UNIT V

Principal Instruments of Monetary Policy of India!

Monetary policy, also known as Credit Policy, helps RBI in deciding about the supply of money in an economy, ratio of interest to be charged for some amount of money. It provides measures to control inflation and most important of all it helps in deciding how to achieve the economic growth and development objectives of an economy.

Principal Instruments of monetary policy or credit control are broadly classified as:

i. Open Market Operations (OMO):

"The open market operation refers to the purchase and/or sale of short-term and long-term securities by the RBI in the open market." Characteristically, the open market operations are anti- inflationary.

Consider the situation where the market is in equilibrium at the rate of interest OR corresponding to the level (or quantity) of money supply OM. If the central bank makes open market sale of securities, the supply of money in the market shrinks to the level OM_1.

Consequently, the demand for credit would increase, resulting in an increase in the rate of interest to the level of OR_1. Conversely, if the central bank purchases securities, the money supply would increase to the level OM_2. The rate of interest too, with the increase in money supply causing a reduction in the demand for credit, would fall to the level OR_2.

The change in the supply of money associated with or brought about by a change in the rate of interest, vis-a-vis the open market operations, would be effective when the government policy permits the prevailing of 'market related or determined rates of interest'.

Alternatively, in a situation where the monetary authority is able to mandate specific interest rates, a raise in the interest rates would result in a contraction of money supply as higher interest rates encourage savings and discourage borrowings.

ii. Bank Rate:

Apart from the open market operations, there are other instruments (or tools), which the central monetary authority can employ to influence the desired change in the money supply. One of the most important among these is the ‘hank rate’ (BR) policy.

The bank rate refers to the ‘standard rate’ at which the central bank (RBI) buys or rediscounts bills of exchange or other commercial papers. More generally, bank rate is taken as the rate at which the RBI extends advances to the commercial banks. By increasing the bank rate, a contraction in the monetary supply can be achieved.

iii. Variable Reserve Requirement (VRR):

Another prominent instrument used is the specification on the level of ‘variable reserve requirement’ (VRR). More particularly, VRR is used to control credit. By changing the ratio of reserves, the RBI influences the volume of credit that banks can advance.

There are two components of VRR vis. the cash reserve ratio (CRR) and the statutory liquidity ratio (SLR). CRR refers to the portion of total deposits of a commercial bank, which it has to keep with the RBI as cash reserves.

The SLR, on the other hand, refers to that portion of total deposits, which a commercial bank has to keep with itself in the form of cash reserves. Increasing or decreasing the SLR and CRR, either decreases or increases the availability of funds with the banks to advance credit. This complements the objective of the central bank to influence the volume of money supply in the economy.

iv. Liquidity Adjustment Facility:

‘Liquidity adjustment facility’ (LAF) is another tool of monetary policy which has acquired significance in the recent times. The LAF is an indirect instrument. It operates through overnight fixed repo and. reverse repo rates. Repo rate is the rate at which banks borrow short-term loans from RBI.

Reverse repo rate is the rate at which banks park their short-term surplus funds with the RBI. Since October 2005, repo rate has been changed frequently, along with changes in the reverse repo rate. Frequent changes-in repo rate indicate that the global factors are being accorded greater weight in the determination of monetary policy contours than ever before.

v. Refinance Policy:

The refinance policy refers to the system of refinance provided by the RBI to the commercial banks for certain credits extended by them. As an instrument of credit control its effectiveness depends upon commercial banks' liquidity position. As the dependence of commercial banks on the RBI has reduced greatly, the effectiveness of this policy as an instrument for credit control has also decreased.

vi. Selective Credit Controls (SCCs):

Selective Credit Controls are designed to curb excess of advancing in select areas/cases without affecting other types of credit.

