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Monetary Policy of RBI and its Latest Review

ABSTRACT

The third quarter review of monetary policy the main challenge of RBI to control the inflation without hearting the growth. In the Q2 review RBI increase the SLR (statutory liquidity ratio) 24 per cent to 25 per cent . Q3 review RBI policy action a 75 basis point increase in the CRR (cash reserve ratio) in two stages and no change in repo rate and the reverse repo rate. The increase of cash reserve ratio 36,000 crore of excess liquidity will be absorbed from the system. The result of CRR increase may be reduction in excess liquidity, to maintain an interest rate environment consistently, and actively manage liquidity to productive sector. We think that action of RBI is the best in present scenario and the RBI achieved the desired expectation.

1. INTRODUCTION

The Monetary Policy is the management of money supply for price stability in the economy. On behalf of Government the central bank i.e RBI regulates the supply of money and credit. In Monetary Policy, issue of currency, control of bank credit, control of foreign exchange, control of inflation etc are included. With the introduction of the Five Year Plans the need for appropriate adjustment in Monetary and Fiscal Policies to suit the pace and patten of planned development became imperative . The Monetary Policy since 1952 emphasised the twin aims of the economic policy of the Government as: i) Speed-up economic development in the country to raise national income and standard of living, and ii) To control and reduce inflationary pressure in the economy.

This policy of RBI since 1952 was termed, broadly, as one of controlled expansion i.e a policy of adequate financing of economic growth and at the same time ensuring reasonable price stability. This policy continued till 1972. After 1972, RBI adopted anti. Inflationary Monetary Policy because the Indian economy has been working with considerable inflationary potential, rapid increase in money supply with the public and with the banking system. There was also expansion of bank credit to finance trade and industry. A serious inflationary situation was emerging from the beginning of 1970's. This was fuelled by frequent fluctuation in agricultural production . So RBI was forced to abandon ' controlled expansion' and adopt the policy of credit restraint.

2. TOOLS OF CREDIT CONTROL

They are brodly of two types:- quantitative and qualitative. Quantitative controls are used to control the volume of credit and indirectly control the inflationary and deflationary pressures caused by expantion and contraction of credit. Quantitative controls are also known as general credit controls. They are :-

a) Bank Rate- Bank rate is the minimum rate at which the RBI provides loan to commercial banks. Any change in bank rate will impact credit increase or decrease in system. A change in bank rate will result in a change in prime lending rate (PLR) of banks and thus act as an instrument of monetary control. Since 1950 it is between 3 to 15 per cent.

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b) Cash Reserve Requirement (CRR)- Another weapon available to RBI for credit control is the use of variable cash reserve requirements. Under the RBI Act 1934 every commercial bank has to keep certain minimum cash reserve with RBI- initially it was 5 per cent against demand deposits and 2 percent against time deposits. There are known as statutory cash reserves. Since 1962, RBI was empowered to vary the cash reserve requirement between 3 to 15 per cent of the total demand and time deposits.

c) Statutory Liquidity Requirement (SLR)- Apart from CRR which banks have to keep with RBI under RBI Act 1934, all commercial banks have to maintain u/s 24 of the Banking Regulation Act, 1949 liquid assets in the form of cash, gold and unencumbered approved securities equal to not less than 25 per cent of their total demand and time deposit liabilities. This is known as statutory liquidity requriment.

d) Repo Rate (Repurchase Option Rate) - Repo rate provides short term liquidity facility to one bank to another bank against government securities. RBI utilizes this weapon to control credit by increasing or decreasing this rate.

e) Reverse Repo Rate- It is an agreement between RBI and commercial banks. RBI sells the securities to reduce the excess liquidity and in future it can repurchase the securities from banks. In this process the interest which is given by RBI to the banks is called reverse repo rate.

f) Open Market Operations (OMO)- In economies with well developed money markets, central banks use open market operations i.e buying and selling eligble securities by the central banks in money market to influence the volume of cash reserves with commercial banks and thus influence the volumes of loans and advances they can make to the industry.

3. SELECTIVE AND DIRECT CREDIT CONTROLS

Under the Banking Regulation Act, 1949 sec. 21 empowers RBI to issue directive to the banking companies regarding their advances. These directives may relate to: a) the purpose for which advances may or may not be made; b) the margins to be maintained in respect of secured advances; c) the maximum amount of advance to any borrower; d) the maximum amount upto which guarantees may be given by the banking companies on behalf of any firm, company etc; and e) the rate of interest and other terms and conditions for granting advances.

RBI had made full use of sec. 21 to check speculation and rising prices. The controls are selective as they are used to control and check the rising tendency of the prices of certain individual commodities of comman use. RBI took this weapon in 2008 to check speculation in Stock market to raise the margin.

4. IMPACT OF LATEST MONETARY POLICY REVIEW

RBI reviews Monetary Policy every quarter. It reviewed its Q3 policy in Jan 2010. There was no change in Bank Rate, SLR, Repo and revese repo rate except CRR. RBI increased CRR by 0.75 per cent in two stages. After review we are underlining the favourable and chalenging points for the Indian economy.

