

ed steadily. Now the RBI performs promotional functions as would be seen below:

#### **savings and extending banking**

RBI's functions are not confined to restrictive controls over the banks. To mobilise savings through various institutions for productive purposes. To give more power, RBI has been putting pressure on banks to open their branches in rural areas. This has reduced the dependence of rural areas on indigenous bankers and has helped them to adjust their activities according to the needs of their customers, particularly at small banks. Small banks have also done several useful practices.

#### **protection to depositors.**

A major obstacle to the growth of banking in India was frequent bank failures. Lack of insurance in mobilising deposits. The objective of providing security to depositors led to the establishment of the Deposit Insurance and Credit Guarantee Corporation in 1962. In order to mobilise savings, the RBI played a key role in the establishment of the Small Finance Banks in 1964. To small investors the advantages of reduced risk, and expert management.

#### **agricultural credit institutions.**

Institutional agricultural credit has been provided by the RBI from its very inception. In fulfilment of its statutory obligation ever since its inception, during the 1960s and 1970s it has been developing agricultural credit. It has participated in the establishment of the Agricultural Credit Corporation and Development Corporation (ACCDC). The National Bank for Agriculture and Rural Finance (NABARD) was set up on July 12, 1975. Capital has been provided by the Government and taken over the entire undertaking.

#### **development of specialised financial institutions.**

Though development of financial institutions has not been a statutory requirement in the context of planned economic development, it is of great importance. Obviously of all factors, capital is of crucial importance. Commercial banks avoid giving long-term loans. This financial requirement of the economy has led to the establishment of specialised institutions of financial institutions. Since India got Independence, there was a need to develop financial institutions. Thus, at the initiative of

the Central government, the RBI actively participated in establishing various specialised institutions of industrial finance, including the Industrial Finance Corporation of India and the State Financial Corporations. The Industrial Development Bank of India was set up as a subsidiary of the RBI. However, later on it was made an autonomous institution.

**5. Advisor to the government.** We have earlier pointed out that the RBI, besides being a controller of credit, is also an advisor to the government. The significance of the RBI's advisory function has considerably increased in the context of government's attempts to accelerate the development process in the country. The Central government asks for its advice not only on financial matters, but also on general economic problems. As such, it plays a useful role in the development process of the country.

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### MONETARY POLICY OF THE RESERVE BANK OF INDIA

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*The monetary policy refers to a regulatory policy whereby the central bank maintains its control over the supply of money for the realisation of general economic goals.* This concept of monetary policy may be right in the context of developed economies, but in less developed countries like India, monetary policy cannot remain confined only to controlling the supply of money. In other words, monetary policy, if it does not play any positive role, will serve only a limited purpose. Viewing the Reserve Bank's monetary policy in this framework we find that it has been designed to meet the particular requirements of India's developing economy. Aptly summarising the RBI's monetary policy, S.L.N. Simha has stated, "The Reserve Bank's responsibility is not merely one of credit restriction. In a growing economy there has to be a continuous expansion of money supply and bank credit and the central bank has the duty to see that legitimate credit requirements are met. The Bank's responsibility in the circumstances is mainly to moderate the expansion of credit and money supply, in such a way as to ensure the legitimate requirements of industry and trade and curb the use of credit for unproductive and speculative purposes. That is why the Bank has rightly called its credit policy in recent years as one of controlled expansion."<sup>3</sup>

*The Chakravarty Committee had emphasised that price stability, growth, equity and social justice, promoting and nurturing new monetary and financial institutions are important objectives of monetary policy in India.* The difficulty in formulating and implementing monetary policies arises from the trade offs among various objectives which need to be evaluated on a continuous basis. This cannot be

done independently by the RBI. The RBI's monetary policy has to subserve the national economic and social objectives as enunciated from time to time in the Five Year Plans. This puts an unusual constraint on the monetary policy options of the RBI. The inflationary pressures in India have often warranted a check on growth of money supply, but the need to prevent the adverse effects of restricting the flow of bank credit on economic growth has dissuaded the RBI from taking action on a scale warranted to achieve the desired stability in prices. Thus in a country like India the thrust of monetary policy cannot be restricted to regulation of money supply alone. Nonetheless, it has to be admitted that the price stability and economic growth should be the two basic objectives of the economic policy in India and regulation of money supply is necessary to achieve these objectives.

