

CHAPTER - 5

MONETARY AND CREDIT POLICY

Definitions:

- The strategy of influencing movements of the money supply and interest rates to affect output and inflation.
- The actions of a central bank that determine the size and rate of growth of the money supply, which in turn affects interest rates.
- A macroeconomic policy tool used to influence interest rates, inflation and credit availability through changes in the supply of money available in the economy.
- An attempt to achieve broad economic goals by the regulation of the supply of money.
- The regulation of the money supply and interest rates by a central bank in order to control inflation and stabilize currency.
- (Monetary policy is the process of managing a nation's money supply to achieve specific goals such as constraining inflation, achieving full employment etc.)
- (Monetary policy is made by the central bank to manage money supply to achieve specific goals-) such as constraining inflation, maintaining an appropriate exchange rate, generating jobs and economic growth. Monetary policy involves changing interest rates, directly or indirectly through open market operations, setting reserve requirements, or trading in foreign exchange markets.

Monetary Policy

(The use by the Central Bank of interest rate and other instruments to influence money supply to achieve certain macroeconomic goals is known as monetary policy). (Credit policy is a part of monetary policy as it deals with how much and at what rate credit is advanced by the banks). Objectives of monetary policy are:

- accelerating growth of economy
- price stability
- exchange rate stabilization

- balancing savings and investment
- Generating employment and

(Monetary policy is generally referred to as either being an expansionary policy, or a contractionary policy:) (expansionary policy increases the total supply of money in the economy) as in 2008-09 all over the world including India to beat recession/slowdown; and (a contractionary policy decreases the total money supply by tightening credit conditions) (2005-07 in India). Expansionary policy is traditionally used to combat unemployment in a recession by lowering interest rates, while contractionary policy has the goal of raising interest rates to combat inflation.

(Historically, (the Monetary Policy was announced twice a year – a slack season policy, (April-September) and a busy season policy (October-March) in accordance with agricultural cycles). These cycles also coincide with the halves of the financial year. Initially, the Reserve Bank of India announced all its monetary measures twice a year in the Monetary and Credit Policy. However, since monetary Policy has become dynamic in nature as RBI its right to alter it from time to time, depending on the state of the economy.

However, with the share of credit to agriculture coming down and credit towards the industry being granted whole year around, the RBI since 1998-99 has moved in for just one policy in April-end. A review of the policy takes place every quarter).

(The tools available for the central bank to achieve the monetary policy ends are the following

- Bank rate
- Reserve ratios
- Open market operations
- Intervention in the forex market and
- Moral suasion)

Bank rate

(Bank Rate is the rate at which RBI lends long term to commercial banks). (Bank Rate is a tool which RBI uses for managing money supply and credit).

Any revision in Bank Rate by RBI is a signal to banks to revise deposit rates as well as prime lending rate (PLR is the rate at which banks lend to the best customers). It stands at 6% presently (2011). It is a blunt instrument and is usually not changed unless the demand is extraordinary. In fact, in the recent liquidity crisis- 2008-09- too, bank rate remained unchanged.

Reserve Requirements

In economics, (fractional-reserve banking is the near-universal practice of banks in which banks keep a fraction of the total deposits managed by a bank as reserves and are not to be lent). The reserve ratios are periodically changed by the RBI. (The reserve requirement (or required reserve ratio) is a bank regulation that sets the minimum reserves each bank must hold as a part of the deposits). These reserves are designed to satisfy various needs like providing loans to the Government (SLR) and inflation management (CRR). They are in the form of RBI approved securities (SLR) kept with themselves or cash that is kept with the RBI (CRR).

Statutory liquidity ratio (SLR)

(It is the portion of time (fixed deposits) and demand liabilities (savings bank and current accounts) of banks that they should keep in the form of designated liquid assets) like government securities and other RBI approved securities like public sector bonds; current account balances with other banks and gold SLR is aims at ensuring that the need for government funds is partly but surely met by the banks. SLR was progressively brought down from 38.5% in 1991 to 24% (2011).

