity Adjustment Facility (LAF).

1. LAF is a monetary policy tool which allows banks to borrow money through repurchase agreements.
2. The LAF is a facility extended by the RBI to the scheduled commercial banks (excluding RRBs) and primary dealers to avail of liquidity in case of requirement (or park excess funds with the RBI in case of excess liquidity) on an overnight basis against the collateral of government securities including state government securities.
3. The introduction of LAF is an important landmark since its objective is to assist banks to adjust their day to day mismatches in liquidity.
4. Currently, the RBI provides financial accommodation to the commercial banks through repos/reverse repos under the LAF.

**SIMILAR QUESTION:**

1. **What is the role of Liquidity Adjustment Facility (LAF)?**

A. Refer above answer

2. **What is meant by Liquidity Adjustment Facility (LAF)? How does it help commercial banks? (MTP1 N18 - 3M)**

A. Refer above answer

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**Q.No.16. Define the term Repo as an instrument of monetary policy and name the types of repo markets operating in India. (A) (SM)**

**Repo:** Repurchase Options or in short 'Repo' is defined as 'an instrument for borrowing funds by selling securities with an agreement to repurchase the securities on a mutually agreed future date at an agreed price which includes interest for the funds borrowed'.

a) Repo is a money market instrument, which enables collateralised short term borrowing and lending through sale/purchase operations in debt instruments.

b) The Repo transaction in India has two elements: - i) the seller sells securities and receives cash while the purchaser buys securities and parts with cash. ii) the securities are repurchased by the original holder.

c) The user pays to the counter party the amount originally received, plus the return on the money for the number of days for which the money was used, which is mutually agreed.

d) All these transactions are reported on the electronic platform called the Negotiated Dealing System (NDS).

e) The Clearing Corporation of India Ltd. (CCIL) has put in an anonymous online repo dealing system in India, with an anonymous order matching electronic platform.

f) Repo or repurchase option is a collaterised lending.

g) The rate charged by RBI for this transaction is called the 'repo rate'.

h) Repo operations thus inject liquidity into the system.

**There are three types of repo markets operating in India namely:**

1. Repo on sovereign securities
2. Repo on corporate debt securities
3. Other Repos

**SIMILAR QUESTION:**

**1. Define 'repo'**

**A.** Refer the definition

**Q.No.17. Define the term Reverse Repo as an instrument of monetary policy. (A) (SM)**

**Reverse Repo:** It is defined as an instrument for lending funds by purchasing securities with an agreement to resell the securities on a mutually agreed future date at an agreed price which includes interest for the funds lent.

**a)** Reverse repo operation takes place when RBI borrows money from banks by giving them securities.

**b)** The securities transacted here can be either government securities or corporate securities or any other securities which the RBI permits for transaction.

**c)** The interest rate paid by RBI for such transactions is called the 'reverse repo rate'.

**d)** Reverse repo operation absorbs the liquidity from the system.

**e)** The collaterals used for repo and reverse repo operations consist of primarily Government of India securities i.e. all SLR-eligible transferable Government of India dated securities/treasury bills.

**f)** From May, 2011 onwards, the reverse repo rate is not announced separately, it will be linked to repo rate.

**Conclusion:** The 'repo rate' and the reverse repo rate' are changed only through the announcements made during the Monetary Policy Statements of the RBI. The RBI also conducts variable interest rate reverse repo auctions, as necessitated under the market conditions.

**SIMILAR QUESTION:**

**1. Define 'Reverse Repo'.**

**A.** Refer the definition

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**Q.No.18. Define the term policy rate as an instrument of monetary policy. (B) (SM)**

**Policy Rate:**

In India, the fixed repo rate quoted for sovereign securities in the overnight segment of Liquidity Adjustment Facility (LAF) is considered as the policy rate. (It may be noted that India has many other repo rates in operation).

**a)** The RBI uses the single independent 'policy rate' which is the repo rate (in the LAF window) for balancing liquidity.

**b)** The policy rate is the key lending rate of the central bank in a country.

**c)** A change in the policy rate alters all other short term interest rates in the economy, by influencing aggregate demand.

**d)** If the RBI wants to make it more expensive for banks to borrow money, it increases the repo rate and vice-versa

**e)** An increase in the repo rate will lead to liquidity tightening and vice-versa, other things remaining constant.

**SIMILAR QUESTION:**

**1. What is meant by 'policy rate'?**

**A.** Refer the definition

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**Q.No.19. Explain the term Marginal Standing Facility (MSF) as an instrument of monetary policy. (A) (SM)**

The Reserve Bank of India, being a bankers' bank, acts as a lender of last resort.