Y. Venugopal Reddy has however remarked, "*In India, monetary policy has always emphasised the objectives of price stability and growth. What this, in effect has meant in practical policy setting is formulating a balance between the two objectives depending on the evolving situation but in the broad context of keeping the inflation rate within a reasonable bound.*"<sup>4</sup> Critics have sometimes argued that commitment to price stability is not demonstrable in the absence of inflation targeting. However, according to Reddy, "The position of the RBI has been that the commitment to price stability in India must be derived from three sources — policy statements, policy actions and, above all, the policy outcomes."<sup>5</sup>

*In order to ensure RBI's complete control over the supply of money and credit, it has been given exclusive power to issue currency notes.* For judging how far the RBI has succeeded in achieving this objective, one has to know the relative importance of various types of money in circulation in the country. In certain countries, the legal tender money (coins and paper money) is the predominant medium of exchange. In other countries, the place of legal tender money is relatively secondary and most payments are made through cheques. Whereas the former type of monetary system is to be found in France, the latter is to be found in England and the United States. The nature of the monetary system in India due to predominance of legal tender money thus resembles the French monetary system rather than the British or the American.

The Urjit Patel Committee Report submitted in January 2014 advocated the adoption of a policy of inflation targeting. Such targeting "tasks monetary policy to achieve price stability as an unambiguous and sustainable goal which the private sector can anchor its expectations about future inflation".<sup>6</sup> In accordance with the recommendations of the Committee, the Reserve Bank of India and the Government

of India signed an agreement on February 20, 2015. *This agreement has put in place a monetary policy framework which makes flexible inflation targeting the official goal of the central bank.* The Reserve Bank of India (RBI) Act, 1934 was amended in May 2016 to provide a statutory basis for the implementation of the flexible inflation targeting framework (for details on inflation targeting, please see the section 'Inflation Targeting: Urjit Patel Committee Report' of Chapter 44).

**The Monetary Policy Process.** Section 45ZB of the amended RBI Act, 1934 provides for an empowered six-member Monetary Policy Committee (MPC) to be constituted by the Central Government by notification in the Official Gazette. Accordingly, *the Central Government in September 2016 constituted the MPC.* The MPC determines the policy interest rate required to achieve the inflation target. The Reserve Bank's Monetary Policy Department (MPD) assists the MPC in formulating the monetary policy. The Financial Markets Operations Department (FMOD) operationalises the monetary policy, mainly through day-to-day liquidity management operations. The Financial Markets Committee (FMC) meets daily to review the liquidity conditions so as to ensure that the operating target of monetary policy (weighted average lending rate) is kept close to the policy repo rate.

Before the constitution of the MPC, a Technical Advisory Committee (TAC) on monetary policy with experts from monetary economics, central banking, financial markets and public finance advised the Reserve Bank on the stance of monetary policy. However, its role was only advisory in nature. With the formation of MPC, the TAC on monetary policy ceased to exist.

**Money Supply in India.** In India, presently both currency notes and cheques are used for payment purposes — coins constitute a very small part of money supply in the country and they are now used for making small payments. As on March 31, 2016, the total money supply ( $M_1$ ) in the country was ₹ 26,10,567 crore.  $M_1$  is money supply in the narrow sense. It includes (i) currency with the public, (ii) demand deposits with banks, and (iii) other deposits with the Reserve Bank of India. The last one is a very small component of  $M_1$  and is thus not considered in any monetary analysis. As on March 31, 2016, the amount of currency with the public was ₹ 15,98,095 crore and demand deposits had amounted to ₹ 9,97,021 crore. The currency with the public and the demand deposits with the banks thus accounted for 61.2 per cent and 38.2 per cent of the money supply ( $M_1$ ) respectively. Other deposits with the RBI were only 0.6 per cent of  $M_1$ . Nowadays a broader concept of money supply, that is  $M_3$  is used.  $M_3$  includes  $M_1$  and time deposits with banks. As on March 31, 2016, the amount of  $M_3$  was

₹ 1,16,54,339 crore of which time deposits with the banks were ₹ 90,43,773 crore.

In monetary economics, *control of money supply usually refers to control of the supply of currency and deposit money.*

### CONTROL OF CURRENCY BY THE RESERVE BANK OF INDIA

*By control of currency, we generally mean the control over the supply of currency notes and coins.* As mentioned earlier, coins constitute a very small part of money supply in the country and special measures are not needed to regulate its quantity. Regulation of the quantity of currency notes is, however, very important and the RBI enjoys monopoly power to issue them. There is a separate Issue Department in the RBI for issuing currency notes. The RBI can issue any amount of notes on the basis of reserves maintained in the form of gold bullion, foreign securities, rupee coins, rupee securities and Treasury bills. The only condition that has to be satisfied is that at no time the gold and foreign exchange reserves should fall below ₹ 200 crore, of which gold reserve must always be of ₹ 115 crore. This system of note issue inherently suffers from inflationary tendency.

The mechanics of note issue is rather simple. When the RBI wants to issue currency notes, it generally transfers either foreign securities or rupee securities or both from the Banking Department to the Issue Department. It has to be mentioned in this context that the amount of note issue will be equal to the amount of securities received by the Issue Department from the Banking Department. The RBI is empowered to issue notes also on the basis of reserves maintained in the form of Treasury bills. When the RBI pursues contractionary policy, it reverses the above process. The securities are transferred from the Issue Department to the Banking Department, and the currency notes of an equal amount are withdrawn from circulation. The success of the RBI in regulating the supply of currency has been doubted by many. It is argued that the rampant inflation over the years is a distinct indication of its failure in this regard. Some other economists contest this view and hold the government responsible for the inflation. In their opinion, as the RBI is completely subservient to the government, it could not pursue an independent policy when the government recklessly indulged in deficit financing under various Plans.