For instance,

(i) ceiling on the amounts of credit for certain purposes and to any one borrower

(ii) discriminatory rates of interest charges on certain types of advances,

(iii) Prohibiting banks from entering into any particular transactions,

(iv) giving directions on the purpose on which advances may not be made by the banks,

(v) laying down maximum amount up to which guarantees made be given by a commercial bank, etc.

vii. Moral Suasion:

Practices under moral suasion includes periodic urging by the RBI to the commercial banks to exercise control over credit in general and certain advances in particular. This method has been found quite useful with the RBI having good informal relations with the banks.

viii. Market Stabilisation Scheme (MSS):

The MSS was launched by the RBI on April 2004. There was a certain background due to, which the MSS was introduced. While intervening in the foreign exchange market, the RBI had been releasing rupees for buying dollars. The rupees so released added to liquidity in the system raising inflationary pressures. To mop up this excess liquidity, the RBI used its huge stock of government securities.

But over a period of time, this stock of securities held with RBI came down substantially. It was in this context that the MSS was launched as an additional channel to reduce liquidity. Under the MSS, the government issues T-Bills (treasury bills) in addition to its normal borrowing requirements. The amounts raised under the MSS will be held in a separately identifiable cash account entitled Market Stabilisation Scheme Account.

The MSS is thus, basically a monetary management tool. The MSS will curb short-term volatility in the forex market. It is also expected to fine tune the structural balance in the money market and enable the RBI to maintain a grip over short-term interest rate.

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Thus, monetary policy of India refers to that policy which is concerned with the measures taken to regulate the volume of credit created by the banks. The main objectives of monetary policy are to achieve price stability, financial stability and adequate availability of credit for growth.

Following are the main elements of the monetary policy of India:

i. It regulates the stocks and the growth rate of money supply.

ii. It regulates the entire banking system of the economy.

iii. It determines the allocation of loans among different sectors.

iv. It provides incentives to promote savings and to raise the savings-income ratio.

v. It ensures adequate availability of credit for growth and tries to achieve price stability.

Objectives of Monetary Policy:

According to RBI Governor Dr. D. Subba Rao, "The objectives of monetary policy in India are price stability and growth. These are pursued through ensuring credit availability with stability in the external value of rupee and overall financial stability."

Following are the main objectives of monetary policy:

i. To Regulate Money Supply in the Economy:

Money supply includes both money in circulation and credit creation by banks. Monetary policy is farmed to regulate the money supply in the economy by credit expansion or credit contraction. By credit expansion (giving more loans), the money supply can be expanded. By credit contraction (giving less loans) money supply can be decreased.

The main aim of the monetary policy of the Reserve Bank was to control the money supply in such a manner as to expand it to meet the needs of economic growth and at the same time contract it to curb inflation. In other words monetary policy aimed at expanding and contracting money supply according to the needs of the economy.

ii. To Attain Price Stability:

Another major objective of monetary policy in India is to maintain price stability in the country. It implies Control over inflation. Price level, is affected by money supply. Monetary policy regulates money supply to maintain price stability.

iii. To promote Economic Growth:

An important objective of monetary policy is to make available necessary supply of money and credit for the economic growth of the country. Those sectors which are quite significant for the economic growth are provided with adequate availability of credit.

iv. To Promote saving and Investment:

By regulating the rate of interest and checking inflation, monetary policy promotes saving and investment. Higher rates of interest promote saving and investment.

v. To Control Business Cycles:

Boom and depression are the main phases of business cycle. Monetary policy puts a check on boom and depression. In period of boom, credit is contracted, so as to reduce money supply and thus check inflation. In period of depression, credit is expanded, so as to increase money supply and thus promote aggregate demand in the economy.

vi. To Promote Exports and Substitute Imports:

By providing concessional loans to export oriented and import substitution units, monetary policy encourages such industries and thus help to improve the position of balance of payments.

vii. To Manage Aggregate Demand:

Monetary authority tries to keep the aggregate demand in balance with aggregate supply of goods and services. If aggregate demand is to be increased than credit is expanded and the interest rate is lowered down. Because of low interest rate, more people take loan to buy goods and services and hence aggregate demand increases and vice-verse.

