What is Monetary Policy?

Monetary policy is a **set of actions** that a country's central bank uses to manage the **money supply and interest rates.**

The goal of monetary policy is to achieve economic growth and regulate macroeconomic variables like inflation and unemployment.

Monetary policy is like **a remote control** for the economy. Just like you use a remote to change the channels on your TV, the government uses monetary policy to manage the country's economy by managing how much money is available, control prices, and encourage or slow down spending and investment to keep the economy in good shape.

Monetary policy strategies include:

- Revising interest rates
- Changing bank reserve requirements
- Increasing or decreasing the amount of currency and credit in circulation.

Monetary Policy in India

In India, the Reserve Bank of India (RBI) is the central monetary authority and to promote economic growth, RBI uses Monetary Policy to control the overall money supply in the economy.

- This Monetary Policy was constructed under the RBI Act in 1934.
- This policy is often considered a contractionary or an expansionary and is different from the fiscal policy, which manages the taxes and overall expenses of the country.
- When the total money is increased more suddenly than normal, it is called expansionary policy.
- When a slower increase or decrease in money occurs, it is called contractionary policy.

RBI Monetary Policy 2023 Highlights

Some of the major highlights of the Monetary Policy 2023 are listed below. It is released by the Governor of the Reserve Bank of India, Shaktikanta Das, on 8th October 2023.

- The **repo rate remains unchanged** for the Fiscal Year 2023-24. It is kept the same, i.e., 6.5%.
- The projection of **GDP Growth rate** is as follows: 6.5% For FY24.
- The Inflation forecast too retained at 5.4% for FY24.

Objectives of Monetary Policy

The primary objective of monetary policy is to maintain price stability. This is important for sustainable economic growth. The objectives include:

- **Price Stability**
    - **Controlling Inflation:** By managing the amount of money circulating in the economy, the central bank aims to keep prices stable. This is important because when prices rise too quickly (inflation), the value of money decreases, and people can buy less with their money. It affects savings and purchasing power.
- **Growth Promotion**
    - **Adequate Credit Availability:** The central bank ensures that there's enough money available for businesses and individuals to borrow at reasonable rates. This helps in funding new projects, investments, and consumer spending, which in turn drives economic growth.
- **Financial Stability**
    - **For regulating Financial Institutions:** The central bank oversees banks and financial institutions to ensure they're strong and stable. This is crucial because if banks are weak or face financial problems, it can lead to a financial crisis, affecting the entire economy.
- **Exchange Rate Management**
    - **Maintaining External Value:** While not the primary goal, managing the exchange rate is important for international trade and stability. The central bank intervenes in the foreign exchange market to prevent abrupt fluctuations in the value of the country's currency, which can impact imports, exports, and the overall economy.

- **Transmission of Monetary Policy**
    - **Effective Implementation:** The central bank's policies need to have a direct impact on the economy. It ensures that changes

made, like adjusting interest rates or reserve requirements for banks, are effectively transmitted to financial institutions and consumers. This way, the intended effects on borrowing costs, credit availability, and spending are realized.

Tools of Monetary Policy:

The **tools of Monetary Policy** can be broadly classified into two major categories of Qualitative tools and Quantitative tools. These tools are utilized in order to maintain the growth rate of the economy thereby controlling inflation.

- **Qualitative Tools of Monetary Policy**: These tools are also referred to as ‘selective’ as they are not used as rigorously as the Quantitative tools. These are used for differentiating between the variety of uses of credit facilities. Examples are –
- **Credit Rationing:** It involves setting limits on the amount of credit that banks can extend to specific sectors or entities. This helps in directing credit to priority sectors or controlling credit flow to speculative or risky areas.
- **Consumer Credit Regulation:** Imposing regulations on consumer borrowing to control excessive spending or borrowing that might lead to inflation or financial instability.
- **Margin Requirements:** Setting limits on the proportion of the total purchase price that investors can borrow to purchase securities. This helps in controlling speculative activities in financial markets.