Banks need more liquidity to lend at lower rates in the current economic downturn. Therefore, RBI reduced the SLR by 1% to 24% temporarily after the global financial crisis erupted and it was restored to 25% in 2009. But in December 2010, it was raised to 25% to augment liquidity in a growing economy. SLR is a blunt instrument and was unchanged for more than a decade and half till it was lowered in 2008.

The Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 fixed the floor and cap on SLR at 25% and 40% respectively. But the amendment made in these statutes in 2007 removed the lower limit but retained the cap at 40% RBI has, as a result, the freedom to reduce the SLR to any rate depending on the macro economic conditions. The amendment was an enabling one.

CRR

CRR is a monetary tool to regulate money supply. (It is the portion of the bank deposits that a bank should keep with the RBI in cash form). CRR deposits earn no interest.

The Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 fixed the floor and cap on CRR at 3% and 20% respectively. But the amendment made in these statutes in 2007 removed the limits- lower and upper. RBI has, as a result, greater operational flexibility to make its monetary adjustments.

CRR is adjusted to manage liquidity and inflation. The more the CRR, the less the money available for lending by the banks to players in the economy. CRR was 15% in 1991 and today it is 6% (2011). If inflation is high, money supply needs to be taken out and so CRR is generally increased. But in a regime of moderate inflation, low CRR is in place.

(RBI increases CRR to tighten credit and lowers CRR to expand credit). During the downturn after the global Great Recession 2008 October onwards, CRR was reduced but as growth and inflation returned since 2009, CRR was gradually increased.

(CRR as a tool of monetary policy is used when there is a relatively serious need to manage credit and inflation). Otherwise, normally, RBI relies on signaling its intent through the policy rates of repo. Based on these rates, RBI conducts open market operations for liquidity management.

Open Market Operations of RBI

(OMOs of the RBI can be described as purchase and sale of government securities in the open market essentially means banks and financial institutions) by the RBI) in order to influence the volume of money and credit in the economy. Purchases of government securities injects money into the market and thus expands credit; sales have the opposite effect- absorb excess liquidity and shrink credit. Open market operations are RBI's most important and flexible monetary policy tool. Open market operations do not change the total stock of government securities but change the proportion held by the RBI, commercial and cooperative banks.

Ready Forward Contracts (Repos)

(It is a transaction in which two parties agree to sell and repurchase the same security).

Under such an agreement the seller specified securities with an agreement to repurchase the

same at a mutually decided future date and a price. Similarly, the buyer purchases the securities with an agreement to resell the same to the seller on an agreed date in future at a predetermined price. (In India, RBI lends on a short term basis to banks on the security of the government paper (repo)). Banks undertake to repurchase the security at a later date – over night or few days. (RBI charges a repo rate for the money it lends). (It is 6.25% presently (2011)).

(Reverse repo is when RBI borrows from the market (absorbs excess liquidity) with the sale of securities and repurchases them the next day or after a few days). The rate at which it borrows is called reverse repo rate as it is the reverse of the repo operation. Reverse repo rate presently is 5.25% (2011)

(The Repo/Reverse Repo transaction can only be done at Mumbai) and in securities as approved by RBI (Treasury Bills, Central/State Govt. securities). RBI uses Repo and Reverse repo as instruments for liquidity adjustment in the system.

(Repo and reverse repo rates are known as policy rates and are used as signals to the financial system to adjust their lending and borrowing operations).

Selective Credit Controls

Certain businesses can be given more and certain others may get less credit from banks on the orders of the RBI. Thus, (selective credit controls can be imposed for meeting various goals like discouraging hoarding and black-marketing) of certain essential commodities by traders etc. by giving them less credit. Either credit can be rationed or interest rate can be hiked by RBI for certain sectors as a part of SCCs. In SCCs, the total quantum of credit does not change, but the amount lent and the cost of credit may be changed for specific sector or sectors.

Moral suasion

(A persuasion measure used by Central bank to influence and pressure, but not force, banks into adhering to policy). Measures used are closed-door meetings with bank directors, increased severity of inspections, discussions, appeals to community spirit etc.

Recently the RBI Governor appealed to banks not to raise rates even though the central bank was following a tight money policy.