viii. To Ensure more Credit for Priority Sector:

Monetary policy aims at providing more funds to priority sector by lowering interest rates for these sectors. Priority sector includes agriculture, small- scale industry, weaker sections of society, etc.

ix. To Promote Employment:

By providing concessional loans to productive sectors, small and medium entrepreneurs, special loan schemes for unemployed youth, monetary policy promotes employment.

x. To Develop Infrastructure:

Monetary policy aims at developing infrastructure. It provides concessional funds for developing infrastructure.

xi. To Regulate and Expand Banking:

RBI regulates the banking system of the economy. RBI has expanded banking to all parts of the country. Through monetary policy, RBI issues directives to different banks for setting up rural branches for promoting agricultural credit. Besides it, government has also set up cooperative banks and regional rural banks. All this has expanded banking in all parts of the country.

Source: https://www.yourarticlelibrary.com/

The following points highlight the top five types of lags in the Monetary Policy. The Lags are: 1. Data lag 2. Recognition lag 3. Legislative lag 4. Transmission lag 5. Effectiveness lag.

Monetary Policy Lag # 1. Data Lag:

Prima facie, policy-makers do not know what is going on in the economy exactly when it happens.

Typically, an economic change that starts at the beginning of the month becomes evident at the middle of the next month. So the data lag is about 1.5 months.

Monetary Policy Lag # 2. Recognition Lag:
Data for real economic variables are required over time as the government agencies receive more complete information. There is a recognition lag of at least two months because no policymaker pays much attention to reversals in data that occur for only one month.

Monetary Policy Lag # 3. Legislative Lag:
Unlike fiscal policy changes, which occur only once a year, monetary policy changes occur at least twice a year or, in some countries, three to four times a year. So an important advantage of monetary policy is the short legislative lag. Monetary policy changes can be legislated quickly. But the legislative lag is a major weakness.

Monetary Policy Lag # 4. Transmission Lag:
The transmission lag is the time interval between the policy decision and the subsequent change in policy instruments. This is also a more serious obstacle for fiscal policy than for monetary policy. For frequent changes in bank rate there is no transmission lag in case of monetary policy.

Monetary Policy Lag # 5. Effectiveness Lag:
The most important lag of monetary policy concerns the length of time required for an acceleration or deceleration in the money supply to influence real output. The effectiveness lag is long and variable and makes the value of the multiplier uncertain.

Source: https://www.economicsdiscussion.net/

The experience of underdeveloped countries reveals that monetary policy plays a limited role in such countries:

The following arguments are given in support of this view.

1. Large Non-monetized Sector:

There is a large non-monetized sector which hinders the success of monetary policy in such countries. People mostly live in rural areas where barter is practised. Consequently, monetary policy fails to influence this large segment of the economy.

2. Undeveloped Money and Capital Markets:

The money and capital markets are undeveloped. These markets lack in bills, stocks and shares which limit the success of monetary policy.

3. Large Number of NBFLs:

Non-bank financial intermediaries like the indigenous bankers operate on a large scale in such countries but they are not under the control of the monetary authority. The factor limits the effectiveness of monetary policy in such countries.

4. High Liquidity:

The majority of commercial banks possess high liquidity so that they are not influenced by the credit policy of the central bank. This also makes monetary policy less effective.

5. Foreign Banks:

In almost every underdeveloped country foreign owned commercial banks exist. They also render monetary policy less effective by selling foreign assets and drawing money from their head officers when the central bank of the country is following a tight monetary policy.

6. Small Bank Money:

Monetary policy is also not successful in such countries because bank money comprises a small proportion of the total money supply in the country. As a result, the central bank is not in a position to control credit effectively.

7. Money not deposited with Banks:

The well-to-do people do not deposit money with banks but use it in buying jewellery, gold, real estate, in speculation, in conspicuous consumption, etc. Such activities encourage inflationary pressures because they lie outside the control of the monetary authority.

