MONETARY POLICY

QUANTITATIVE RESTRICTIONS

Bank Rate Policy

- Bank rate is the minimum rate at which the central bank of a country provides a loan to the commercial bank of the country.
- Bank rate is also called discount rate because the central bank provides finance to commercial banks by rediscounting bills.
- The RBI uses bank rate to control credit in the economy.
- For instance, in an inflationary scenario, the RBI increases the Bank Rate, which increases the cost of borrowing for commercial banks, this would discourage the commercial bank from borrowing from the RBI, hence lending in the economy will fall along with increase in lending rates by commercial bank, increase in lending rate will discourage investment and hence Aggregate Demand will fall. A fall in AD will reduce income and output in the economy. Thus, Inflation will Subside.

Open Market Operations

- OMO are another important instrument of credit control.
- OMO means the purchase and sale of securities by the RBI.
- For instance, in an inflationary scenario, the RBI will start selling government securities, the selling of securities will reduce money supply from the system (Since the buyer of the securities will pay for them in Rupee, hence currency from the system goes out), reduction in money supply will lead to reduction in funds with the commercial banks, which further reduce their lending capability. A fall in lending thus contracts credit in the economy.
- However, there are certain limitations that affect OMO viz; underdeveloped securities market, excess reserves with commercial banks, indebtedness of commercial banks, etc.

Cash Reserve Ratio

- Banks in India are required to keep certain proportions of their deposits in the form of cash with themselves as reserves.
- If the legal CRR is 10%, then the bank will have to keep Rs 100 as reserves against the deposit of Rs 1000.
- If at any time, the RBI decides to increase the CRR from 10 to 20%, then bank have to keep Rs 200 as reserves against the deposit of Rs 1000. This will reduce the credit in the economy as the banks now have less money to lend (800 in our example), less lending means less borrowing and investment and hence reduction in income and aggregate demand.
- Similarly, a reduction in CRR from 10 to 5%, will reduce the reserve requirement and hence increases the lending capacity of the banks. Increased lending will lead to increased investment, increase investment will increase AD and Income.

Liquidity Adjustment Facility

- LAF is a monetary policy instrument which allows commercial bank and primary dealers to borrow money through repurchasing agreement or repos/reverse repos.
- LAF is used to aid banks in adjusting day to day fluctuations in liquidity.
- RBI extends LAF facility only to commercial banks (excluding RRBs) and Primary dealers.
- LAF allowed banks to park their excess money with the RBI in case of excess liquidity or to avail liquidity from the RBI at the time of deficit on an overnight basis against the collateral of government securities.
- The operations of LAF are conducted by way of repos and reverse repos.
- **Repos or Repurchase Agreements** is an instrument which allows banks to borrow money from the RBI to manage short term needs of liquidity against the selling of government securities with an agreement to repurchase the same government securities at a predetermined date and rate. The rate at which the RBI lends to the banks is called Repo Rate.
- **Reverse Repo** is an instrument which allows the RBI to borrow from the banks by lending government securities. The rate at which the Banks lends to the RBI is called Reverse Repo Rate.
- **Repo** injects money into the system whereas Reverse Repo takes money out of the system.
- The RBI increases the Repo Rate during the time of inflation and decreases the Repo Rate during the time of deflation and low growth.
- The important point to remember is that the window of LAF does not allow the banks to borrow the unlimited amount from the RBI. The Banks are permitted to borrow only a limited percentage of its Net Demand and Time Liabilities under LAF window.

Marginal Standing Facility

- MSF is a new scheme announced by the RBI in the year 2011-12.
- MSF is a penal rate at which banks can borrow money from the RBI over and above of what they can borrow from the RBI under the LAF window.
- MSF is a penal rate and is always fixed at a higher rate than the Repo rate.
- The MSF would be a penal rate for banks, and the banks can borrow funds by pledging government securities within the limits of the statutory liquidity ratio.
- The scheme has been introduced by RBI with the main aim of reducing volatility in the overnight lending rates in the inter-bank market and to enable smooth monetary transmission in the financial system.

Statutory Liquidity Ratio

- SLR is that percentage of the deposits which the banks have to hold with themselves in highly liquid government securities.
- SLR is one of the many arrows in the RBI’s monetary policy quiver. These are used, sometimes in isolation, sometimes in combination, to manage the money supply, interest rates and credit availability in the country.
- The SLR is an important tool of monetary policy, and its primary aim is to ensure that banks always have enough liquidity (cash and cash equivalent securities) to honour depositor’s demands and that they don’t lend away all their funds.