In the USA, the central bank (the Federal Reserve System) is an autonomous institution and is thus the sole monetary authority. The situation is, however, different in India. The RBI which is the central bank in this country is not a completely autonomous monetary institution. It is

under a statutory obligation to lend any amount of money that the Central government decides to borrow from it. Though the State governments are not empowered to borrow from the RBI, they nonetheless draw unauthorised overdraft from the RBI with impunity. The role of the RBI as the monetary authority has thus been undermined by the government. In practice, there are two monetary authorities in this country. These are the Central government and the RBI. Between these two, the Central government is more powerful.

### THE RESERVE MONEY (RM)

In order to understand the role of the various monetary institutions and the government in determining the supply of money, it is necessary to understand the concept of the reserve money and the money multiplier process.

#### The Reserve Money and Money Multiplier

*The reserve money is often referred to in monetary economics as high powered money, basic money, primary money or monetary base. The ability of the banking system to create deposit money depends on the amount of reserve money available and the portion of it which public holds in the form of currency.* In India, the reserve money represents those liabilities of the RBI and the government which are considered to be eligible as reserves to be held by banks for the purpose of deposit money creation. Generally, currency liabilities of the RBI and the Central Government are considered eligible for being held as bank reserves to support deposit money creation. While the currency liabilities of the RBI consist of currency notes (excluding one rupee notes) the currency liabilities of the Central government consist of rupee coins and notes and small coins. Coins are not the liabilities of the RBI. The RBI performs only the task of issuing them on behalf of the government. Currency liabilities of the RBI and the government are thus the sum total of currency with the public, banks' reserves consisting of cash with banks and bankers' deposits with the RBI and 'other' deposits with the RBI. 'Other' deposits with the RBI are liabilities of the RBI to the non-bank sector and are thus in their character equivalent to currency with the public. They are very much relevant to deposit money creation. Hence, in India, the components of the reserve money are: (i) currency in circulation, (ii) bankers' deposits with the RBI and (iii) other deposits with the RBI. In India, currency in circulation is the biggest component of the reserve money. The share of currency in circulation was 63.0 per cent in the total reserve money on March 31, 1991. It rose to 76.3 per cent on March 31, 2016. Bankers' deposits with the RBI is the other important component of

the reserve money. Its share in the reserve money was 36.2 per cent on March 31, 1991. It, however, declined to 23.0 per cent on March 31, 2016. 'Other' deposits with the RBI is a relatively smaller component of the reserve money. It accounted for 0.7 per cent of the reserve money on March 31, 2016.

Having discussed the concept of the reserve money, its various components and the rates at which it has grown since April 1991, it would be pertinent to explain the roles of various monetary institutions in its creation. In India, currency consists of currency notes and coins. Currency notes constitute the bulk of the currency in circulation and are being issued by the RBI. In contrast, coins and one rupee notes which are being issued by the Central government constitute a very small portion of the amount of currency in circulation. This fact leaves the impression that the RBI is the major monetary authority in this country. This, however, is not correct. In the formal sense, the RBI is the currency notes issuing authority. But since it is under a statutory obligation to buy all the Treasury bills which are being offered to it by the Central government, the latter has become the real monetary authority in the country. The bankers' deposits with the RBI are not made voluntarily by the banks. Their amount depends on the statutorily determined cash reserve ratio and the amount of demand and time liabilities of the banks. Hence, banks' role in creating reserve money is rather passive. They, however, remain a major monetary institution by virtue of being the creator of deposit money. The ability of the banking system to create deposit money depends on the amount of reserve money and portion of it which the public holds in the form of currency. Thus, bank reserves have a residual character. Another factor which determines the ability of the banking system to create deposit money is deposit multiplier, which depends on the currency-deposit ratio and the required reserve-deposit ratio.

The currency-deposit ratio in India was 1.35 at end-March 1956 (deposits in this computation represent aggregate deposits which are defined as demand deposits plus time deposits). Since then it has steadily declined to 0.16 in 2015-16. This steep fall signified the growth of bank deposits resulting from the rapid growth of banking facilities. The money multiplier (defined as  $M_3 + M_0$  where  $M_3$  is broad money and  $M_0$  is reserve money) had, therefore, risen from 1.60 at end-March 1956 to 5.3 at end-March 2016.

