RESERVE BANK OF INDIA (RBI) – MONETARY POLICY

Prior to establishment of RBI, the functions of a central bank were virtually being done by the Imperial Bank of India. RBI started its operations from April 1, 1935. It was established via the RBI act 1934, so it is also known as statutory body.

The core structure of RBI includes one Central Board of Directors, two Assistive bodies (BFS and BPSS), four local boards, 33 departments, 19 regional offices and 9 sub-offices.

Main functions of RBI
a) To work as monetary authority and implement it’s Monetary Policy.
b) To serve as issuer of bank notes
c) Serve as banker to Central and State Governments
d) Serve as debt manager to central and State Governments
e) Provide ways and means advances to the State Governments
f) Serve as banker to banks and lender of last resort (LORL) for them
g) Work as supervisor and regulator of the Banking and Financial System
h) Management of Foreign Exchange Reserves of the country
i) Support the government in department of the country

Meaning and Objectives of Monetary Policy:

Monetary policy refers all those operations, which are used to control the money supply in the economy.

The overall objective of the monetary policy is twofold:
a) To maintain economic and financial stability
b) To ensure adequate financial resources for the purpose of department

These objectives can further simplified to:
a) Maintaining price stability
b) Adequate flow of credit to productive sectors
c) Promotion of productive investments and trade
d) Promotion of exports and economic growth

Reserve Bank of India announces Monetary Policy every year in the Month of April. This is followed by three quarterly Reviews in July, October and January.

Various tools / instruments of Monetary Policy

Various instruments of monetary policy can be divided into
Quantitative instruments: Which are directly affects the quantity of money supply in the economy.
Qualitative instruments: Impact the money supply indirectly.

QUANTITATIVE INSTRUMENTS:

a) Open Market Operations (OMO): OMO refers to the purchase and sale of the Government Securities by RBI from/to market. The objective of OMO is to adjust the rupee liquidity conditions in the economy on a durable basis. Purchases inject money into the banking system and stimulate growth while sales of securities do the opposite.
b) Liquidity Adjustment Facility (LAF): LAF is the primary instrument of Reserve Bank of India for modulating liquidity and transmitting interest rate signals to market. LAF was first introduced in June 2000.
It refers to the difference between the two key rates viz. Repo Rate and Reverse Repo Rate. Informally, Liquidity Adjustment Facility is also known as Liquidity Corridor.

i) **Repo Rate**: It is the rate of interest at which RBI lends money to commercial banks for short term. Any reduction in the repo rate helps banks to get money at cheaper rate.

ii) **Reverse Repo Rate**: It is the rate at which RBI borrows money from commercial banks. It is usually 1% less than Repo rate.

c) **Marginal Standing Facility (MSF)**: MSF is new Liquidity Adjustment Facility (LAF) window created by Reserve Bank of India in its credit policy of May 2011. MSF is the rate at which the banks are able to borrow **overnight funds from RBI** against the approved government securities.

d) **Statutory Liquidity Ratio (SLR)**: The banks and other financial institutions in India have to **keep fraction of their net time and demand liabilities** in the form of Liquid assets as Government Securities, precious metals, other approved securities. This fraction is called Statutory Liquidity Ratio (SLR).

e) **Cash Reserve Ratio (CRR)**: CRR is the amount of funds that the banks are bound to **keep with Reserve Bank of India** as a portion of their Net Demand and Time Liabilities (NDTL). This is also a statutory pre-emption because it draws its legality from Banking Regulation Act 1949.

f) **Bank Rate**: Bank Rate refers to the official interest rate at which RBI will provide loans to the banking system which includes commercial/cooperative banks, development banks etc. Such loans are given out either by direct lending or by rediscounting (buying back) the bills of commercial banks and treasury bills. Thus, bank rate is also known as discount rate.

g) **Credit Ceiling**: Under the credit ceiling, RBI informs the banks to what extent/limit they would be getting credit. When RBI imposes a credit limit, the banks will get tight in advancing loans to public. Further, RBI may also direct the banks to provide certain fractions of their loans to certain sectors such as farm sector or priority sector.

**QUALITATIVE INSTRUMENTS**

a) **Margin requirements** refers to difference between the securities offered and amount borrowed by the banks.

b) **Consumer credit regulation** refers to issuing rules regarding down payments and maximum maturities of instalment credit for purchase of goods.

c) **RBI Guidelines** refers to the oral, written statements, appeals, guidelines, warnings, etc, to the banks by RBI.

d) **Rationing of the credit** refers to control over the credit granted/allotted by commercial banks.

e) **Moral Suasion** refers to a request by the RBI to the commercial banks to take certain measures as per the trend of the economy.

f) **Direct Action** is taken by the RBI against banks that don’t fulfil conditions and requirements. RBI may refuse to rediscount their papers or may give excess credits or charge a penal rate of interest over and above the Bank rate, for credit demanded beyond a limit.

**IMPORTANT NOTES:**

Raghuram Rajan the governor of RBI's has published third bi-monthly monetary policy statement for the fiscal year 2016-17 on August 9th 2016.

**Major Highlights of RBI’s third bi-monthly monetary policy statement:-**

i) **Repo Rate**- 6.50%

ii) **Reverse Repo Rate** - 6.00%

iii) **Marginal Standing Facility Rate (MSF)**- 7.00%

iv) **Bank Rate**- 7.00%
v) Cash Reserve Ratio (CRR) - 4%
vi) Statutory Liquidity Ratio (SLR) - 21%
vii) Base Rate - 9.30% - 9.70%
viii) Savings Deposit Rate - 4.00%
ix) Term Deposit Rate > 1 Year - 7.00% - 7.50%
x) Growth forecast at 7.6% for the current fiscal
xi) Inflation target remains 5% for January 2017, upside risk
xii) Normal monsoon, 7th Pay Commission award to boost growth
xiii) GST rollout to boost business sentiment, investment, and Timely implementation of GST a challenge
xiv) Marginal Cost Lending Rate framework for the interest rate to be modified.