**Marginal Standing Facility (MSF):**

The MSF announced by the RBI in its Monetary Policy, 2011-12.

It refers to the facility under which scheduled commercial banks can borrow additional amount of overnight money from the central bank over and above what is available to them through the LAF window by dipping into their SLR portfolio up to a limit (a fixed percent of their net demand and time liabilities deposits (NDTL) liable to change every year) at a penal rate of interest.

a) This provides a safety valve against unexpected liquidity shocks to the banking system.

b) The main aim of MSF is to reduce volatility in the overnight lending rates in the inter-bank market and to enable smooth monetary transmission in the financial system.

c) Banks can borrow through MSF on all working days except Saturdays, between 7.00 pm and 7.30 pm, in Mumbai.

d) The minimum amount which can be accessed through MSF is Rs.1 crore and more will be available in multiples of Rs.1 crore.

e) The MSF would be the last resort for banks once they exhaust all borrowing options including the LAF on which the rates are lower compared to the MSF.

f) The MSF rate being a penal rate automatically gets adjusted to a fixed per cent above the repo rate.

g) MSF is at present aligned with the Bank rate.

h) Practically, MSF represents the upper band of the interest corridor with repo rate at the middle and reverse repo at the lower band.

i) In fact, the MSF rate and reverse repo rate determine the corridor for the daily movement in the weighted average call money rate.

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**SIMILAR QUESTION:**

1. **Explain how Reserve Bank of India acts as a 'lender of last resort 'to commercial banks? (Or) Explain the operation of Marginal Standing Facility? (MTP1 N18 - 3M, MTP2 N18 - 3M)**

A. Refer above answer

**Q.No.20. What are the recent amendments of monetary policy in India? (A) (SM)**

1. In addition to the existing overnight LAF (repo and reverse repo) and MSF, from October 2013, the Reserve Bank has introduced 'Term Repo' (repos of duration more than a day) under the LAF for 14 days and 7 days tenors. LAF is conducted at a fixed time on a daily basis on all working days in Mumbai (excluding Saturdays).

2. As per the Second Bi-Monthly Monetary Policy Statement 2017-18 of the RBI on June 7th 2017, the MPC has decided to keep the policy repo rate under the LAF unchanged at 6.25 %, the reserve repo rate at 6.00 % and the MSF rate and the Bank rate at 6.50 %.

**Q.No.21. Explain briefly about Market Stabilisation Scheme as a part of monetary policy frame work. (B) (SM)**

**Market Stabilisation Scheme (MSS)**

MSS for monetary management was introduced in 2004 following a MoU between the RBI and the Government of India (GoI) with the primary aim of aiding the sterilization operations of the RBI.

Under this scheme, the GoI borrows from the RBI (additional to its normal borrowing requirements) and issues treasury-bills/dated securities for absorbing excess liquidity from the market arising from large capital inflows.

**Note:** *Sterilization is the process by which the monetary authority sterilizes the effects of significant foreign capital inflows on domestic liquidity by off-loading parts of the stock of government securities held by it.*

**SIMILAR QUESTIONS:**

**1. What role does Market Stabilisation Scheme (MSS) play in our economy? (RTP M18)**

**A.** Refer above answer

**2. Define the term Sterilisation as an instrument of Market Stabilisation Scheme.**

**A.** Refer note

**Q.No.22. Define the term Bank Rate as an instrument of monetary policy. Explain its applicability. (A) (SM)**

**Bank Rate:**

Under Section 49 of the Reserve Bank of India Act, 1934, the Bank Rate has been defined as 'the standard rate at which the RBI is prepared to buy or re- discount bills of exchange or other commercial paper eligible for purchase under the Act'.

**Introduction and applicability of Bank rate in India:**

**a)** The bank rate once used to be the policy rate in India.

**b)** Discounting/rediscounting of bills of exchange by the RBI has been discontinued on introduction of LAF.

**c)** Thus the bank rate has been aligned to the MSF rate. When the MSF rate changes alongside policy, the repo rate changes, the bank rate also changes automatically.

**d)** MSF assumed the role of bank rate and currently the bank rate is purely a signaling rate and most interest rates are delinked from the bank rate.