Quantitative Tools of Monetary Policy:

These tools are the more commonly utilized tools by the central bank to regulate the economy's liquidity and credit availability. Quantitative tools used by RBI are –

1. **Bank rate**
2. **Repo rate**
3. **Reverse repo**
4. **Long Term Repo Operations (LTRO)**
5. **Open Market Operations (OMO)**
6. **Standing Deposit Facility (SDF)**
7. **Cash Reserve Ratio (CRR)**
8. **Statutory Liquidity Ratio (SLR)**
9. **Base Rate vs MCLR vs now what has been introduced**

These tools are being discussed in detail in further paragraphs.

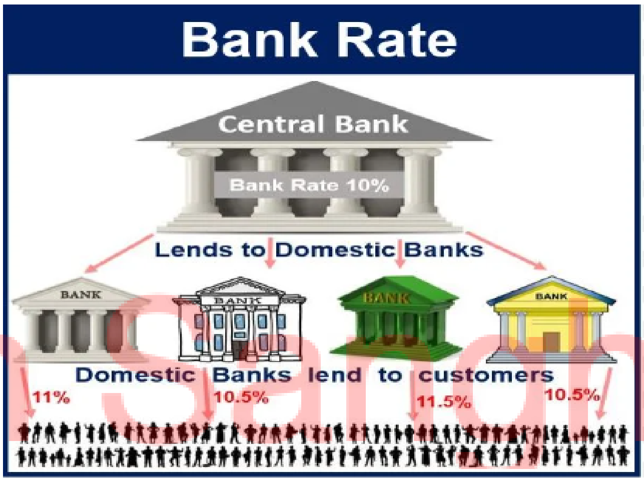
1. BANK RATE:

The rate at which the central bank lends money to commercial banks. It influences interest rates in the economy.

What is Bank Rate?

- **Definition:** The Bank Rate, also known as the discount rate or policy rate, is the interest rate at which a central bank lends money to commercial banks or financial institutions *without keeping any security.*

Current rate as on 02 December, 2023
Bank Rate – 5.15%



Mechanism of the Bank Rate:

The RBI decides the Bank Rate, which is the interest rate at which it lends money to commercial banks for longer durations.

It is usually higher than a Repo Rate on account of its ability to regulate liquidity.

Duration of Bank Rate:

Loans provided through the Bank Rate are generally more long-term in nature, typically beyond 90 days.

Role and Significance:

1. **Control of Money Supply:** Bank Rate plays a pivotal role in regulating the money supply in the economy. When the central bank increases the Bank Rate, borrowing from the central bank becomes more expensive for commercial banks. As a result, commercial banks tend to reduce borrowing, leading to a decrease in the overall money supply.

2. **Influence on Interest Rates:** The Bank Rate acts as a benchmark for other interest rates in the economy. When the central bank raises the Bank Rate, it often leads to an increase in other lending rates across the financial system. This affects borrowing costs for businesses and individuals, influencing spending and investment decisions.

Impact on Economy:

- **Inflation Control:** Increasing the Bank Rate can help in controlling inflation. By making borrowing more expensive, it discourages excessive spending and borrowing, thereby curbing inflationary pressures in the economy.
- **Economic Growth:** Conversely, a decrease in the Bank Rate stimulates borrowing and spending, potentially boosting economic growth. Lower borrowing costs encourage investment and consumption, leading to increased economic activity.

RBI's Use of Bank Rate:

- The RBI uses the Bank Rate as part of its monetary policy to achieve macroeconomic objectives like **controlling inflation and promoting economic growth.**
- It periodically reviews and adjusts the Bank Rate based on prevailing economic conditions, inflationary pressures, and growth targets.

In essence, the Bank Rate serves as a critical tool for the central bank to regulate credit availability, influence interest rates, and steer the economy towards desired economic outcomes.

2. REPO RATE

Repo rate can be defined as an amount of interest that is charged by the Reserve Bank of India while lending funds to the commercial banks.

Mechanism of the Repo Rate:

The word ‘Repo’ technically stands for **‘Repurchasing Option’ or ‘Repurchase Agreement’.** Both the parties are required to sign an agreement of repurchasing which will state the repurchasing of the **securities** on a specific date at a predetermined price.