On account of these limitations of monetary policy in an under-developed country, economists advocate the use of fiscal policy along-with it.

Demonetization: Still Haunts Indian Economy

The Demonetization was announced as a surprise in the night on November 8, 2016. The Economic Survey of India which was released just before the presentation of General Budget 2018 in Parliament emphasized that all the negative impact of Demonetization of Rs.500/- and Rs.1000/- currency notes has ended. However, the analysis in India and abroad has claimed that demonetization of November 2016 has failed to do what it was supposed to do and its impact has turned out to be more protracted than initially expected.

Experts think that even from the point of view of promoting digital money, there was no need for the government to have put 86 per cent of all currency out of circulation. Studies have pointed out that very little black money was caught. On August 30, 2017, the Reserve Bank of India released its report on Demonetisation. The report said 99 per cent of the banned notes came back into the banking system. This belies the Government claims that the Demonetization would flush out the black money and counterfeit currency. Claiming the Demonetization as a wrong decision, as 99 per cent currency is back in the system, it points to one of the two things -

Either the black money held in cash was very low, or The government could not implement the demonetization efficiently due to which all the black money held in Rs. 500 and Rs. 1000 bank notes laundered back to the banking system.

Demonetization: Positive Impacts on Indian Economy Claimed

Economic Survey after careful review of Demonetization which was announced one and a half year back, has found that the cash-to-GDP ratio has stabilized. It suggests a return to equilibrium:

- The Economic Survey says that India's GDP is set to grow at 7 to 7.5 percent in 2018-19. This is an increase from its prediction of 6.75 percent growth this fiscal year.
- The Economic Survey has cited exports and imports data to claim that the demonetisation effect was now over. It claims that re-acceleration of export growth to 13.6 percent in the third quarter of Financial Year 2018 and deceleration of import growth to 13.1 percent is in line with global trends. This suggests that the demonetization and GST effects are receding. Services export and private remittances are also rebounding
- According to the statistics released in the Survey, the Demonetization had led to Rs 2.8 lakh crores less cash (Equivalent to 1.8% of GDP) and Rs 3.8 lakh crores less high denomination notes (Equivalent to 2.5% of GDP) in the Indian economy.

- The Economic Survey has also clarified that income tax collections have touched new high with demonetization and introduction of GST, "From about 2 percent of GDP between 2013-14 and 2015-16, they are likely to rise to 2.3 percent of GDP in 2017-18, a historic high."

Demonetization: Back ground and key facts

- On November 8, 2016, the Prime Minister of India, Narendra Modi announced the Demonetization of all Rs.500 and Rs. 1,000 denominationbanknotes of the Mahatma Gandhi Series.
- The demonetization announcement made the use of Rs.500 and Rs.1000 banknotes invalid past midnight of November 8.
- It was also announced that the new Rs.500 and Rs.2000 banknotes of the Mahatma Gandhi new series would be introduced in exchange for the old banknotes.
- The objective of demonetization as claimed by Government of India was to curtail the black money running as shadow economy and to stop the use of counterfeit cash to fund illegal activity and terrorism.
- The sudden nature of the announcement—and the prolonged cash shortages in the weeks that followed—created significant disruption throughout the economy, threatening economic output.
- The demonetization move was heavily criticized as poorly planned and unfair, and was met with protests, litigation, and strikes.

The announcement was sudden and unscheduled. It was a live television address at 8PM on November 8, 2016. In the days following the demonetisation, the country faced severe cash shortages with severe detrimental effects across the economy. People seeking to exchange their bank notes had to stand in lengthy queues, and several deaths were linked to the inconveniences caused due to the rush to exchange cash. As the cash shortages grew in the weeks following the move, the demonetization was heavily criticised by prominent economists and by world media.

