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Theme 189

MONETARY AND CREDIT POLICY

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SIB STUDENTS' ECONOMIC FORUM

AUGUST 2007

Theme No. 189 : MONETARY AND CREDIT POLICY

RBI announces its annual Monetary and credit policy in April each year and undertakes a quarterly review. RBI announced the Annual policy statement for 2007-08 on 24th April-2007 and its first policy review on 31st July 2007.

What are the objectives of Monetary and credit policy?

The main objective is to ensure price stability and provide adequate credit flow to the productive sectors of the economy. Managing the capital flows and growth momentum are also important goals of Monetary and credit policy. The other major objectives are to increase operational effectiveness of monetary policy by broadening and deepening various segments of the market, to redefine the regulatory role of RBI in order to make it more efficient and purposive, to strengthen the prudential and supervisory norms, to improve the credit delivery system and to develop the technological and institutional infrastructure of the financial sector.

What is monetary policy?

Monetary policy can be summarised as the central bank's actions to influence the availability and cost of money and credit in the economy. While contributing to growth, it will ensure and maintain conditions of price and financial stability.

How does RBI ensure price stability?

As an example, consider that an economy is growing too fast. This is also referred to as overheating of the economy: a situation that typically happens in the boom phase when GDP (gross domestic product) growth exceeds the long-term growth potential of the economy. The producers of goods are not able to make enough goods to meet the rising demand. The resultant demand-supply mismatch creates inflationary pressures in the economy. This situation is regarded as unsustainable, as the high growth translates into higher inflation. In this situation, the RBI raises interest rates to depress spending and reduce the pressure on inflation. Conversely, when the economy is growing too slowly, interest rates are reduced to stimulate demand.

What are the instruments of monetary policy?

Macro-Economic tools are made use of to achieve the objectives of the policy.The Reserve Bank of India can influence the cost of funds and availability of credit in the economy by altering the bank rate, repo rate, reverse repo rate, reserve requirements, and engaging in open market operations.

Repo is the short form of repossess or repurchase. Repo rate is the rate that RBI charges the banks when they borrow from it. Repo operations increase liquidity in the system. Reverse repo rate is the rate that RBI offers the banks for parking their funds with it. Reverse repo operations suck out liquidity from the system. CRR is the portion of deposits that banks are required to keep with the RBI.

What are the changes in these rates during the recent past?

Ever since monetary tightening started in 2004, reverse repo rate has been raised six times to 7.75% and repo rate seven times to 6%. By raising repo/reverse repo rates, the RBI signals interest rate hikes. As a part of monetary tightening, the RBI has raised CRR from 4.5% to 7% during the period. The variation in bank rate was lesser and it is 6 percent now.

Which works better: Repo or CRR?

Unlike repo and reverse repo rates, which act as signaling devices, CRR is a blunt instrument that directly acts on liquidity. By raising CRR, the RBI sucks out liquidity from the system and puts upward pressure on interest rates. As per the quarterly policy review announcement on 31st July' 07, CRR has been raised from 6.50 percent to 7 percent. The hike in CRR is expected to suck out Rs. 16000 crores from the banking system.

What are the major changes in the recent quarterly review?

In addition to increasing the CRR by half percent, RBI has allowed banks to keep more funds with it under the daily liquidity adjustment facility by removing the Rs 3000 crore cap imposed in March this year.

However, the interest paid by the RBI on such short term funds can hence forth be either at fixed rate or at variable rates. In other words, the RBI will undertake short-term lending and borrowing through repo and reverse repo at a rate of interest which it thinks appropriate. The removal of the Rs. 3000 crore LAF is expected to push up overnight call rates which have been ruling below, 1 percent. It may come back to the corridor between the repo and reverse repo.

How does the hike in CRR affect the interest rates?

The cost of funds for banks will rise as they have to park more funds with RBI. So normally a CRR hike is followed by a rise in lending rates. However, due to excess liquidity in the system, now banks may not look at increasing their lending rates. Alternately banks can consider reduction in deposit rates. But the CRR hike is unlikely to have any major impact on either deposit rates or lending rates.

What are the important macro-overview of the economy for the year?

