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THE ART AND SCIENCE OF INVESTING

CONCEPTOPEDIA

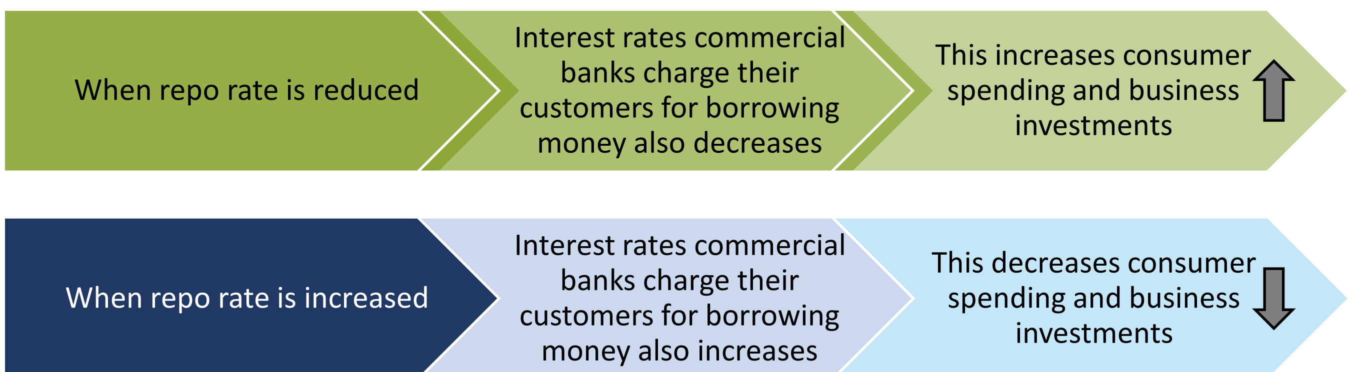
“Primer on Monetary Policy”

Learning Objectives

- Define and describe Monetary Policy
- Differentiate between Fiscal and Monetary Policy
- Define Expansionary and Contractionary monetary policy actions
- Describe the concept of Money Supply
- Outline the Monetary Policy Framework of India
- Understand the role of Monetary Policy Committee of India
- Outline and describe various monetary policy tools:
  - Liquidity Adjustment Facility (LAF)
  - LAF Corridor
  - Repo rate
  - Standing Deposit Facility
  - Reverse Repo Rate
  - Marginal Standing Facility
  - Reserve requirements – Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)
  - Open Market Operations
- Give an overview of unconventional monetary policy tools like Operation Twist, LTRO (Long Term Repo Operation), TLTRO (Targeted Long Term Repo Operation), OMO purchase of SDLs (State Development Loans), Forex Swaps, and MSS (Market Stabilization Schemes)

What is meant by Monetary Policy?

- Monetary Policy concerns the decisions taken by Central Banks (For e.g. RBI, ECB, Federal Reserve etc.) to influence the cost and availability of money in an economy.
- It is primarily done by making changes to the key interest rate or policy rate, for e.g. the repo rate by the RBI, or the discount rate by the Federal Reserve etc.
- In addition to the policy rate, the other monetary policy instruments are reserve ratios, and open market operations to name a few.
- One of the main objectives of monetary policy is to keep prices stable, i.e. keep the inflation at a certain band or level, which helps in aiding economic growth and employment.



What is the difference between Fiscal Policy and Monetary Policy?

- Both Fiscal and Monetary policies are macro-economic tools to manage or stimulate the economy. They together have a greater impact over a country's economy, its businesses, and its consumers.
- Higher coordinated efforts between fiscal and monetary policies have been seen in the past, especially during black swan events like Covid-19, Global Financial Crisis – 2008, to stimulate economic growth in a recessionary environment and to help households and businesses deal with the economic and market jolts.

Fiscal Policy

- It refers to the government policy initiatives, taxation changes and reforms, spending and allocating funds to different sectors to help them grow.
- It is determined by the central government legislation.
- It impacts a household and a firm's tax outgo. Better government policies helps in creating employment opportunities, increases wealth, and discretionary income.
- E.g., Production Linked Incentive Schemes (PLI), Corporate tax rate cuts, Higher capex spending, Government borrowing program etc.

Monetary Policy

- It refers to policy interest rate changes, so as to influence money supply and to keep inflation under control.
- It is administered by the central banks.
- It boosts consumer spending and business expansion through lower interest rates, and by making borrowing cheaper.
- E.g., Changing repo rates, changing reserve requirements like CRR, SLR etc. of the banks.

What is meant by Expansionary and Contractionary monetary policy?

Expansionary and Contractionary monetary policies are types of monetary policy actions.