LAF

(Liquidity Adjustment Facility (LAF) was introduced

by RBI in 2000. Funds under LAF are used by the banks for their day-to-day mismatches in liquidity. (Commercial banks use this window at the repo and reverse repo rates). Under the revised Scheme, RBI will continue to have the discretion to conduct overnight reverse repo or longer term reverse repo auctions at fixed rate or at variable rates depending on market conditions and other relevant factors. RBI will also have the discretion to change the spread between the repo rate and the reverse repo rate as and when appropriate.

The Growing Importance of Monetary Policy

The growing importance of monetary policy in the management of the economy during the era of globalization in a fact.. Generally, (democratically elected governments resist to use fiscal policy to fight inflation as it requires government to take unpopular actions like reducing spending or raising taxes). The option of cutting indirect taxes is a limited one and is used rarely as it was done in 2009. Political realities favor a bigger role for monetary policy during times of inflation and deflation/disinflation (deflation is drop in prices and disinflation is drop in the rate of growth of prices).

Fiscal policy may be more suited to fighting unemployment as the government can step up spending to create public works and in the process jobs; while monetary policy may be more effective in fighting inflation/deflation. There is a limit to how much monetary policy can do the help the economy during a period of severe economic crisis.

(The monetary policy remedy to economic decline is to increase the amount of money in circulation by cutting interest rates and increasing the money supply: for example, during the 2008-09 economic downturn world wide including India.

But once interest rates reach zero or near zero, the central bank can do no more-economists call it the “liquidity trap,” what Japan did during the late 1990s. That’s (liquidity is trapped in banks-banks do not want to lend as credit may turn into bad asset. Businesses do not want to borrow as demand has slumped. It is a classical case of liquidity trap and was seen all over the world including India in the current downturn-2008-09.

With its economy stagnant and interest rates near zero, many economists argued that the Japanese government had to resort to more aggressive fiscal policy, if necessary, running up a sizable government deficit to spur renewed spending and

economic growth. Monetary policy proved to be of no real value then.

When reduced rates do not help, unconventional step are taken as in the USA where the Federal Reserve (its central bank) resorted to quantitative easing (discussed in the class).

Monetary policy has grown from simply increasing the money supply to keep up with both population growth and economic activity. It must now take into account such diverse factors as:

- Signals to the economy by way of rate and reserve adjustment
- exchange rates;
- credit quality;
- international capital flows of money on large scales;

With globalization and the increase in the flow of funds- highly speculative in character, monetary policy acquires unprecedented importance for the country. The following will illustrate the point further that globalization challenges monetary policy:

Management of the exchange is a crucial part of the monetary policy as exchange rate holds the key to many important macroeconomic goals and dictates foreign flows-inflows and outflows. It has a close bearing on money supply and inflation and interest rates. For instance, if foreign flood the country, in order to maintain its monetary stability, RBI has buy the foreign currency to save the rupee from excessive appreciation. The rupee that is printed has to be sucked out with Government securities as otherwise it will be inflationary.

Similarly when the Fed of the USA takes up quantitative easing, foreign can create huge challenges for us.

(The Market Stabilization Bond Scheme in India was started as a sterilization attempt in 2004). Under the MSS, RBI generates government securities to sterilize excess liquidity in the market to prevent inflation). Such sterilization can be expensive as the money so sucked out costs by way of the interest paid on it. Thus, the purpose of stemming rupee appreciation leads to excess of money supply which could inflate the economy unless sterilized with the direct intervention (selling MSBs) which is a costly process. Hike in interest rates and CRR may also become necessary- it hurts growth even as it reduces inflation. The latter was seen in India in the 2006-08 period.

After the 2008 global financial crisis, monetary policy faces another challenge- financial stability as banks go bankrupt and other financial institutions are destabilized.

Thus, monetary policy acquires enormous importance during globalization.

Market Stabilization Bonds

In 2004, RBI began floating Government securities and T-Bills, as a part of the Market Stabilization Scheme, to absorb excess liquidity from the market. The excess liquidity is the result of RBI buying dollars from the market. MSS is a sterilization effort of the central bank. The normally available government securities are not enough for the RBI to suck out the huge rupee supply (printed money called base money or reserve money or high powered money) that was caused for buying dollar. Therefore, the MSS was started.

