Monetary Policy

Monetary policy is adopted by the monetary authority of a country that controls either the interest rate payable on very short-term borrowing or the money supply. The policy often targets inflation or interest rate to ensure price stability and generate trust in the currency.

The monetary policy in India is carried out under the authority of the Reserve Bank of India.

What are the main objectives of monetary policy?

Simply put the main objectives of monetary policy is to maintain price stability while keeping in mind the objective of growth as price stability is a necessary precondition for sustainable economic growth.

In India, the RBI plays an important role in controlling inflation through the consultation process regarding inflation targeting. The current inflation-targeting framework in India is flexible.

What role does the Monetary Policy Committee play?

The Reserve Bank of India Act, 1934 (RBI Act) was amended by the Finance Act, 2016, to provide for a statutory and institutionalised framework for a Monetary Policy Committee, for maintaining price stability, while keeping in mind the objective of growth. The Monetary Policy Committee is entrusted with the task of fixing the benchmark policy rate (repo rate) required to contain inflation within the specified target level.

The Government of India, in consultation with RBI, notified the 'Inflation Target' in the Gazette of India ExtraordTheinary dated 5 August 2016 for the period beginning from the date of publication of the notification and ending on March 31, 2021, as 4%. At the same time, lower and upper tolerance levels were notified to be 2% and 6% respectively.

What are the instruments of monetary policy?

Some of the following instruments are used by RBI as a part of their monetary policies.

1. **Open Market Operations:** An open market operation is an instrument which involves buying/selling of securities like government bond from or to the public and banks. The RBI sells government securities to control the flow of credit and buys government securities to increase credit flow.

2. **Cash Reserve Ratio (CRR):** Cash Reserve Ratio is a specified amount of bank deposits which banks are required to keep with the RBI in the form of reserves or balances. The higher the CRR with the RBI, the lower will be the liquidity in the system and vice versa. The CRR was reduced from 15% in 1990 to 5 % in 2002. As of 31st December 2019, the CRR is at 4%.

3. **Statutory Liquidity Ratio (SLR):** All financial institutions have to maintain a certain quantity of liquid assets with themselves at any point of time of their total time and demand liabilities. This is known as the Statutory Liquidity Ratio. The assets are kept in non-cash forms such as precious metals, bonds etc. As of December 2019, SLR stands at 18,25%.

4. **Bank Rate Policy:** Also known as the discount rate, bank rates are interest charged by the RBI for providing funds and loans to the banking system. Increase in bank rate increases the cost of borrowing by commercial banks which results in the reduction in credit volume to the banks and hence the supply of money declines. Increase in the bank rate is the symbol of the tightening of RBI monetary policy. As of 31 December 2019, the bank rate is 5.40%.

5. **Credit Ceiling:** With this instrument, RBI issues prior information or direction that loans to the commercial bank will be given up to a certain limit. In this case, a commercial bank will be tight in advancing loans to the public. They will allocate loans to limited sectors. A few examples of credit ceiling are agriculture sector advances and priority sector lending.