- The RBI has reiterated its objective of holding inflation within 5 per cent during the current year, and to bring it down to 4% to 4.5% in the medium term.
- The growth of non-food credit is expected to decelerate by 24-25 per cent in the current year, against an average growth of 29.8 percent in the last three year.
- The RBI has also reiterated its projection of GDP growth at 8.5 per cent.
- M3 expansion to be contained at around 17.0-17.5% during 2007-08.
- Consistent with the projections of money supply growth, the growth in aggregate deposits in 2007-08 is placed at around Rs.4, 90,000 crore.

What is open market operations?

RBI sells and buys government securities. These activities are called open market operations (OMO). When inflationary pressures exist, the RBI sells securities to mop up excess cash from the system; and vice-versa in case of tight liquidity/ shortage of funds. Controlling the growth of the money supply is the primary concern. Greater the rate of growth of the money supply, compared to growth rate of GDP, the higher will be the rate of inflation. The money supply growth rate is curtailed through open market operations of buying or selling securities.

What is transmission mechanism or how monetary policy is impacting the economy through various channels, directly as well as indirectly?

Assume that inflation is rising in the economy and the RBI, to tackle it, decides to signal a rate hike by raising CRR or the reverse repo rate. This reduces money supply in the economy as banks are induced to park their cash with the RBI. That puts pressure on the long term interest rates in the economy-for example, the lending rates for housing, consumer loans, etc. These rates tend to go up.

The impact of RBI action on long term commercial rates also depends on the expectations of financial market participants, which are shaped by both actions and statements of the central bank.

What is the adverse impact of controlling inflation?

Measures to control inflation leads to higher interest rates. Higher interest rates discourage consumption and investment, leading to a reduced aggregate demand (GDP growth) in the system. As a consequence of reduced demand, the pressure on inflation eases. The policy objective of reducing inflation is achieved but at the cost of growth. This is often referred to as the growth-inflation trade-off.

What is expansionary or contractionary policy?

When RBI attempts to lower the cost of funds to spur growth so that cheap and abundant money may persuade industry to set up new capacities or produce to the maximum extent available, it is called expansionary. When RBI tightens the monetary aggregates, it is called contractionary policy.

What other challenges, the conduct of monetary policy face in India?

Apart from the issues related to monetary policy transmission, the huge inflow of foreign capital has complicated the conduct of monetary policy. The capital inflows have increased the supply of dollars, which makes the rupee stronger.

Has RBI resorted to any monetary measure to keep the rupee from strengthening any further?

Fifteen years ago RBI was initiating steps to increase the inflow of foreign capital to India. But now the monetary efforts are to manage its inflow, so as to keep the rupee from strengthening any further. Not too long ago, the chairman of prime Minister’s Economic Advisory council stated that an inflow of $ 25 billion a year was a manageable level for monetary authorities. But between March and July’07, the economy received $ 22 billion in foreign direct investments, equity and External Commercial Borrowings. Capital inflows increase money supply, so the CRR is raised to reduce the resources available to banks.

As recommended by RBI in its recent monetary policy review, Finance Ministry has decided to control the flow from ECBs into the domestic economy. Accordingly, ECBs of over $ 20 million for foreign currency expenditures, by any borrower company for permissible end uses, will have to be parked overseas. ECBs up to $ 20 million also will have to be parked overseas, even if it is for rupee payments under the Approval Route, till such time they are actually required in India. But for actual rupee use in India funds below $ 20 million can be brought in. This will enable the RBI to manage liquidity and the exchange rate better and give further boost to anti- inflation drive.

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Mr. Sanjeev Sanyal, Chief Economist, Deutsche Bank, Asia giving a lecture organized under the auspices of "SIB Students Economic Forum of South Indian Bank on 'China- India and the global talent shortage'.

South Indian Bank - Manorama

INDIA @ 60 QUIZ

To celebrate and commemorate 60 years of Independent India South Indian Bank is conducting India @ 60 Quiz in association with Manorama News TV Channel . The programme is being conducted on a large scale all over India encompassing over 5000 schools . Only students studying in Class 8 to Class 12 are eligible. The preliminary qualifying test to select 32 teams was conducted on 11th August 2007 across 40 centres in Kerala, Delhi, Mumbai, Bangalore and Chennai.

Winners will be given cash prizes and trophies will be presented to the schools. Apart from this, each participant will be given an Atlas CD and Tell Me Why books as compliments from the bank. The event will be telecast weekly for 15 weeks in Manorama News TV Channel. The first episode is set to telecast on 2nd October, 2007. For more details please log on to www.sib.co.in