### CONTROL OF CREDIT BY THE RESERVE BANK OF INDIA

*In India, the legal framework of the RBI's control over the credit structure has been provided under the*

*Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949. The RBI has been empowered to use almost all the traditional instruments of credit control under the former; the latter has given it additional powers to use some other direct methods of credit regulation. If we consider the combined legal provisions under the two Acts we find that the RBI's powers to control the banking system are fairly comprehensive. Like any other central bank, the RBI resorts to bank rate manipulations, open market operations, reserve requirement changes, direct action, rationing of credit and moral suasion. Apart from employing these traditional methods of credit control, it directly influences commercial banks' lending policy, rates of interest, form of securities against loans and portfolio distribution.*

*However, the RBI's control over the supply of credit is rather weak in spite of the wide powers enjoyed by it. The main reason for this appalling state of affairs is the underdeveloped character of the Indian money market. As pointed out earlier, the traditional sector which includes indigenous bankers and moneylenders as the constituents, is completely out of its control. Whatever limited success the RBI has achieved in the past is mainly on account of its control over the modern sector of the money market. In the following pages, we shall consider the effectiveness of various techniques of credit regulation in India.*

### The Bank Rate Policy

*Bank rate is the re-discounting rate that RBI extends to banks against securities such as bills of exchange, commercial papers and any other approved securities. The effectiveness of the bank rate policy depends mainly on three factors: (i) that the commercial banks in the country should not be averse to availing rediscounting facility from the central bank; (ii) that banks do not maintain any excess cash reserve against deposits and thus if extraordinary demands are made by the depositors, they have no option except that they rediscount bills from the central bank; and (iii) that banks must hold adequate quantity of such credit instruments which will be rediscounted by the central bank as per the legislation. Last two conditions are not satisfied in India. In the first place, the commercial banks in India are not much dependent on the RBI for financial assistance. Secondly, in the absence of a well organised bill market they lack adequate quantity of eligible bills which can be rediscounted from the RBI. Proper organisation of the various components of the money market is a prerequisite for the success of the RBI's bank rate policy.*

*The bank rate was 10 per cent during the 1980s. It was raised to 11 per cent effective from July 4, 1991 and further to 12 per cent effective from October 8, 1991. This was believed to be necessary to counteract the inflationary*

pressure. However, under the conditions that prevailed in India, the bank rate changes were not a very efficient method to regulate the supply of credit and money. This limitation of the bank rate was often underlined by the experts in this area. Making his observations on the effects of the RBI's bank rate changes on the Indian money market and the amount of credit, B. Rama Rao, a former Governor of the RBI, had stated, "The increase in the bank rate was intended to be a warning signal, for apart from its psychological effect, I doubt if under Indian conditions a slight increase of the rate can have any appreciable influence on inflationary situation."<sup>37</sup>

Bank rate is currently 6.25 per cent. As a policy rate, it is now defunct and the RBI now focuses only on one policy rate — repo rate.

### Open Market Operations

The technique of open market operations as an instrument of credit control was developed much later. In fact, the need for open market operations was felt only when the bank rate policy turned out to be a rather weak instrument of monetary control. Some monetary economists and bankers assert that bank rate policy and open market operations are complementary measures in the realm of monetary management. In India whereas bank rate changes were found to be rather ineffective due to the underdeveloped nature of the money market, importance of open market operations has always been recognised. As the government securities market is fairly well developed in the country, the environment for open market operations is quite favourable. At present the RBI Act authorises the RBI to conduct purchase and sale operations in the government securities, treasury bills and other approved securities. The RBI is also empowered to buy and sell short-term commercial bills. In India, since government securities are predominantly held by institutional investors, notably banks and insurance companies, dealings of the RBI in regard to open market operations are mostly confined to them.

Theoretically, the technique of open market operations is superior to bank rate policy. For the success of open market operations, the central bank has not to depend on the co-operation of commercial banks as it happens in the case of bank rate policy. Retaining initiative in its own hands, it can influence the reserve position of the commercial banks and thereby their capacity to advance credit. Open market operations are also considered superior to both CRR and SLR because they can be used as and when need arises whereas CRR and SLR are only altered in RBI's bi-monthly policy review. They are also long-term in nature since the securities sold or bought have maturities which are more than a year while a small hike in either the CRR or the SLR

would have only short-term effects. Moreover, while CRR and SLR are dependent on consumers as they are calculated with respect to the net demand and time liabilities (NDTL) (that includes savings accounts, fixed deposits, etc.), open market operations do not have such constraints. On account of reasons such as these, Federal Reserve of New York has observed that "Open market operations are by far the most powerful and flexible tool of monetary policy".