5. FAVOURABLE IMPACT

a) GDP Growth- India – In Q2 review of monetary policy the target of GDP Growth For 2009-10 at 6 per cent with as upside bias. During the Q2 of 2009-10 the Indian economy showed better than expected growth of 7.9 per cent. In this tremendous growth public expenditure continues to play a dominant role including the government

expenditure. In 2009-10 Agriculture grew a near zero and continued recovery in industrial production and service sector activity. During 2009-10 real GDP Growth accelerated from 6.1 per cent in Q1 to 7.9 percent in Q2 driven by revival in industrial growth and pick-up in services sector growth aided by payment of arrears arising out of the sixth pay commission award. Q2 GDP numbers as a result of the improvement in the global economic situation, Exports expanded in November 2009, after contracting for 13 straight months. In Dec 2009 export grew 9.3 per cent suggesting the country's trade was coming out of the recession. Imports which are a reflection of domestic economy activity turned positive after falling for 11 months registering an impressive growth of 27.2 per cent in dec 2009. This positive trend is expected to persist. Cement sector growth returned to double digit in Dec. on the back of rising. According to number released by SIAM (Society of Indian Automobile Manufacturers) the Indian auto industry has made a super recovery in the April to Dec. 09. Rising auto sales are usually indication of healthy recovery.

b) GDP Growth- Global – The global economy is showing increasing sign of stabilization during the quarter third and quarter Fourth 10. The IMF reduce the projected rate of Economic contraction in 2009 from 1.1 per cent made in October 09 to 0.8 per cent in the latest world economic outlook update released on 26 January 2010. The IMF has also revised the projection of global growth for 2010 to 3.9 per cent up from 3.1 percent (Table-2). The IMF has also revised upwards its projection of the real GDP growth of emerging and developing economies for 2009 to 2.1 per cent from its earlier number of 1.7 per cent the estimatesare even more optimistic for 2010.

c) Capital Inflow- The revival in capital flows which started in financial year 2009-10 and gathered momentum in the second and

Table- 1

(India GDP constant 1999-2000 prices) (Y-o-Y)

Period	GDP Growth in per cent
Apr - Jun 08	7.80
July - Sep 08	7.70
Oct - Dec 08	5.80
Jan - Mar 09	5.80
Apr - Jun 09	6.10
July - Sep 09	7.90

Source- Bloomberg.

Table- 2

Projected Global GDP Growth (%)

Country	2009	2010
US	(-) 2.5	2.7
UK	(-) 4.8	1.3
Euro Area	(-) 3.9	1.0
Japan	(-) 5.3	1.7
China	8.7	10
India	5.6	7.7
Emerging and Developing	2.1	6.0
Economies World	(-) 0.8	3.9

Source:World Economic Outlook Update, IMF, 26-1- 2010.

Table- 3

ECBB, FCCB (in $ million)

Month	ECB	FCCB
April 09	286.13	12.50
May 09	433.29	61.00
June 09	1919.4	-
July 09	1924.22	90.00
August 09	1074.57	15.00
Sepetember 09	1334.57	175.00
October 09	71072	1875.00
November 09	948.67	1405.00

Source- SEBI

Table- 5

Inflation

Month	Inflation Percent
Oct. 09	1.34
Nov. 09	4.80
Dec. 09	7.30

Source- RBI

third quarter. In the period From april 09 to 15 Jan 10 net FII inflow increased to $24.7 billion from $ 12.1 billion in the same period last financial year. The value of ADRs and GDRs nearly tripled to $3.1billion in April-Nov. 2009 compared to $1.1billion in the same period last financial year. Inflows under net external commercial borrowings however remained low during the period.

6. CHALLENGES

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a) Inflation- For several months rising food inflation has been a cause of concern. Food inflation has two reasons one the supply side and second the price of commodity rise in international market. Food inflation is begining to spill over into other commodities and services. In Q2 RBI projected WPI inflation for end march 2010 of 6.5 per cent with an upside bias. In the Q3 review RBI Projected WPI for end march 2010 is now 8.5 per cent. When crude oil price jumps in upside in international market then inflation is a big trouble. From the month of October 09, the inflation data(WPI) released on monthly basis but the Whole sale Price Index for essential commodities data issued every week. From the month of October 09, the inflation data(WPI) released on monthly basis but the Whole sale Price Index for essential commodities data issued every week.

b) Credit Growth- For the first time since april 1997 growth in bank credit has dropped to single digit levels for the year upto October 23, bank credit flow by 9.65 per cent. This is the slowest pace of increase since 25 april 1997 when the growth rate was 9.61 per cent. Upto 15 January 13.88 per cent credit growth reported by RBI . Its means turnaround credit growth. In Q3 review RBI lower the credit growth estimates for 2009-10, 16 per cent from 18 per cent. At the start of the financial year RBI had projected a credit growth of around 20 per cent for the year ending march 10. The gap between sanctions and disbursals went up, then the RBI to revise the estimate to 18 per cent during the Q2 review . Same deposit growth estimates for 09-10 to 17 per cent from 18 per cent. The reason of low credit growth is also the corporate sector flow of resources from other route such as commercial paper and other forms of corporate debt issued to mutual fund .NBFC, Insurance companes, Private equity placements to qualified institutional buyers, Foreign direct investment, some equity issued in overseas markets in the form of American depositary receipts and Global depository receipts and some External commercial borrowings, FCCBs and NCDs.

c) Government Borrowing- RBI expected the centre's gross borrowings to go beyond this year (2009-10) level of 4,51,000 crore . Governer RBI said " we believe that the absolute amount of borrowing in net terms will be congruable to the absolute amount amount of borrowing this year. In gross terms, it may be slightly higher because of the redemption." The RBI Governor said that there would be a challenge as the central bank had limited room for liquidity management.

7. CONCLUSION

From the above information, it may be said that there are many challenges before the nation in the form of price rise, streamline the growth, capital inflows, FDI credit growh etc. but the significant challenge was to control inflation without hearting the growth story of India and we think that the step taken by RBI to increase CRR and not touching other tool of Monetary Policy was good and worth paising. It will control the inflationary pressure on one hand and on the other hand, it will not restrict or hurt our growth.

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