Expansionary monetary policy:

It is also referred to as "dovish" monetary policy action, where-in key interest rate or policy rate like the repo rate is reduced by a central bank to make interest rates cheaper, and to spur spending and accelerate higher borrowings by individuals and firms.
This leads to increase in supply of money circulation and inflation.
During recession, expansionary monetary policy actions help in increasing economic activity. It stimulates a receding economy.

Contractionary monetary policy:

It is also referred to as "hawkish" monetary policy action, where the central banks in order to control inflation, increase policy rates there-by making borrowings expensive.
It lowers consumer spending, as loans become more expensive, and it thus reduces the level of money circulating in the economy (money supply) and keeps a tab on inflation.
When economy is over-heated and inflation spirals out of control leading to asset bubbles, contractionary monetary policy helps in taming inflation and in cooling down of speculative activities and overspending.

What is meant by Money Supply?

- It is the total stock of money circulating in an economy to purchase goods and services. It includes currency, printed notes, money in the deposit accounts, and in the form of other liquid assets.

- Money Supply is measured and expressed using different monetary aggregates like M0, M1, M2, M3, M4 etc.

- The Reserve Bank of India (RBI) uses the terms **Reserve Money (M0),** and **Broad Money (M3)** to denote money supply. The data on M0 and M3 gets published on a weekly basis on the website of the Reserve Bank of India (RBI) under a report called **Weekly Statistical Supplement (WSS).**

- **M0 or Reserve Money:** It is also known as 'High-Powered Money', 'Monetary base of the economy', and 'Base money' etc. It is the base for creating broad money supply (M3) and is the liability of the RBI.

M0 = Currency in Circulation (currency and notes, and cash in hand with banks) + Bankers' Deposits with the RBI (CRR reserves) + Other deposits with RBI (deposits from foreign central banks and financial institution)

- **M3 or Broad Money:** It is the widely used indicator for money supply. It depicts the total amount of financial resources available in the economy and due to the presence of NDTL (Net Demand and Time Liabilities) in its formula, it is the liability of the commercial banks.

M3 (Broad Money or Money Supply) = Currency with Public + NDTL (Net Demand and Time liabilities with banks)

- Currency with the public is arrived at after deducting cash with banks from total currency in circulation.

- NDTL (Net Demand and Time Liabilities) refers to deposits of the general public and the balances held by the bank with other banks.

Monetary Policy Framework of India

The **Central Government, in consultation with the RBI, determines the inflation target** in terms of the Consumer Price Index (CPI), once in 5 years and notifies it in the Official Gazette.

Accordingly, on August 5, 2016, **4% Consumer Price Index (CPI) inflation was set as the target** for the period from August 5, 2016 - March 31, 2021, with the **upper tolerance limit of 6% and the lower tolerance limit of 2%.**

On March 31, 2021, the **Central Government retained the inflation target and the tolerance band for the next 5-year period** i.e., April 1, 2021 - March 31, 2026.

*The aim of the monetary policy operating framework is to **align the operating target which is the weighted average call rate (WACR) with the policy repo rate.***

Source: www.rbi.org.in

What is Monetary Policy Committee of India (MPC)?

- Monetary Policy Committee (MPC) is a **six-member team** constituted by the RBI to **determine the policy rate (repo rate)** required to achieve the inflation target.
- The **Chairperson of the MPC is the Governor of RBI**, and the other members include Deputy Governor of India, an RBI officer nominated by the Central Board and renowned academicians from reputed educational and research institutes.
- The MPC is **required to meet at least 4 times in a year.** The minimum number for the meeting of the MPC is four members.
- Each member of the MPC has one vote, and in the event of an equality of votes, the RBI Governor has a second or casting vote.
- Each member of the Monetary Policy Committee writes a statement specifying the reasons for voting in favor of, or against the proposed resolution.

Monetary Policy Committees around the Globe

US: Federal Open Market Committee (FOMC) is a branch of the Federal Reserve System comprising 12 members. It is a committee within the Fed and is responsible only for open market operations. It meets eight times a year to discuss whether there should be any changes to near-term monetary policy.

UK: The Monetary Policy Committee (MPC) of The Bank of England comprises 9 members and decides what monetary policy action to take. The MPC sets and announces policy eight times a year.

Euro Area: European Central Bank's (ECB) main decision-making body, the Governing Council, sets monetary policy for the euro area. The Council consists of 6 ECB Executive Board members and the Governors of euro area national central banks.

Japan: Monetary policy is decided by the Policy Board of the Bank of Japan (BoJ) at the Monetary Policy Meetings (MPMs). The Policy Board comprises 9 members and the MPMs are held eight times a year for two days.