### The Cash Reserve Ratio

The cash reserve ratio (CRR) is a portion of the banks' NDTL (net demand and time liabilities) or deposits that they are required to maintain with the Reserve Bank in their specified current accounts. This money earns no interest. CRR, which is maintained on a fortnightly basis, is a tool that the central bank uses to manage money supply and liquidity in the market. A high CRR means banks have less to lend, which curbs liquidity; a low CRR does the opposite. Under the RBI (Amendment) Act 1962, the RBI is empowered to determine CRR for the commercial banks in the range of 3 to 15 per cent for the aggregate demand and time liabilities. This technique of credit control was used quite often during the 1970s and 1980s for controlling inflation. In the late 1980s, there was rapid growth of liquidity and thus the CRR was raised from 10 per cent to 15 per cent. For four years, the CRR remained unchanged at 15 per cent (this meant that for every ₹ 100 deposit that a bank held, ₹ 15 had to be kept aside with RBI).

The Narasimham Committee which submitted its report in November 1991 did not favour use of CRR to combat inflationary pressures. In its opinion, a high CRR adversely affected bank profitability and thus pressured banks all the time to charge high interest rates on their commercial sector advances. The CRR was thus brought down from a peak of 15 per cent in 1994-95 to 8.0 per cent in 2000-01. In October 2001, it was reduced to 5.5 per cent. CRR was reduced to 4.5 per cent effective from June 14, 2003. All these reductions of CRR freed cash balances and the lendable resources of the commercial banks. However, in a bid to control inflationary tendencies in the economy, the CRR was subsequently raised in stages. The final increase was made in August 2008, when CRR was raised to 9.0 per cent. Thereafter, it was again reduced in stages. The final reduction was carried out on February 9, 2013 when CRR was brought down to 4.0 per cent.

### The Statutory Liquidity Ratio

Apart from keeping a portion of deposits with the RBI as cash, banks are also required to maintain a minimum percentage of their deposits with them at the end of every business day, in the form of gold, cash, government bonds, or other approved securities. This minimum percentage is

called the statutory liquidity ratio (SLR). In monetary jargon, SLR is the percentage of net demand and time liabilities (NDTL); in other words, bank deposits, that must be used to buy specified assets. *The current SLR ratio is 20.0 per cent which means that for every ₹ 100 deposited in a bank, it has to invest ₹ 20.0 in any of the asset classes approved by RBI.*

**CRR vs. SLR.** While CRR is maintained in cash with RBI, SLR is maintained in liquid form with banks themselves in the form of gold or approved government securities. The purpose of maintaining SLR with banks themselves is to ensure that they can meet any unexpected demand from depositors at short notice by selling the bonds. Another difference between CRR and SLR is that while banks earn interest on their SLR deposits, they do not earn any returns from the money parked in the form of CRR. However, both CRR and SLR are reserves. A higher reserve requirement through either of them reduces the resources available with a bank to lend.

The Banking Regulation (Amendment) Act 1962, provided for maintaining a minimum SLR of 25 per cent by the banks against their NDTL (net demand and time liabilities). The Amendment Act also empowered the RBI to raise the SLR upto 40 per cent if it is considered necessary to control liquidity. The RBI used this power to raise SLR quite often during the 1970s and 1980s. Effective from September 22, 1990, SLR was made as high as 38.5 per cent of the commercial banks' net demand and time liabilities. The SLR remained at this level upto March 31, 1992. There were two reasons why the RBI had raised the SLR for banks. First, it reduced commercial banks' ability to create credit and thus eased inflationary pressures. Secondly, it made larger resources available to the State.

The Narasimham Committee did not favour maintenance of a high SLR. In its opinion, the SLR had become an instrument in the hands of the government to mobilise resources in support of the Central and State budgets. Keeping in view the recommendations of the Narasimham Committee, the government decided to reduce SLR in stages from 38.5 per cent to 25 per cent. The SLR was lowered down to 25 per cent effective from October 10, 1997. Thereafter, it was again reduced in stages and *presently stands at 20.0 per cent.*

### Selective Credit Control

Selective credit controls are generally meant to regulate credit for specific purposes. In a developing economy where frequent use of quantitative techniques of credit control may jeopardise development efforts, selective credit controls can be safely introduced to check misuse of borrowing facilities. *The RBI, like many other central*

*banks in various countries, has been empowered to use selective credit controls to regulate credit to specific branches of economic activities.* Thus, it can prevent speculative hoarding of essential commodities and check undue rise in the prices. However, prior to May 1956, the RBI never introduced selective credit controls, though the speculative hoarding of foodgrains and essential raw materials causing steep rise in their prices warranted them.

The RBI relied mainly on three techniques of selective credit controls, viz., the determination of margin requirements for loans against certain securities; determination of maximum amount of advances or other financial accommodation; and charging of discriminatory interest rates on certain types of advances. Apart from these measures the RBI may give directions to banks in general or even some particular bank as to the purpose for which loans may or may not be given. While introducing selective credit controls the government takes special precaution that the credit for production, movement of commodities and exports is not denied as it may have serious repercussions on the performance of the economy. The main thrust of selective controls is against speculative hoarding of essential commodities by traders.