Developing countries and Monetary Policy

Developing countries have problems operating monetary policy effectively. The primary difficulty is that fiscal policy of the Government sets priorities and the Central bank is not actively involved in decisions related to money supply through borrowings. The welfare schemes; foreign trade policy, tax policy etc. are the privilege of the central government and the central bank largely acts to support the same. Further, few developing countries have deep markets in government debt. Thus, the OMOs have limited value.

In India, situation is improving with RBI being given importance after economic reforms started early in the 1990's. The introduction of WMAs for the central government; FRBM Act 2003 etc. gave autonomy to the RBI and a consultative role to it. So does the FSDC set up in 2010- Financial Stability and Development Council.

Interest rates and their significance

Interest rates are the rates offered to money that is deposited in the banks; rates offered for investment in bonds; rates at which money is borrowed from banks and financial institutions; and rates charged from the borrowers etc.

Savers want higher interest rate while investors want the cost of credit to be low. There has to be a balance. The determinants of interest rates are:

- Inflation- the higher the inflation, the higher the interest rates because the same money invested in commodities and other assets should not fetch more, because of the inflation:

- Need for growth lower interest rates reduce cost of credit and facilitate investment for growth.
- Promotion of savings
- Government's need to borrow: the magnitude of government's borrowing programme also determines interest rates. The more the borrowing, the higher the interest rates.
- Need to generate demand as interest rates come down, consumer demand for credit goes up and there will be a stimulus for growth
- Global trends as we need to retain foreign funds

Deregulation of Interest Rates

(As a part of banking sector reforms, interest rates have been deregulated. The rationale is that banks can adjust rates quickly according to market conditions; financial innovations should be facilitated; populism through regulation can be prevented; competitive rates can be good for savers and investors; global alignment is possible dynamically; etc. RBI however, uses repo rates and CRR adjustments to influence interest rates.

Presently, bank rate is 6% (2011) and prime lending rate (PLR) is about 12% - PLR being the rate at which corporate with excellent credit record are lent. See elsewhere for base rate that is introduced by the RBI on the basis of the Deepak Mohanty report in 2010).

Interest rates came down for a decade from 1994 to promote growth; dropped further since the beginning of the current decade for more growth; climbed up since 2004 till mid-2008 to beat inflation; and dropped rapidly since mid-2008 as inflation eased and growth requirements demanded. In 2010, they are being hiked again as growth is high and inflation is also a worry- food inflation on the WPI being 18.3% in December 2010.

Floating and Flexible Rates of Interest

(There are two types of interest rate- fixed and floating. If they are offered together (when they co-exist), it is called flexible interest rate regime). Floating interest rates are linked to an underlying benchmark rate. In other words, the interest rate offered 'floats' in relation to the interest rate of a government security instrument of similar maturity (5 years or 10 years maturity etc.) as determined by the market. That is, (floating rates of interest are basically market driven rather than 'fixed'). The effective rates is adjusted on a quarterly or semi-annually or annually.

Inflating targeting

Under this policy approach the target is to keep inflation in a particular range or at a particular level. Government and the RBI agree on convergence between the fiscal the monetary policies to achieve the common goal. RBI is given autonomy to manage inflation while the government agrees to have a fiscal policy that will contribute to price stability- for example, not borrow excessively etc. India does not follow it.

(This monetary policy approach was pioneered in New Zealand). It is currently used in the Eurozone, Australia, Canada, New Zealand, Sweden, South Africa, Norway and the United Kingdom. (See Chapter on Inflation for more)

Reserve Bank of India

The central bank of the country is the Reserve Bank of India (RBI). It was established in 1935 with a share capital of Rs. 5 crores on the basis of the recommendations of the Hilton Young Commission. The share capital was entirely owned by private shareholders in the beginning. The Government held shares of nominal value of Rs. 2,20,000.

