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RBI’s Monetary Policy

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Why in news?

RBI’s three day monetary policy meeting begins today.

The MPC must convene at least four times a year.

About Monetary policy:

The Reserve Bank of India (RBI) implements monetary policy to manage the economy's money supply and interest rates, aiming to achieve objectives like controlling inflation, managing employment levels, and maintaining financial stability.

key components of RBI's monetary policy:

Policy Rates:

Repo Rate: The interest rate at which the RBI lends money to commercial banks.

A lower repo rate makes borrowing cheaper, encouraging spending and investment.

Reverse Repo Rate: The rate at which the RBI borrows money from commercial banks.

A higher reverse repo rate can help control inflation by encouraging banks to deposit excess funds with the RBI.

Cash Reserve Ratio (CRR): The percentage of a bank's net demand and time liabilities (NDTL) that must **be kept in reserve with the RBI.**

Increasing the CRR reduces the amount of money banks can lend out, which can help control inflation.

Statutory Liquidity Ratio (SLR): The percentage of a bank's net demand and time liabilities that must be **maintained in the form of liquid assets like cash, gold, or government securities**. This ensures that banks have enough liquid assets to meet short-term obligations.

Open Market Operations (OMO): The buying and selling of government securities in the open market to regulate the money supply. Buying securities injects money into the economy, while selling them absorbs money from the economy.

Bank Rate: The rate at which the RBI is prepared to buy or discount eligible commercial paper or bills of exchange. It influences the cost of borrowing and lending in the economy.

Marginal Standing Facility (MSF): A facility that allows banks to borrow from the RBI overnight against government securities. It's used to manage liquidity shortfalls.

Forward Guidance: Communication by the RBI about future monetary policy actions. It helps manage market expectations and economic behavior.

Repo rate

6.50%

Reverse Repo rate

3.35%

CRR

4.00%

SLR

2.75%

Bank rate

6.50%

What is Monetary Policy Framework?

In May 2016, the RBI Act was amended to provide a legislative mandate to the central bank to operate the country's monetary policy framework.

Objective:

The framework aims at setting the policy (repo) rate based on an assessment of the current and evolving macroeconomic situation, and modulation of liquidity conditions to anchor money market rates at or around the repo rate.

Reason for Repo Rate as Policy Rate: *Repo rate changes transmit through the money market to the entire financial system, which, in turn, influences aggregate demand.*

Thus, it is a key determinant of inflation and growth.

What is the Monetary Policy Committee?

Origin: Under **Section 45ZB of the amended (in 2016) RBI Act, 1934**, the central government is empowered to constitute a ***six-member Monetary Policy Committee (MPC).***

Further, Section 45ZB lays down that "the Monetary Policy Committee shall determine the Policy Rate required to achieve the inflation target".

The **decision** of the Monetary Policy Committee **shall be binding on the Bank**.

Composition: Section 45ZB says the MPC shall consist of 6 members:

1***RBI Governor*** as its ex officio chairperson, 2***Deputy Governor*** in charge of monetary policy,

3***An officer of the Bank*** to be **nominated by the Central Board**,

4***Three persons to be appointed by the central government***.

This category of appointments must be from "***persons of ability, integrity and standing, having knowledge and experience in the field of economics or banking or finance or monetary policy***".

Expansionary Monetary Policy:

An expansionary monetary policy is ***focused on expanding (increasing) the money supply*** in an economy. This is also known as Easy Monetary Policy.

It is implemented by lowering key interest rates thus increasing market liquidity (money supply). High market liquidity usually encourages more economic activity.

When RBI adopts Expansionary Monetary Policy, it decreases Policy Rates (Interest Rates) like Repo, Reverse Repo, MSF, Bank Rate etc.

Effects:

Causes an **increase in bond prices** and a **reduction in interest rates**.

Lower interest rates lead **to higher levels of capital investment**.

The lower interest rates make domestic bonds less attractive, so the demand for domestic bonds falls and the demand for foreign bonds rises.

The **demand for domestic currency falls** and **the demand for foreign currency rises**, causing a decrease in the exchange rate. (The value of the domestic currency is now lower relative to foreign currencies)

A lower exchange rate causes exports to increase, imports to decrease and the ***balance of trade to increase.***

Contractionary Monetary Policy:

A contractionary monetary policy is ***focused on contracting (decreasing) the money supply*** in an economy. This is also known as Tight Monetary Policy.

A contractionary monetary policy is implemented by increasing key interest rates thus reducing market liquidity (money supply). Low market liquidity usually negatively affects production and consumption. This may also have a negative effect on economic growth.

When RBI adopts a contractionary monetary policy, it increases Policy Rates (Interest Rates) like Repo, Reverse Repo, MSF, Bank Rate etc.

Effects:

Contractionary monetary policy causes a **decrease in bond prices** and an **increase in interest rates.**

Higher interest rates lead to **lower levels of capital investment**.

The higher interest rates ***make domestic bonds more attractive***, so the demand for domestic bonds rises and the demand for foreign bonds falls.

The ***demand for domestic currency rises*** and the ***demand for foreign currency falls***, causing an ***increase in the exchange rate***. (The value of the domestic currency is now higher relative to foreign currencies)

A higher exchange rate ***causes exports to decrease***, ***imports to increase*** and ***the balance of trade to decrease.***

Kamaraj IAS Academy
Plot A P.127, AF block, 6 th street, 11th Main Rd, Shanthi Colony, Anna Nagar, Chennai, Tamil Nadu 600040
Phone: **044 4353 9988 / 98403 94477** / Whatsapp : **09710729833**