*For over 40 years, the RBI had extensively relied on the technique of margin requirements to check the hoarding of essential commodities for it causes artificial scarcities in the market and tends to raise prices.* Since 1973-74 for more than two decades, stricter selective controls were imposed. The Credit Authorisation Scheme introduced in 1965 was also a kind of selective credit control. Under the scheme, the RBI regulated not only the quantum but also the terms on which credit flowed to the different large-borrowers. The Credit Authorisation Scheme was finally withdrawn as part of financial sector reforms.

In 1996-97 the selective credit controls were liberalised on bank advances against a large number of price sensitive commodities. They have now been dispensed with.

### SHORT-TERM LIQUIDITY MANAGEMENT

As stated earlier, the two basic objectives of Reserve Bank's monetary policy have been price stability and growth. The emphasis between these twin objectives has varied over time depending upon the evolving price-output situation. Initially, this was guided by the concept of developmental central banking crystallised in the First Five Year Plan, which required the Reserve Bank to create an institutional framework for industrial as well as rural credit to support economic growth. This reflected a widespread consensus that public investment could spur rapid growth. However, deficit financing which was undertaken on a massive scale

to push up public investment caused intense inflationary pressures. In fact, inflation in 1970s trended up to around 9 per cent. Against this background, the Chakravarty Committee (1985) emphasised that price stability should be the 'dominant' objective of monetary policy with a concomitant commitment to fiscal discipline. The case for price stability as the dominant – if not sole objective of monetary policy gathered momentum in the early years of financial liberalisation. Although it had to stabilise the economy in the face of the balance of payments crisis of 1991, the Reserve Bank emphasised that its ultimate mission was to steer monetary policy, with its sights firmly set on inflation control. In its *Annual Report 1992-93* (published in 1993), Reserve Bank noted that price stability is critical to sustain the process of reforms.

The period of 1990s and afterward has seen massive financial liberalisation all over the world and this has induced far-reaching changes in monetary policy. With increasing trends of deregulation of financial markets and globalisation the process of monetary policy formulation has acquired a much greater market orientation than ever before, inducing a shift from direct to indirect instruments of monetary control. This has been accompanied by several institutional changes in the monetary-fiscal interface to ensure that central banks possess the autonomy to anchor inflation expectations. The increasing trade and financial openness has further complicated the problems of monetary management. This is due to the reason that opening up of capital account exposes the economy to sudden switches in capital flows. These, in turn, can cause large changes in exchange rates over short periods of time. Volatility in capital flows and exchange rate impacts not only domestic demand and inflation, but also has implication for the maintenance of financial stability. Central banks are thus concerned not only about price stability but also financial stability. With exogenous shocks hitting the economy at different points of time, the stabilisation of the real economy as well as financial markets requires a multi-pronged response from central banks. In a way, central banks have, therefore, emerged as the primary shock absorbers in the system.<sup>8</sup>

Starting 1991, the Government of India has undertaken massive programmes of liberalisation in the industrial sector, external sector, and the financial sector. The Indian economy has been increasingly integrated with the global economy. The government also gave up the pegged exchange rate system and since 1993, the market exchange rate regime has been in vogue. Under this regime, the day-to-day movements in exchange rate are largely market-determined. In this scenario of opening of Indian economy and its increasing global integration, a re-orientation of monetary

policy was required. It had not only to ensure price stability but also financial stability. "The growing integration of financial markets, while necessary for economic efficiency, posed challenges for monetary management in terms of heightened risks of contagion. Episodes of financial volatility, often sparked off by sudden switches in capital flows in response to various shocks — such as the East Asian financial crisis, sanctions after the nuclear explosions, downgrading of credit ratings, the meltdown of the information technology bubble and the September 11 US terrorist attacks required a swift monetary policy response. The Reserve Bank, therefore, began to emphasise the need to ensure orderly conditions in the financial markets as a prime concern of monetary management. Financial stability is now being recognised as a key consideration in the conduct of monetary policy, in terms of ensuring uninterrupted financial transactions; maintenance of a level of confidence in the financial system amongst all the participants and stakeholders; and absence of excess volatility that unduly and adversely affects real economic activity."<sup>9</sup> In fact, monetary policy in India now simultaneously pursues the objectives of price stability, provision of appropriate credit for growth and increasingly, financial stability.

The above discussion shows that the liberalisation of the Indian economy required a comprehensive recast of the operating procedures of monetary policy. In consonance with the increasing market orientation of the economy, the Reserve Bank had to shift from direct to indirect instruments of monetary policy. This required development of an array of monetary policy instruments, which would effectively modulate monetary conditions. The Reserve Bank is now able to influence short-term interest rates by modulating the liquidity in the system through repo operations under the Liquidity Adjustment Facility (LAF), reinforced by interest rate signals. Thus short-term liquidity management via repo operations and LAF has become an important operating procedure of monetary policy. LAF has also emerged as the key instrument of managing capital inflows that India has experienced since 2001-02 through sterilisation. This has helped in reducing the episodes of volatility in foreign exchange markets. In April 2004, the Market Stabilisation Scheme (MSS) was introduced to provide the Reserve Bank with an additional instrument of liquidity management and to relieve the LAF from the burden of sterilisation operations.