Reserve Bank of India was nationalized in the year 1949. (The general superintendence and direction of the Bank is entrusted to Central Board of Directors of 20 members, the Governor and four Deputy Governors, one Government official from the Ministry of Finance, ten nominated Directors by the Government to give representation to important elements in the economic life of the country, and four nominated Directors by the Central Government to represent the four local Boards with the headquarters at Mumbai, Kolkata, Chennai and New Delhi.

The Reserve Bank of India Act, 1934 came into effect in 1935. The Act provides the statutory basis of the functioning of the Bank.

Reserve Bank of India

Functions

The Reserve Bank of India Act of 1934 entrusts all the important functions of a central bank to the Reserve Bank of India.

Bank of Issue

Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations. The distribution of one rupee notes and coins and small coins all over the country

is undertaken by the Reserve Bank as agent of the Government. The Reserve Bank has a separate Issue Department which is entrusted with the issue of currency notes.

RBI should maintain gold & foreign exchange reserves of Rs. 200 cr, of which Rs. 115 cr. should be in gold. However, the amount of currency that the RBI can print depends upon the need of the economy. The only restriction is the systemic one- it should not create instability with too much or too less of money supply. Money supply should have a correspondence to the goods in the economy and the rates of growth.

Banker to Government

The second important function of the Reserve Bank of India is to act as Government banker, agent and adviser. The Reserve Bank is agent of Central Government and of all State Governments in India. The Reserve Bank has the obligation to transact Government business, to receive and to make payments on behalf of the Government and to carry out their other banking operations. The Reserve Bank of India helps the Government- both the Union and the States to raise loans. The Bank makes ways and means advances to the Governments. It acts as adviser to the Government on all monetary and banking matters.

Bankers Bank and Lender of the Last Resort.

The Reserve Bank of India acts as the bankers' bank.

The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities by rediscounting bills of exchange. CRR deposits of banks are kept with the RBI.

Since commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crises, the Reserve Bank is the lender of the last resort.

Controller of Credit

The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India. It can do so through changing the instruments available to it(see above). According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons.

The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a license from the Reserve

Bank of India to do banking business within India, the license can be cancelled by the Reserve Bank if certain stipulated conditions are not fulfilled. Every bank has to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a periodical return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

Custodian of Foreign Reserves

The Reserve Bank of India has the responsibility to act as the custodian of India's reserve of international currencies. It takes up operations in the forex market to stabilize the exchange rate of rupee and ensure that there is no speculation and there is order. To be able to do so effectively, it holds forex reserves which it acquires from the market (purchases). It has about 300b of forex reserves (2011) which includes foreign currency assets, gold and IMF's SDRs). SDRs are increasing in importance since 2008 when dollar stability came under question. Diversification and hedging of risk is being done by all central banks. Even though rupee exchange rate is market driven, RBI watches the movement to ensure order and normalcy and there is no volatility. Thus, it maintains exchange rate oversight.

Supervisory functions

In addition to its traditional central banking functions, the Reserve bank has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishments, branch expansion, setting reserve ratios etc.

Promotional functions

Since Independence, the range of the Reserve Bank's functions has steadily widened. The Bank now performs a variety of developmental and promotional functions. The Reserve Bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialized financing agencies. Accordingly, the Reserve Bank has helped in the setting up of the IFCI and the SFC; the Industrial Development Bank of India in 1964,

the Agricultural Refinance Corporation of India in 1963 and the Industrial Reconstruction Corporation of India in 1972. These institutions were set up directly or indirectly by the Reserve Bank to promote savings, and to provide industrial finance as well as agricultural finance. NABARD was set up in 1982. It has an important role in facilitating microfinance for financial inclusion. Further, its innovations include banking correspondent model for rural banking.

Functions of central bank, in sum

- monopoly on the issue of banknotes
- the Government's banker
- bankers' bank
- Lender of Last Resort
- manages the country's foreign exchange and gold reserves
- regulation and supervision of the banking industry;
- setting the official interest rate- used to manage both inflation and the country's exchange rate.
- debt management

The central bank's main responsibility is the making of monetary policy to ensure a stable economy, including a stable currency. It aims to manage inflation (rising average prices) as well as deflation (falling prices). It is the lender of last resort, and assists banks in cases of financial distress (see also bank runs).