Disclaimer: The above information is for illustrative purposes only.

What are the various instruments of Monetary Policy?

There are several direct and indirect instruments that are used for implementing monetary policy in India.

- Liquidity Adjustment Facility (LAF) & LAF Corridor - Repo rate, Standing deposit facility (SDF), Reverse Repo rate, Marginal standing facility (MSF), and Bank rate
- Main Liquidity Management Tool
- Fine Tuning Operations
- Reserve requirements – Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)
- Open Market Operations

The interaction of all the monetary policy tools is to align the operating target which is the weighted average call rate (WACR) with the policy repo rate.

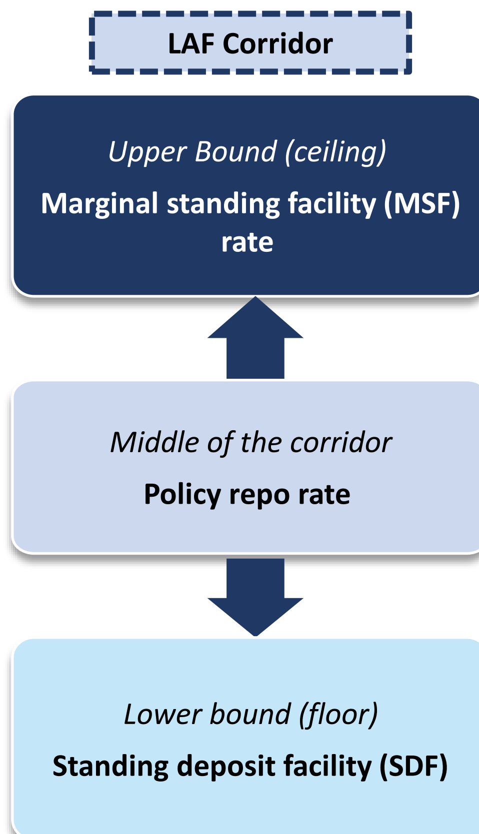
WACR is the interest rate at which banks lend overnight money to each other.

WACR, in turn, directly influences other short-term rates.

WACR also indirectly influences long-term interest rates, foreign exchange rates, and the supply of credit and demand for investment, employment, and economic output.

Liquidity Adjustment Facility (LAF)

- The LAF refers to the Reserve Bank's operations through which it injects or absorbs liquidity into or from the banking system.
- It consists of **overnight and term repo/reverse repos (fixed and variable rates), Standing Deposit Facility (SDF) and Marginal Standing Facility (MSF).**



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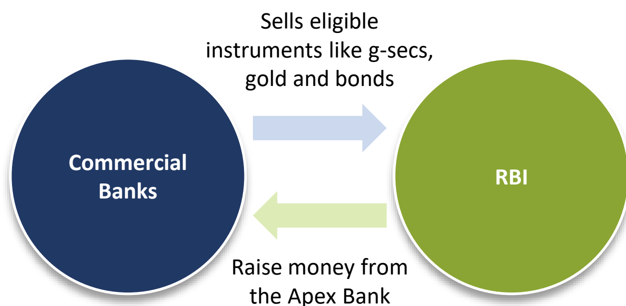
Source: www.rbi.org.in

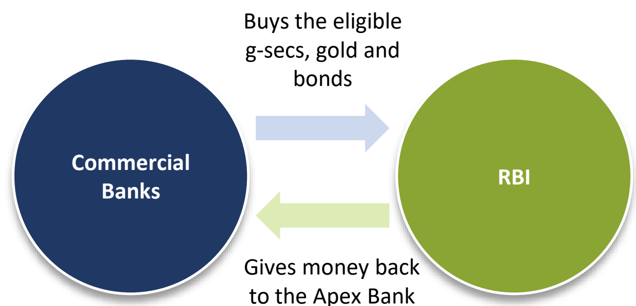
Repo rate

- The term 'REPO' rate stands for 'Repurchasing Option' rate.
- It is the interest rate at which the Reserve Bank provides liquidity by lending money to banks against collateral of government and other approved securities. Current Policy Repo rate is 6.5%.
- Just like an individual borrows money from Banks to bridge the gap in shortfall of funds, similarly when banks face shortage of funds, they borrow money from the Apex bank through the Repo rate.
- Borrowing at the repo rate is usually done to maintain the minimum reserve balances like CRR and SLR by the banks.