**e)** Now, bank rate is used only for calculating penalty on default in the maintenance of CRR and the SLR.

**SIMILAR QUESTION:**

**1. Assess the role of Bank Rate as an instrument of monetary policy**

**A.** Refer above answer

**Q.No.23. Explain the concept of Open Market Operations as an instrument of monetary policy. (B) (SM)**

**Open Market Operations (OMO):** OMO is defined as market operations conducted by the RBI by way of sale/ purchase of Government securities to/ from the market with an objective to adjust the rupee liquidity conditions in the market on a durable basis.

**a)** When the RBI feels there is excess liquidity in the market, it resorts to sale of securities thereby sucking out the rupee liquidity.

**b)** When the liquidity conditions are tight, the RBI will buy securities from the market, thereby releasing liquidity into the market.

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**Q.No.24. Explain the Monetary Policy Framework Agreement. (B) (SM, N18 - 2M)**

**The Monetary Policy Framework Agreement:**

The Reserve Bank of India Act, 1934 was amended on June 27, 2016, for giving a statutory backing to the Monetary Policy Framework Agreement.

It is an agreement reached between the GoI and the RBI on the maximum tolerable inflation rate that the RBI should target to achieve price stability.

**a)** The amended RBI Act (2016) provides for a statutory basis for the implementation of the 'flexible inflation targeting framework'.

**b)** Announcement of an official target range for inflation is known as inflation targeting.

**c)** The Expert Committee under Urijit Patel on January, 2014 suggested that RBI abandon the 'multiple indicator' approach and make inflation targeting the primary objective of its monetary policy.

**d)** The inflation target is to be set by the GoI, in consultation with the RBI, once in every five years.

**e)** Accordingly, the Central Government has notified 4 % Consumer Price Index (CPI) inflation as the target for the period from August 5, 2016 to March 31, 2021 with the upper tolerance limit of 6 % and the lower tolerance limit of 2 %.

**f)** The RBI is mandated to publish a Monetary Policy Report every 6 months, explaining the sources of inflation and the forecasts of inflation for the coming period of 6 to 18 months.

**g)** The following factors are notified by the central government as constituting a failure to achieve the inflation target:

- **i)** The average inflation is more than the upper tolerance level of the inflation target for any three consecutive quarters; or
- **ii)** The average inflation is less than the lower tolerance level for any three consecutive quarters.

**Note:** *The choice of CPI was made because it closely reflects cost of living and has larger influence on inflation expectations compared to other anchors. With this step, India is following countries such as the New Zealand, the USA, the UK, European Union, and Brazil. In recent times many countries are moving away from this approach and the targeting nominal GDP growth.*

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**SIMILAR QUESTION:**

**1. Describe the organizational structure for monetary policy decisions in India**

**A.** Refer above answer

**Q.No.25. Explain the role of Monetary Policy committee (MPC in India? (B) (SM, N18 - 2M)**

The Reserve Bank of India Act, 1934 was amended on June 27, 2016, for setting up a Monetary Policy Committee (MPC).

An important landmark in India's monetary history is the constitution of an empowered six-member Monetary Policy Committee (MPC) in September, 2016.

**a)** MPC consists of

- **i)** The RBI Governor (Chairperson),
- **ii)** The RBI Deputy Governor in charge of monetary policy,
- **iii)** One official nominated by the RBI Board and
- **iv)** The remaining three central government nominees representing the Government of India who are persons of ability, integrity and standing, having knowledge and experience in the field of economics or banking or finance or monetary policy.

**b)** The MPC shall determine the policy rate required to achieve the inflation target.

**c)** The Reserve Bank's Monetary Policy Department (MPD) assists the MPC in formulating the monetary policy.

**d)** The views of key stakeholders in the economy and analytical work of the RBI contribute to the process for arriving at the decision on the policy repo rate.

**e)** Accordingly, fixing of the benchmark policy interest rate (repo rate) is made through debate and majority vote by this panel of experts.

**f)** With the introduction of the MPC, the RBI will follow a system which is more consultative and participative similar to the one followed by many of the central banks in the world.

**g)** The new system is intended to incorporate:

**i)** Diversity of views,

**ii)** Specialized experience,

**iii)** Independence of opinion,

**iv)** Representativeness, and

**v)** Accountability.

**h)** The Financial Markets Operations Department (FMOD) operationalises the monetary policy, mainly through day-to-day liquidity management operations.

**i)** The Financial Markets Committee (FMC) meets daily to review the liquidity conditions so as to ensure that the operating target of monetary policy is kept close to the policy repo rate.