Reserve Bank now carries out short-term liquidity management through open market operations (OMOs) in the form of outright purchases/sales of government securities and repo and reverse repo operations under LAF. The OMOs are supplemented by changes in the Bank Rate/repo rate.

LAF has emerged as the principal operating instrument to modulate short-term liquidity. Since April 2004, MSS has also been used as an instrument of liquidity management. The latest instrument introduced by RBI is Marginal Standing Facility (MSF). 7.8.2019 → MSF = 5.65%

### Repos and Reverse Repos

Repo rate is the rate at which RBI lends to banks (i.e., the price at which it injects liquidity into the system). The higher the repo rate, more costly are the funds for banks and hence, higher will be the rate that banks pass on to customers. A higher rate signals that access to money is expensive for banks; lesser credit will flow into the system thus helping to bring down the liquidity in the economy. On the other hand, reverse repo rate is the rate at which RBI sucks out money from banks (i.e., the price at which it absorbs liquidity from the system). A higher reverse repo rate would give incentive to the banks to park money with the Reserve Bank, reducing liquidity and demand.

To control the strong inflationary pressures in the economy, RBI has relied basically on repo rate and reverse repo rate in recent times. This would be clear from the fact that over the period March 2010 to October 25, 2011, these rates were raised as many as 13 times. On October 25, 2011 repo rate was fixed at 8.50 per cent and reverse repo rate at 7.50 per cent. In its Monetary Policy for the year 2011-12 announced by the Reserve Bank on May 3, 2011, it was decided to shift towards a single policy rate regime — the repo rate. Thus, repo rate is now the single independently varying rate. The reverse repo rate was pegged at 100 basis points (bps) below the repo rate. Repo rate was fixed at 7.5 per cent and reverse repo rate at 6.5 per cent in March 2015. In its 'First Bi-Monthly Monetary Policy Statement, 2016-17' released on April 5, 2016, RBI pegged the reverse repo rate at 50 basis points (bps) below the repo rate. In this Policy Statement, repo rate was fixed at 6.5 per cent. Accordingly, the reverse repo rate was fixed at 6.0 per cent. The repo rate was fixed at 6.25 per cent in October 2016. Consequently, reverse repo rate was fixed at 5.75 per cent. In its First Bi-Monthly Monetary Policy Statement 2017-18 released on April 6, 2017, RBI pegged the reverse repo rate at 25 basis points below the repo rate. On August 2, 2017, the Reserve Bank fixed the repo rate at 6 per cent. Consequently, reverse repo rate became 5.75 per cent. 7.8.2019 - Repo - 5.4  
Reverse Repo - 5.15

### Liquidity Adjustment Facility (LAF)

The difference between the repo and reverse repo rates is the liquidity corridor or the liquidity adjustment facility (LAF). LAF was introduced by RBI in June 2000. The LAF operates through reverse repo auctions, i.e., the sale of government securities from the RBI portfolio for

absorption of liquidity) and repo auctions, i.e., buying of government securities for injection of liquidity on a daily basis, thereby creating a corridor for the call money rates and other short-term interest rates. All scheduled banks and primary dealers (PDs) are eligible to participate in the repo and reverse repo auctions. The maturity of repos is from one day to fourteen days. The funds under LAF are expected to be used by banks to meet their day-to-day mismatches in liquidity. The LAF has emerged as the principal operating instrument of monetary policy enabling the Reserve Bank to modulate short-term liquidity under varied financial market conditions. The LAF has enabled the Reserve Bank to de-emphasise targeting of bank reserves and focus increasingly on interest rates. This has also helped reducing the CRR (Cash Reserve Ratio) without engendering liquidity pressure.

**Role and Importance of LAF.** According to Reserve Bank of India, LAF plays an important role in market stabilisation as is clear from the following discussion:<sup>10</sup>

1. The LAF stabilises regular liquidity cycles, by allowing banks to tune their liquidity requirements to the averaging requirements over the reporting fortnight and smoothening liquidity positions between beginning-of-the-month drawdown of salary accounts to fund household spending and end-of-the month post-sales bulge in business current accounts.
2. The LAF irons out seasonal fluctuations. It injects liquidity during quarterly advance tax outflows or at end-March, when banks avoid lending on call, which adds to their Capital to Risk-weighted Assets Ratio (CRAR) requirements. It mops up liquidity in April to counter the typically large ways and means advances drawn by the government prior to the inception of its borrowing programme.
3. LAF modulates sudden liquidity shocks, by injecting liquidity on account of, say, temporary mismatches arising out of timing differences between outflows on account of government auctions and inflows on account of redemptions.
4. The LAF serves as an effective instrument for maintaining orderly conditions in the financial markets in the face of sudden capital outflows to ward off the possibility of speculative attacks in the foreign exchange market.
5. By funding the government through private placements and mopping up the liquidity by aggressive reverse repo operations at attractive rates, the LAF helps to minimise the impact of market volatility on the cost of public debt.
6. The LAF bore much of the burden of sterilisation in the face of sustained capital flows, especially since November 2000, by mopping up bank liquidity through reverse repos and, at the same time, gradually reducing



reverse repo rates to enable a softening of the interest rate structure (the burden of sterilisation has been taken over by MSS since April 2004 as discussed below).