Duration of Repo rate:

The duration of these loan generally varies between **one day to a fortnight**.

- **Role and Function:** The Repo Rate serves as a benchmark for the interest rates in the economy. When the RBI changes the Repo Rate, it impacts the cost at which commercial banks borrow money from the central bank.
- **Impact on Economy:** If the RBI decreases the Repo Rate, borrowing becomes cheaper for commercial banks. This can encourage banks to borrow more, increase liquidity in the banking system, and potentially lower interest rates for consumers and businesses.
- **Conversely,** if the RBI raises the Repo Rate, borrowing becomes more expensive for banks. This can reduce liquidity in the banking system, potentially leading to increased interest rates for consumers and businesses, which might help in controlling inflation.

3. REVERSE REPO RATE

- **Concept:**
  The Reverse Repo Rate is the interest rate at which commercial banks lend funds to the central bank (RBI) by **depositing their surplus short-term funds or excess money for a specified period.**

  In other words, Reverse repo is when banks keep their extra cash with the RBI for a short while and earn interest, known as the reverse repo rate. It's like a safe place for banks' spare cash, with a small reward from the RBI for using it.

  Mechanism of the Reverse Repo Rate:

When the RBI increases the Reverse Repo Rate, it incentivizes banks to **park more funds with the central bank due to the attractive interest rate.** This action reduces the amount of money in circulation, impacting liquidity in the banking system.

Duration of Reverse Repo rate:

The duration of these loans is similar to repo generally varying between **one day to a fortnight**.

Current Reverse rate as on 02 December, 2023 – 3.35%

- **Impact on Money Supply:** A higher Reverse Repo Rate encourages banks to prefer safer investments by parking excess funds with the RBI rather than lending to customers. This, in turn, reduces the money available for lending in the market, influencing money supply and potentially increasing interest rates.

4. LONG TERM REVERSE REPO OPERATION

Long Term Repo Operations is a liquidity management tool used by central banks, including the Reserve Bank of India (RBI), to inject liquidity into the banking system for an extended period at a fixed interest rate.

Why was LTRO introduced?

LTRO was introduced in response to the **economic slowdown in India** and the increase in borrowing costs following the IL&FS crisis. The RBI sought to stimulate the economy through lenient monetary policies.

LTRO aims to provide **longer-term funds to banks** to address liquidity concerns and ensure the smooth functioning of the financial system.

Duration of Long Term Repo rate:

The duration of these loan generally are for longer duration, often **1 to 3 years.**

How does it work?

In an LTRO, the central bank offers funds to banks for an **extended period (usually one to three years) at a pre-determined fixed rate through repurchase agreements (repos)**. Banks borrow funds by **pledging government securities as collateral.**

- According to the RBI, the LTRO scheme will be in addition to the existing Liquidity Adjustment Facility and Marginal Standing facility operations.
.

IN SIMPLER TERMS

Long Term Repo Operations (LTRO) by the RBI are a bit like providing banks with a longer borrowing option at a fixed interest rate. It's akin to **offering banks a special fund for a longer period (usually 1-3 years) at a set interest rate.** This helps banks have stable access to funds for a longer time, encouraging them to lend more to people and businesses, thus aiding economic growth.

Additional Information-

- The central bank has been conducting LTROs for one- and three-year tenors of appropriate sizes for up to a total amount of Rs 1,00,000 crore at the policy repo rate from the fortnight beginning February 15, 2020.
  The central bank received total bids of ₹1.94 lakh crore, for the three-year repo, compared with the notified amount of ₹25,000 crores.
- In yet another (LTROs) ₹48,856 crores worth of bids were conducted for an amount of ₹25,000 crores with a three-year tenor.

- LTROs are conducted on **Core Banking Solution (E-KUBER) platform.** The operations would be conducted at a fixed rate.
- The minimum bid amount would be Rs 1 crore and multiples thereof. There will be no restriction on the maximum amount of bidding by individual bidders.