Furthermore, it holds foreign exchange reserves and official gold reserves, and has influence over exchange rates. Some exchange rates are managed, some are market based (free float) and many are somewhere in between ("managed float" or "dirty float"). India falls in the market-determined category largely.

Typically a central bank controls certain types of short-term interest rates (repo and reverse repo rates) These influence the stock-and bond markets as well as mortgage and other interest rates.

RBI Act amended 2006

Government made amendments to RBI Act 1934 and Banking Regulation Act for allowing the apex bank to have more flexibility to fix the SLR and Cash Reserve Ratio (CRR). It removed the floor and cap on CRR and floor on statutory liquidity ratio (SLR) to provide flexibility to RBI to manage liquidity.

This would result in better liquidity management in the system.

Autonomy for RBI

RBI being the architect of the monetary policy requires autonomy to be effective. Advocates of central bank independence argue that a central bank should be autonomous to manage money, credit and exchange rate dynamics in the globalizing economy. It helps check populist expenditure and schemes that the political leadership may be tempted to indulge in. Others believe that the elected governments should have the final say within which RBI should be autonomous both while tendering advice and also with enough discretionary powers. For example, fixing CRR and SLR as deems fit with the amendments to the RBI Act in 2006.

The recent measures to make RBI independent are?

- replacement of adhoc treasury bills with WMA from 1997
- FRBM Act empowers RBI with autonomy- no primary borrowing from 1-4-2006.
- RBI Act amended in 2006.
- FSDC 2010

The arguments in favour of autonomy are:

- monetary stability which is essential for the efficient functioning of the modern economic system can be best achieved if professional Central bankers with the long term perspective are given charge. Otherwise, political leadership may be tempted to populism.
- without such autonomy, government tends to be profligate with its policies of automatic monetization.
- monetary credibility is high in public perception if professionals manage it.

The arguments against are:

- democratic systems are run with Parliament and Cabinet making all important policies.
- monetary policy is an integral policy of the overall economic policy and so RBI has to subordinate itself to the larger objective.

The best course is to have a middle path where autonomy should be linked to performance like in the policy of 'inflation targeting' where the central bank should justify its autonomy with performance

in the field of management of prices at reasonable levels.

Money Supply

This refers to the total volume of money circulating in the economy. Money supply can be estimated as narrow or broad money.

M1 equal the sum of currency with the public and demand deposits with the banks. It is the narrow money.

M3 or the broad money concept, as it is also known includes time deposits (fixed deposits), savings deposits with post office saving banks and all the components of M1.

Monetary and fiscal policy

Two important tools of macroeconomic policy are monetary policy and fiscal policy. Both have same goals. Fiscal policy is made by Government while the architect of monetary policy is the central bank.

The monetary policy aims to maintain price stability, exchange rate stability, full employment and economic growth.

Reserve Bank of India can increase or decrease the supply of money as well as interest rate, carry out open market operations, control credit and vary the reserve requirements to achieve these objectives.

Monetary policy is different from fiscal policy as the former brings about a change in the economy by changing money supply and interest rate, whereas fiscal policy is a broader tool with the government. Fiscal policy relates to taxation and other means of raising money and setting expenditure priorities. It can be used to direct economic growth in a desirable direction; provide social welfare; fight recession (pump prime the economy) and create employment.

For instance, at the time of recession the government can increase expenditures or cut taxes in order to generate demand, or do both.. The three fiscal stimulus packages given by government since October 2008 are the examples of stimuli where tax reliefs and public investment are the main features. On the other hand, the government can reduce its expenditure when the economy is doing well.

Supply side economics is resorted to boost economy- it means cutting taxes to boost consumption and investment. It is also called Reaganomics, after the former US President Ronald Reagan.

Monetary policy also has same goals as fiscal policy- growth, employment, price stability etc. Its tools are different.