Merits-Demonetization Favoured India's Economic Growth

- Demonetization policy of the Government has been termed as the greatest financial reform that aimed to curb the black money, corruption and counterfeit currency notes.
- All the people who are not involved in malpractices welcomed the demonetization as the right move.
- Demonetization was done to help India to become corruption-free as it will be difficult now to keep the unaccounted cash.
- Demonetization will help the government to track the black money and the unaccounted cash will now flow no more and the amount collected by means of tax can be better utilized for the public welfare and development schemes.
- One of the biggest achievements of demonetization has been seen in the drastic curb of terrorist activities as it has stopped the funding the terrorism which used to get a boost due to inflow of unaccounted cash and fake currency in large volume.
- Money laundering will eventually come to halt as the activity can easily be tracked and the money can be seized by the authorities.
- Demonetization aimed to stop the running of parallel economy due to circulation of fake currency as the banning of Rs.500 and Rs. 1000 notes will eliminate their circulation.
- The unaccounted cash could be deposited in the Pradhan Mantri Garib Kalyan Yojana after paying 50% tax. The money will remain deposited for 4 years with the bank without incurring any interest. However, after 4 years the amount will be returned. This amount can be utilized for social welfare schemes and making the life of low income groups better.

- The Public Sector Banks which were reeling under deposit crunch and were running short of funds have suddenly swelled with lot of money which can be used for future finances and loans after keeping a certain amount of reserve as per RBI guidelines.
- The people who opened the Jan Dhan accounts will now use their accounts and become familiar with banking activitiy. The money deposited in these accounts can be used for the developmental activity of the country.
- The tax collected due to launch of demonetization policy will be put to developmental activities in the country.
- Demonetization has driven the country towards a cashless society. Lakhs of the people even in remote rural areas have started resorting to use the cashless transactions. The move has promoted banking activities. Now even the small transactions have started going through banking channels and the small savings have turned into a huge national asset.
- The high rising price pattern and inflationary trends which the Indian economy was facing are taking a down turn making the living possible within low income group reach.

  Demerits-Blow to economic growth and inconvenience all around
  The very next day of announcing the demonetization, the BSE Sensex and NIFTY 50 stock indices fell over 6%. The severe cash shortages brought detrimental impact on the economy. People trying to exchange their bank notes had to stand in lengthy queues causing many deaths due to inconvenience and rush.
- The sudden announcement has made adverse impact on business and economy. Instead of a growing economy India has become a standstill and no growth economy. It is fearedthat a fall of 2-3% in the GDP growth will be recorded coming year.
- India is an agriculture based economy. Due to the cash crunch, the farmers especially small and marginal who largely depend on cash to buy seeds, fertilizers and to pay for sowing, borrowing water for irrigation and for other related agriculture equipments remained worst affected and could not complete the crop related activity.
- Since small branches of the banks were also not supplied with adequate cash within time of sowing season of the crop, farmers could not get their crop loans disbursed. This added to the woes of the farmers leading to a weak agriculture production the coming year.
- Real Estate sector came to a stand still and is still gasping for buyers of the constructed and half constructed inventory without buyers. This has resulted in poor cash flow leading to a poor demand.
- Demonetization has made the situation become chaotic. Tempers are running high among the masses as there is a delay in the circulation of new currency.
- Due to the inability to pay cash to poor daily wage workers, the small employers have stopped their business activity.
- The poor planning on the part of the government has also added to the woes of the common people with low incomes. The Rs.2000 currency note does not find many takers as it is difficult to get the balance back when you are buying daily needs like vegetables, milk, bread or paying for petty expenses like bus fare. While rs.100 currency notes were not available in sufficient number, Rs.500 note arrived in the market very late.
- Demonetization is the 2 way sword in regard to incurring the public expenditure. On the one hand huge cost is to be incurred on printing the new currency and on the other hand managing the lakhs of crores of old currency volume has also become a big expenditure incurring item.
- Many Economists are of the view that Rs.2000 currency note will be much easier to hide and can be used to store black money in shorter space.

- Entire opposition has stood against demonetization and has called this decision a draconian law.