**SIMILAR QUESTION:**

**1. Outline the role of Monetary Policy Committee (MPC) in an Indian economy.**

**A.** Refer above answer

## QUESTIONS FOR ACADEMIC INTEREST - FOR STUDENT SELF STUDY

**Q.No.26. What are the additional complexities arise in terms of monetary policy in an emerging market like India. (C) (SM)**

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There are many challenges which need to be addressed, such as rudimentary and noncompetitive financial systems, lack of integrated money and interbank markets, external uncertainties and issues related to operational autonomy of the central bank.

**Q.No.27. What does an explicit inflation targeting requires in a monetary policy? (C) (SM)**

Explicit inflation targeting requires a good degree of operational autonomy for the central bank and a system in which there is a good coordination between fiscal and monetary authorities.

**Q.No.28. Why there are differences among different countries in respect of the selection of objectives, implementation procedures and tools of monetary policy? (C) (SM)**

The differences among the countries in selection of monetary policy may be either due to differences in the underlying economies or due to differences in the financial systems and in the infrastructure of financial markets.

**Q.No.29. What were the objectives of monetary policy in the past? (C) (SM)**

| Period | Objectives of monetary policy |
|---|---|
| Pre-Keynesian period | Establishment and maintenance of stability in prices. |
| The Great Depression in 1930s and the associated economic crises | Maintenance of full employment, more generally described as economic stability. |

**Q.No.30. What are the most commonly pursued objectives of monetary policy of the central banks across the world? (C) (SM)**

**The most commonly pursued objectives of monetary policy of the central banks across the world are:**

1. Maintenance of price stability (or controlling inflation)
2. Achievement of high level of economy's growth
3. Maintenance of full employment

**Q.No.31. Why the Reserve Bank of India Act, 1934 sets the objectives of the Bank? (C) (SM)**

RBI sets the objectives in its preamble due to following reasons:

1. To regulate the issue of bank notes
2. keeping of reserves with a view to securing monetary stability in India
3. To operate the currency and credit system of the country to its advantage.

**Q.No.32. What are the two distinct credit channels also allow the effects of monetary policy actions to spread through the real economy? (C) (SM)**

Two distinct credit channels- **the bank lending channel and the balance sheet channel**- also allow the effects of monetary policy actions to spread through the real economy.

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**Q.No.33. How the different channels functions in an economy in terms of monetary transmission mechanisms? (C) (SM)**

The manner in which different channels function in a given economy depends on:

1. The stage of development of the economy, and
2. The underlying financial structure of the economy

**Q.No.34. State the organisational structure for monetary policy decisions? (C) (SM)**

The organisational structure of monetary policy decisions is necessary to understand the way in which monetary policy is conducted in India.

The Reserve Bank of India Act, 1934 was amended on June 27, 2016, for giving a statutory backing to the Monetary Policy Framework Agreement and for setting up a MPC.

**Q.No.35. What is the role of Technical Advisory Committee (TAC) before the constitution of Monetary Policy Committee (MPC)? (C) (SM)**

Before the constitution of the MPC, a Technical Advisory Committee (TAC) on monetary policy with experts from Monetary Economics, Central Banking, Financial Markets and Public Finance advised the RBI on the standpoint of monetary policy.
However, its role was only advisory in nature. With the formation of MPC, the TAC on Monetary Policy ceased to exist.

# DIFFERENCES

## Q.No.36. Cash Reserve Ratio and Statutory Liquidity Ratio (B)

| Point | Cash Reserve Ratio (CRR) | Statutory Liquidity Ratio |
|---|---|---|
| **Meaning** | Scheduled Commercial Banks should maintain a fraction of the total Net Demand & Time Liabilities (NDTL) as Cash Deposit with RBI. | Scheduled Commercial Banks should maintain a stipulated percentage of their Total / Net DTL in Cash or Gold, or prescribed Investments. |
| **Maintained with-** | CRR has to be maintained as Cash with RBI. RBI does not pay any Interest on such balances. | SLR requires holding of Assets in one of the 3 categories (Cash / Gold / Investments) by the Bank itself. |

## Q.No.37. Liquidity Adjustment Facility (LAF) & Marginal Standing facility (B) (M18 - 3M)

| | Liquidity Adjustment Facility (LAF) | Marginal Standing facility |
|---|---|---|
| **Central Bank's Role** | RBI, being a Banker's Bank, provides Liquidity to Banks when it faces shortage of Liquidity | RBI, being a Banker's Bank, acts as a Lender of Last Resort to Commercial Banks, in suitable situations. |
| **Interest** | Lower compared to MSF. Repo Rate is changed only through the Monetary Policy Statements of RBI. Reverse Repo Rate will be linked to Repo Rate | MSF rate, being a Penal Rate, gets adjusted to a fixed percent above the Repo Rate. MSF is at present aligned with the Bank Rate. |
| **Availability** | LAF is conducted at a fixed time on daily basis on all Working Days in Mumbai (excluding Saturdays).<br>a) **Overnight LAF:** Repo & Reverse Repo<br>b) **Term Repo:** Repos of 14/7 days duration. | Banks can borrow through MSF on all working days (except Saturdays) from 7.00 pm to 7.30 pm, in Mumbai. Minimum amount of MSF is Rs. 1 crore and more will be available in multiples of 1 crore. |