The two policies need to work for convergence as their objectives are the same. The 1997 initiative to replace adhoc treasury bills with WMAs is an example of the harmonization of the two policies. Another example is the FRBM Act. FSDC set up in 2010 is a prime example as in this institutions the government of India and the RBI, among others, are represented for macro prudential regulation.

If the fiscal policy borrows excessively, the resultant higher interest rates and inflation cannot be managed by the RBI. Therefore, the need is for convergence. The challenge to enable convergence between the two has never been felt more than it is since the global meltdown of 2008 when the government borrowed heavily to stimulate the economy while the RBI eased the monetary policy to lend more and buoy up the economy.

Quantitative easing

The term quantitative easing describes an extreme form of monetary easing used to stimulate an economy where interest rates are either at, or close to, zero and are still not working to revive the economy. Central bank uses unconventional means, other than the usual monetary policy tools, to flood the financial system with new money through quantitative easing.

In practical terms, the central bank purchases financial assets, including treasuries and corporate bonds, from financial institutions (such as banks) using money it has created. Central Banks all over the world have used quantitative easing to overcome the liquidity crisis since the fall of Lehman Brothers in 2008 September when credit froze.

Credit crunch/liquidity crunch / liquidity crisis

Credit/Liquidity crunch refers to a state in which there is a short supply of money to lend to businesses and consumers and interest rates are high. It may happen when the government borrows heavily and there is crowding out of the corporate sector.

It may also refer to a serious crisis of confidence in the financial system (as in 2008) when banks refuse to lend to even genuine businesses fearing default and credit turning into bad debt.

In such a situation, banks may have liquidity but would not lend as fear grips them.

Monetary expansion/easing/stimulus

The current global recession is being overcome through stimulus packages of which the monetary stimulus by the central banks is an important part. It operates through reduction of rates-policy rates of repo and reverse repo; and reserve ratios-SLR and CRR. The goal is to take enough liquidity available to the banks so that they reduce the rates and lend more for making more investment possible and growth can be revived.

Another aspect of the monetary stimulus we have witnessed is the quantitative easing.

In countries like Japan, all these efforts have not yielded results as liquidity trap is the best description for the recessionary situation there. In India, however, the stimulus package is working and there is a cautious and calibrated exit from it since 2010.

Words

Monetary base is also called the reserve money. It is the sum of the currency in the hands of the public and the currency commercial banks keep as reserves with the central bank (RBI). It is also known as High-powered Money. In sum it is: Reserves + Currency with the public.

Prime Lending Rate (PLR) is the rate at which banks lend to the best customers. It is replaced with base rate since 2010 (see elsewhere for a detailed account).

Basis point: Changes in interest rates and other variables are expressed in terms of basis points to magnify and express the importance of changes. One basis point is 1% of 1%.

Mid-Quarter Monetary Policy Review: December 2010

Monetary Measures

It has been decided to:

- retain the repo rate at 6.25 per cent and the reverse repo rate at 5.25 per cent under the Reserve Bank's liquidity adjustment facility (LAF);
- retain the cash reserve ratio (CRR) at 6.0 per cent of net demand and time liabilities (NDTL) of scheduled banks.

Liquidity Measures

- first, reduce the statutory liquidity ratio (SLR) of scheduled commercial banks (SCBs) from 25 per cent of their NDTL to 24 per cent with effect from December 18, 2010;

- second, conduct open market operation (OMO) auctions for purchase of government securities for an aggregate amount of 48,000 crore in the next one month, the schedule for which is being issued separately.

The above two measures are expected to inject liquidity on an enduring basis of the order of 48,000 crore.

Global Economy

There have been significant global and domestic macroeconomic developments since the announcement of the Second Quarter Review of Monetary Policy on November 2, 2010. A slow recovery and persistent unemployment motivated another round of quantitative easing in the US. However, recent data show some signs of improvement, especially in respect of real GDP and consumer confidence, even though the unemployment rate has increased. Although economic recovery has been progressing in Europe, financial stability concerns have resurfaced as the sovereign debt problem spread further. Major emerging market economies (EMEs) continue to experience robust growth.