Demonetisation: Success points

India has marched on the path of digital transactions at a much faster pace. Key points describing success of demonetisation are:

Rate of Inflation goes down

Prices of commonly consumed commodities like Pulses, fruits, vegetables had gone down substantially post demonetization. Accordingly it brought down the rate of inflation during the months that followed demonetization.

India moves to cashless economy

One of the key effects of Demonetization 2016 has been that more people have made digital payments part of their lives moving towards a cashless economy. The details of growth of such digital transactions since January 2016 to August 2017 reflect that NEFT transactions that involved Rs. 7086 bn increased to Rs.12500 bn; Debit cards transactions increased from Rs.2328 bn to Rs. 2700 bn; credit cards from Rs. 214 bn to Rs.366bn and the IMPS transaction which was not used by the people, got a share of Rs.651 bn.

Stock Market gets bullish

After demonetization stock market in India got bullish. While BSE index which was 27, 459 on November 7, 2016 rose to 33680.92 on November 6, 2017, the NSE rose from 8497 to 10,443.

Banks' lending increases for small businesses

Banks' finance to small business was going down in pre-demonetization period. There was a negative growth even in short period of months. As on November 25, 2016, a negative growth of -7.71% was recorded in Banks' lending to small business. It went to -8.16% as on December 23, 2016. However, as on September 29, 2017 the Reserve Bank of India has reported a positive growth of 1.65% in lending to small business by the Banks.

Automobile sales picked up

Sale of 2 wheelers and 4 wheelers was showing a negative growth in 2016. In 2017 it went up substantially and recovered from the impact of negative growth to high positive growth as reflected in the report.

More people use Mobile wallets than cash

Instead of using cash, more people have started using Mobile wallets for making payments for their regular needs. Even less educated people have learned and switched over to mobile transactions. The volume of transactions which was Rs.22.14 bn in January 2016, had gone up to Rs. 83.53bn in January 2017.

Failures of Demonetization

Economic Growth slows down

Post demonetization growth of Indian Economy slowed down from 9.1% to 5.7% in less than one year. Month-wise GDP growth chart for the period March 2016 to September 2017

Realty sector bears the brunt

The triple decisions of demonetisation, RERA and GST resulted in a deceleration of new property launches. The supply of new housing units in the top-6 cities in India during the first three quarters of 2017 was down by around 60 per cent, compared with the corresponding period of 2016.

With respect to property sales, the secondary market was obviously highly susceptible to demonetisation as compared to the primary market. Property transactions in the secondary sales

and luxury housing segments tended to have significant cash components, and such sales have been hampered significantly due to demonetization.
However, the shadow of Demonetization now appears to be fading in reality sector. The prevailing attractive home loan rates, flexible payment plans and other attractive offers by developers, coupled with restricted new supply addition, has led to a steady decline in the unsold inventory.

As of Q3 2017, only 6,38,500 units remained unsold in the top-6 cities, registering a 9 per cent decline from Q4 2016 levels. The demand for affordable and mid-segment housing has been on a rise.

Initiatives such as interest waivers on home loans, the government's push for affordable housing through Pradhan Mantri Awas Yojana (PMAY) and the 'Housing for all by 2022' mission have come to the forefront over the past one year. Various policy initiatives, amendments and reforms were all aimed at making the real estate sector more transparent, organised and fundamentally stronger. Demonetisation played a significant role in this process.

In the long term, the real estate sector is likely to regain a faster growth trajectory and is estimated to contribute around 13 per cent to India's gross domestic product by 2028. This optimistic forecast is very much attainable because the various reforms now redefining the realty landscape in India will not only incrementally boost consumer sentiment but also improve investment inflows from foreign and domestic institutional investors.

The Finance Minister Arun Jaitley on November 7, 2017 came out with a spirited defence of demonetisation announcement on November 8, 2016 calling it a "watershed moment for the Indian economy". According to him the demonetization has not only changed the agenda but also made corruption difficult. Thus, in his opinion, it was not only a "morally and ethically correct" step but also "politically correct".

Source: https://www.mbauniverse.com/