Under Repo Window



At Maturity



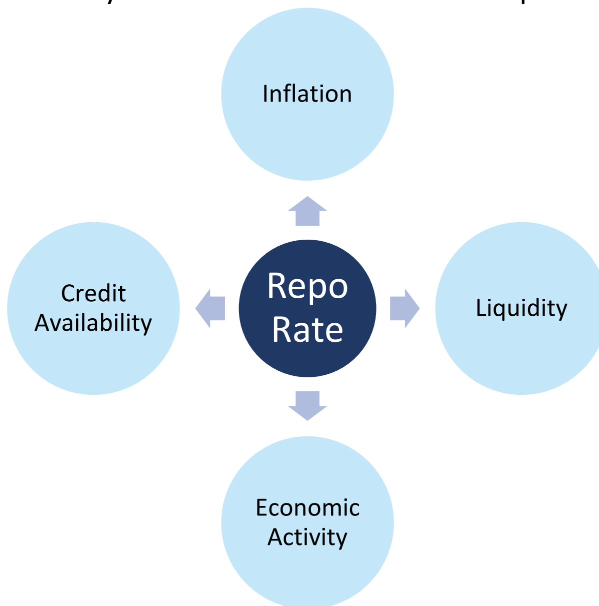
The difference between the buy and the sell rate is called the repo rate.

Disclaimer: The above information is for illustrative purposes only.

Overnight and Term Repo:

- Borrowing for one-day is called the Overnight repo, while more than that is a Term repo. **Overnight repo rate** is also called the **policy repo rate**.

- Term repos can be for 7, 14, or 28 days and are also called Variable Rate Term Repo. RBI normally announces auction for term repos.



A few basis point of increase can have a significant impact on consumption and borrowings by household and firms .

The RBI increases repo rate to keep a check on inflation.

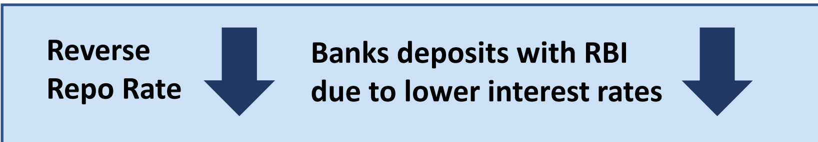
Disclaimer: The above information is for illustrative purposes only.

Reverse Repo rate

- As the name suggests, it is the reverse of the Repo Rate. It is the rate at which banks lend to or have deposits with RBI.

- Through reverse repos the Reserve Bank absorbs liquidity from banks. RBI provides the collateral of eligible government securities to banks to take reverse repo loans or bank deposits. Current Fixed Reverse Repo rate is 3.35%.

- Following the introduction of Standing Deposit Facility (SDF) in April 2022, the fixed rate reverse repo operations will be at the discretion of the RBI for purposes specified from time to time.



Reverse Repo Rate is dependent on Repo Rate.

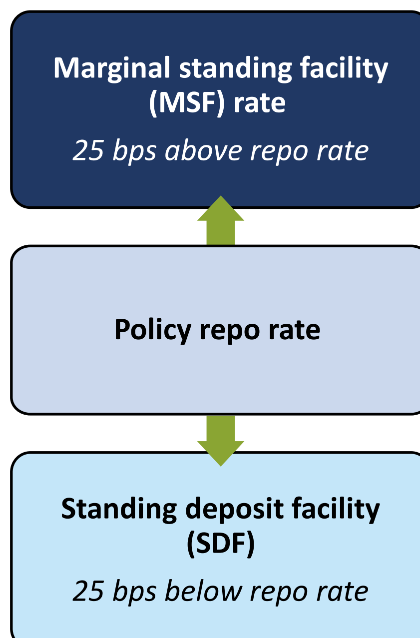
Reverse Repo Rate is always lower than Repo Rate because the spread between the two is RBI's income.

Standing Deposit Facility (SDF) Rate

- The rate at which the Reserve Bank accepts uncollateralized deposits, on an overnight basis, from all LAF participants. In addition to its role in liquidity management, it also considered as financial stability tool.
- It is placed at 25 basis points below the policy repo rate. Current SDF rate is 6.25%.
- With introduction of Standing Deposit Facility in April 2022, the SDF rate replaced the fixed reverse repo rate as the floor of the LAF corridor.

Marginal Standing Facility (MSF) Rate

- Marginal standing facility (MSF) is a window for banks to borrow from the Reserve Bank of India on an overnight basis by giving a collateral of government securities, in an emergency when inter-bank liquidity dries up completely.
- Banks can borrow from MSF by using their excess g-sec holdings under Statutory Liquidity Ratio (SLR) or dipping into their SLR portfolio up to a predefined limit (2 per cent). This provides a safety valve against unanticipated liquidity shocks to the banking system.
- The MSF rate is placed at 25 basis points above the policy repo rate. Current MSF rate is 6.75%



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Main Liquidity Management Tool

- Main liquidity management tool refers to a 14-day term repo/reverse repo auction at a variable rate, which is conducted to coincide with the cash reserve ratio (CRR) maintenance cycle for managing frictional liquidity requirements.