Significantly, despite the slow recovery and slack capacity in advanced economies, international commodity prices such as oil, food, industrial inputs and metals have risen noticeably in recent weeks. Reflecting the strength of demand and higher commodity prices, inflation has started creeping up in most EMEs.

Domestic Economy

Growth

GDP growth of 8.9 per cent in Q2 of 2010-11 suggests that domestic momentum remains strong. Agricultural growth has recovered on the back of a good monsoon. After flagging during August-September, the index of industrial production (HP) grew by over 10 per cent in October 2010. Various indicators of industrial activity, including the Purchasing Managers' Index (PMI) also suggest a strong underlying momentum. Lead indicators of services sector activity have continued to increase at a robust pace. These developments reinforce the Reserve Bank's projection of 8.5 per cent for real GDP growth for 2010-11 which will be reviewed in the Third Quarter Review scheduled on January 25, 2011.

Inflation

After remaining in double digits for five successive months, year-on-year headline WPI inflation

declined to 8.8 per cent in August 2010 and further to 7.5 per cent in November 2010. Consumer price (CPI) inflation for industrial workers and rural/agricultural labourers softened to single digit rates from August 2010, after remaining in double-digits for over a year. The overall reduction in inflation reflects moderation of good price inflation following a favourable monsoon. Food price inflation moderated from an average of 15.7 per cent in Q1 of 2010-11 to 12.3 per cent in Q2, to 10.0 per cent in October 2010 and further to 6.1 per cent in November 2010. Amongst food items, the moderation in inflation for cereals and pulses has been larger than that in inflation of protein related food items such as egg, fish, meat and milk reflecting the structural nature of food inflation. In addition, inflation for non-food primary articles such as raw cotton, raw rubber and minerals rose sharply. Reversing the declining trend in the last six months, non-food manufactured products inflation edged up to 5.4 per cent in November 2010.

Though inflation has moderated, inflationary pressures persist both from domestic demand and higher global commodity prices. The pace of decline in food price inflation has been slower than expected due largely to structural factors. There is a risk that rising international commodity prices will spill over into domestic inflation. Going forward, rising domestic input costs for the manufacturing sector combined with aggregate demand pressures could weigh on domestic inflation. The risk to the Reserve Bank's projection of 5.5 per cent inflation by March 2011 is on the upside.

Liquidity

While the overall liquidity in the system has remained in deficit consistent with the policy stance, the extent of tightness has been beyond the comfort level of the Reserve Bank. This has been mainly due to persistence of large government cash balances which have averaged 84,000 crore since the Second Quarter Review of November. In addition, the liquidity deficit has been accentuated by relatively sluggish growth in bank deposits even as the credit growth accelerated in 2010-11.

In view of the persistent liquidity pressures in November 2010, the Reserve Bank implemented some measures such as additional liquidity support to SCBs under the LAF and OMO purchase of government securities. While these measures have helped stabilize overnight interest rates, the extent of deficit could constrain banks' ability to expand their balances sheets commensurate with

the productive needs of the economy. The additional liquidity measures initiated by the Reserve Bank respond to these concerns.

As the economy expands; it needs primary liquidity, which will have to be provided in a manner consistent with the monetary policy stance. Such provision of liquidity should not be construed as a change in the monetary policy stance since inflation continues to remain a major concern. The measures taken in this review need to be appreciated in that context.

Summing Up

To sum up, underlying growth momentum of the Indian economy remains strong. Even as inflation has moderated, it remains significantly above the comfort level of the Reserve Bank. Moreover, risks to inflation remain on the upside, both from domestic demand and higher global commodity prices. There is, therefore, a need for continued vigilance on the inflation front against the build-up of demand side pressures. A major challenge for the Reserve Bank in the recent period has been liquidity management. It is the Reserve Bank's endeavour to alleviate the liquidity pressure in a manner consistent with the monetary policy stance of containing inflation and anchoring inflationary expectations.

Expected Outcomes

The policy actions in this Review are expected to:

- release s??izable primary liquidity into the system;
- bring down the liquidity deficit in the system close to the comfort zone of the Reserve Bank; and
- stabilize interest rates in the overnight inter-bank market.