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## Q.No.38. Repo Vs. Reverse Repo (A)

| | Repurchase Transaction (Repo) | Reverse Repurchase (Reverse Repo) |
|---|---|---|
| **Meaning** | Instrument for borrowing Funds by selling Securities with an agreement to re-purchase them on a mutually agreed future date at an agreed price which includes Interest for the Funds borrowed. | Instrument for Lending Funds by purchasing Securities with an agreement to resell them on a mutually agreed future date at an agreed price which includes Interest for the Funds lent. |
| **Process** | Repo Operation takes place when other Banks borrow Money from RBI by giving Securities to the RBI. | Reverse Repo Operation takes place when RBI borrows Money from Banks by giving them Securities. |
| **Impact** | Repo Operations inject Liquidity into the system. | This operation absorbs the Liquidity in the system. |
| **Interest** | Interest Rate charged by RBI for this transaction is called the 'Repo Rate'. Higher than Reverse Repo Rate. | Interest Rate paid by RBI for such transactions is called the 'Reverse Repo Rate'. Less than Repo Rate. |
| **Presently** | Repo Rate is 6.25%. | Reverse Repo Rate is 6%. |

## Q.No.39. Policy rate Vs. Bank Rate (C)

| | Policy Rate (Repo Rate) | Bank Rate |
|---|---|---|
| **Meaning** | Fixed Repo Rate quoted for Sovereign Securities in the Overnight Segment of LAF is considered as the Policy Rate. (India has many other Repo Rates in Operation). | It is the Standard Rate at which RBI is prepared to buy or re-discount Bills of Exchange or other Commercial Paper eligible for purchase under the Act. **[RBI Act]** |

## Q.No.40. Market Stabilisation Scheme (MSS) Vs. Open Market Operations (OMO) (C)

| | Market Stabilisation Scheme (MSS) | Open Market Operations (OMO) |
|---|---|---|
| **Objective** | It was introduced following the MoU between RBI and the Government of India with the primary aim of aiding the Sterilization Operations of RBI. | The Objective of this operation is to adjust the Rupee Liquidity Conditions in the Market on a durable basis. |
| **Impact** | Government borrows from RBI (additional to its normal Borrowing) and issues Treasury Bills/ Dated Securities for absorbing the excess liquidity from the Market arising from Large Capital Inflows. | During excess liquidity conditions, RBI sells Securities thereby sucking out the Liquidity. During tight Liquidity Conditions, it buys Securities thereby releasing Liquidity. |

## AMENDMENTS

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**5th Bi-monthly Monetary Policy Statement of 2018-19 by RBI**

| Monetary Policy Instrument | Rate |
|---|---|
| CRR | 4% |
| SLR | 19.5% |
| Reverse repo rate | 6.25% |
| Repo rate | 6.5% |
| MSF / Bank rate | 6.75% |
| Economic Growth Rate (Target) | 7.4% |
| Consumer Inflation Rate (Target) | 4.7% to 5.1% |

## TEST YOUR KNOWLEDGE

1. Fundamentally, what is the primary objective of monetary policy?
2. How the monetary policy can influence overall economic performance?
3. Open Market Operations.
4. Make a critical evaluation of the latest monetary policy statement of the Reserve Bank of India.
5. What will be the nature of the monetary policy undertaken by RBI in the following?
   - **a)** Increases repo rate by 50 basis points
   - **b)** Reduces the cash reserve ratio
   - **c)** Increases the supply of currency and coins
   - **d)** Terminates marginal standing facility
   - **e)** Increases the interest rates chargeable by commercial banks
   - **f)** Sells securities in the open market

**g)** Initiates reverse repo operation

**h)** Changes in the SLR

**6.** Write a brief note about the reasons why the policy rates were changed /not changed in the recent monetary policy announcement by the RBI

**7.** Explain why people hold money according to Liquidity Preference Theory. **(M18 - 3M)**

**8.** Differentiate Narrow Money and Reserve money.

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## THE END

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