- The current rate of SLR is 20%. It simply means that the bank has to invest 20 Re out of every 100 Rupee deposited with him in government securities.
- The SLR is being used by the RBI to tighten or easing money supply in the economy. For instance, a 50 BPS reduction in SLR will leave more money with the banks to lend. More lending means more investment and hence more income and growth.
- Over the years, the use of CRR and SLR as instruments of monetary control has been reduced. From 37-38 percent in the early 1990s, the RBI has reduced the SLR to 20 percent now. But this is still significant to influence credit and rates.
- The RBI doesn't always prefer bringing out the big guns in its monetary tools armament for fear of causing collateral damage — the risk of stoking inflation due to a repo rate cut.
- In such situations, SLR can be an effective pistol, so to speak. Reducing SLR can free up banks' funds, which if deployed for lending can boost investment cycle. The RBI lowering SLR this time was broadly seen as an attempt to revive the slack credit demand in the economy.

Bank Base Rate

- The Base Rate is the minimum interest rate of a bank below which it is not permissible to lend, except in some cases if allowed by the RBI.
- BR is the minimum interest rate that a bank must charge because below the base rate it is not viable for the bank to lend.
- The base rate, introduced with effect from 1st July 2011 by the Reserve Bank of India, is the new benchmark rate for lending operations of banks.
- Thus, all categories of domestic rupee loans should be priced only with reference to the Base Rate.
- The reason for introducing Base Rate was to bring out the transparency in bank lending rates as well as to improve monetary transmission mechanism.
- Base Rate has replaced the previous benchmark prime lending rate (BPLR) which bank charged to its most trustworthy customers.
- The committee constituted under the than DY Governor of the RBI Deepak Mohanty recommended the abolishment of the BPLR and establishment of more transparent Base Rate.

QUALITATIVE MEASURE OF THE RBI

Fixing Margin Requirements

- The margin refers to the "proportion of the loan amount which is not financed by the bank". Or in other words, it is that part of a loan which a borrower has to raise in order to get finance for his purpose.
- A change in a margin implies a change in the loan size. This method is used to encourage credit supply for the needy sector and discourage it for other non-necessary sectors. This can be done by increasing margin for the non-necessary sectors and by reducing it for other needy sectors.
- Example, If the RBI feels that more credit supply should be allocated to agriculture sector, then it will reduce the margin and even 85-90 percent loan can be given.

Consumer Credit Regulation

- Under this method, consumer credit supply is regulated through hire-purchase and instalment sale of consumer goods. Under this method, the down payment, instalment amount, loan duration, etc., is fixed in advance. This can help in checking the credit use and then inflation in a country.
  Publicity

- This is yet another method of selective credit control. Through it, Central Bank (RBI) publishes various reports stating what is good and what is bad in the system. This published information can help commercial banks to direct credit supply in the desired sectors. Through its weekly and monthly bulletins, the information is made public, and banks can use it for attaining goals of monetary policy.
  Credit Rationing

- Central Bank fixes credit amount to be granted. Credit is rationed by limiting the amount available for each commercial bank. This method controls even bill rediscounting. For certain purpose, the upper limit of credit can be fixed, and banks are told to stick to this limit. This can help in lowering banks credit exposure to unwanted sectors.
  Moral Suasion

- It implies to pressure exerted by the RBI on the Indian banking system without any strict action for compliance with the rules. It is a suggestion to banks. It helps in restraining credit during inflationary periods. Commercial banks are informed about the expectations of the central bank through monetary policy. Under moral suasion, central banks can issue directives, guidelines and suggestions for commercial banks regarding reducing credit supply for speculative purposes.
  Control Through Directives

- Under this method the central bank issue frequent directives to commercial banks. These directives guide commercial banks in framing their lending policy. Through a directive, the central bank can influence credit structures, the supply of credit to a certain limit for a specific purpose. The RBI issues directives to commercial banks for not lending loans to the speculative sector such as securities, etc. beyond a certain limit.
  Direct Action Under this method, the RBI can impose an action against a bank. If certain banks are not adhering to the RBI's directives, the RBI may refuse to rediscount their bills and securities. Secondly, RBI may refuse credit supply to those banks whose borrowings are in excess to their capital. The Central bank can penalize a bank by changing some rates. At last, it can even put a ban on a particular bank if it does not follow its directives and work against the objectives of the monetary policy.