7. The Reserve Bank tailors monetary policy action through both quantum and rate channels of transmission. The LAF accords the Reserve Bank the operational flexibility to alter the liquidity in the system (by rejecting bids) as well as adjusting the structure of interest rates (through fixed rate operations) in response to evolving market circumstances.

### Capital Inflows and MSS

Since the initiation of economic reforms in 1991, the country has witnessed large-scale capital inflows. While these capital inflows eased the external financing constraint, they also posed dilemmas for the conduct of the monetary policy. Under the circumstances, the objectives of containing exchange rate volatility and the maintenance of orderly conditions in the foreign exchange markets become difficult to achieve. As correctly pointed out by *Report on Currency and Finance*, "More particularly, if capital inflows outstrip the demand for foreign exchange, the appreciation of the domestic currency often necessitates interventions by the central bank to drain off the excess supply of foreign currency. In doing so, the accretion to foreign exchange reserves implies an immediate expansion in primary money with attendant consequences for maintaining price stability".<sup>11</sup>

Apart from the LAF, which is essentially an instrument of day-to-day liquidity management, Market Stabilisation Scheme (MSS) was introduced in April 2004 to provide the Reserve Bank with an additional instrument of liquidity management and to relieve the LAF from the burden of sterilisation operations. The MSS is an arrangement between the Government of India and the Reserve Bank to mop up the excess liquidity generated on account of the accretion to the foreign exchange assets of the Bank to neutralise the monetary impact of capital flows. Under the scheme, the Reserve Bank issues treasury bills/dated Government securities by way of auctions and the cost of sterilisation is borne by the government. The sale of government securities helps in absorbing liquidity and in maintaining stability in the foreign exchange market.

### Marginal Standing Facility (MSF)

Marginal Standing Facility (MSF) is a relatively new instrument. It was first announced by RBI in its credit policy released in the first week of May 2011. The objective of the MSF is to 'contain volatility in the overnight inter-bank rates'. Under this facility, all scheduled commercial banks can borrow overnight from RBI up to 1 per cent of their net demand and time liabilities. The interest rate is

fixed at 25 basis points (bps) above the repo rate. With MSF, RBI has created a 50 bps corridor in policy rates with repo rate in the middle and MSF at 25 bps above the repo rate and reverse repo rate at 25 bps lower than the repo rate. Since repo rate is presently 6.0 per cent, MSF is fixed at 6.25 per cent.

Under MSF, banks can request for a minimum of ₹ 1 crore and thereafter in multiples of ₹ 1 crore. In order to avail funds from MSF facilities, banks have to fulfil the margin requirement of 5 per cent in case they are borrowing against the Government of India dated securities and 10 per cent in case they wish to borrow against State development loans. Therefore, to make a request for, say ₹ 100, banks have to furnish ₹ 105 worth of Government of India bonds or ₹ 110 worth of State development funds.

As stated earlier, repo rate is now the single policy rate. Thus, every time the repo rate is increased, the reverse repo rate and MSF rate increase automatically. The liquidity corridor thus remains constant. By making repo the single policy rate, RBI has ensured that banks focus on deposit mobilisation to improve liquidity, and give better returns to customers.

## BANKING LAWS (AMENDMENTS) ACT, 2012

The Banking Laws (Amendment) Bill, 2012 was approved by both the Houses of Parliament in December 2012. It received Presidential assent and was notified as the Banking Laws (Amendment) Act 2012 in January 2013. This Act paves the way for issuing new banking licences by giving the RBI greater regulatory power over the banking sector before it issues new licences to various private players. It is expected that opening of new private banks will increase competition in the banking sector and this, in turn, will be beneficial to banking customers by giving them more choice at competitive prices.

With this background, the amendments introduced by the Act can be categorised under two broad heads: (i) those intended to attract private sector investment and build investor confidence in the banking sector, and (ii) those intended to strengthen the RBI's regulatory powers over banks.

### Reforms to Attract Investment

1. **Banks may now issue more preference shares.** The Act allows banks to issue preference shares in accordance with guidelines issued by the RBI. The permission given to private sector banks to issue preference shares provides banks with an additional avenue to raise finance without ceding any voting control to the holders of those instruments.