Fine Tuning Operations

- The main liquidity operation is further supported by fine-tuning operations that helps to tide over any unanticipated liquidity changes during the reserve maintenance period by banks.
- Under this, the Reserve Bank conducts, overnight and if needed, longer-term variable rate repo/reverse repo auctions of more than 14 days.

Bank Rate

- The rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers from banks.
- The Bank Rate acts as the penal rate charged on banks for shortfalls in meeting their reserve requirements (cash reserve ratio and statutory liquidity ratio).
- This rate has been aligned with the MSF rate and, changes automatically as and when the MSF rate changes alongside policy repo rate changes. Current Bank Rate is 6.75%.

Cash Reserve Ratio (CRR)

- It is the portion of a commercial bank's total deposits (NDTL - Net Demand and Time Liabilities) that needs to be maintained with the RBI. Every commercial bank is obligated to maintain CRR.
- The percentage of CRR to be maintained is determined by the RBI and it currently stands at 4.5% as of 2023. It means that for a Rs. 100 deposit, banks must set aside Rs. 4.5 as Cash Reserves with the RBI.
- The CRR deposits are in the form of liquid cash and must be kept in an account with the RBI. They don't earn any interest.
- Banks can't lend the CRR money to corporates or individual borrowers and cannot use it for investment purposes.

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Is Fiscal Deficit – Good or Bad for the economy?

- Main liquidity management tool refers to a 14-day term repo/reverse repo auction at a variable rate, which is conducted to coincide with the cash reserve ratio (CRR) maintenance cycle for managing frictional liquidity requirements.

Managing Inflation

CRR helps in keeping inflation under control as when CRR is increased, commercial banks maintain higher deposits with the RBI.

Excess reserve balance is depleted there-by limiting their lending capacity.

This slows down borrowings and reduces consumption and helps in controlling inflation.

CRR was increased from 4% to 4.5% in May 2022, to keep a check on retail inflation which was surging past the RBI's comfort limit.

Managing Exigencies

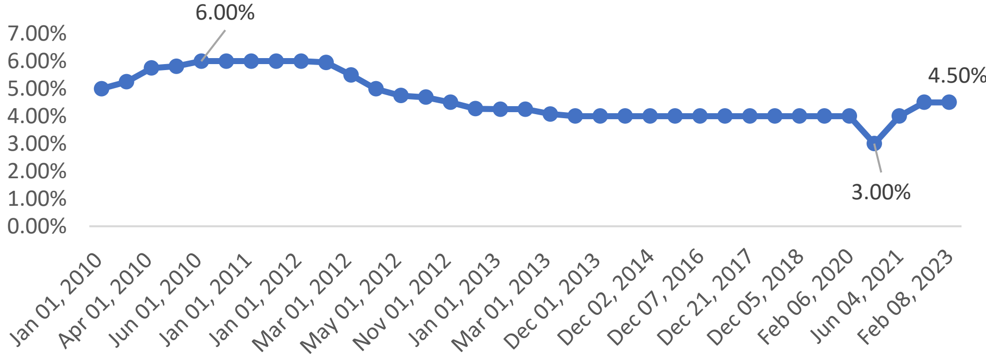
During Covid' 19 pandemic, CRR rate was reduced by 100 bps to 3% in March'2020. This gave extra reserves in the hands of the banks and infused liquidity in the banking system to the tune of ~ Rs. 1.37 lac crs.

During that time-period RBI had also reduced the requirement of minimum daily CRR balance maintenance from 90% to 80%.

Disclaimer: The above information is for illustrative purposes only.

Maintenance of CRR:

- Banks report their CRR Balance to RBI on a fortnightly basis and have to maintain a minimum of 90% of the required CRR on a daily basis over a period of 14 days.
- However, on the reporting fortnight, the CRR must be the full prescribed limit or 100% of the required CCR.
- Banks failing to maintain the CRR can attract penal charges by RBI.
- The total CRR balance maintained with RBI as of March' 2023 is around Rs. 8.1 lac crs.



Did You Know

The highest CRR rate was 15% in October 1995.

As per the suggestion by the Narasimham Committee report, the CRR was reduced from 15% in 1990 to 5% in 2002.

Disclaimer: The chart is for illustrative purposes only
Source: Weekly Statistical Supplement (WSS) RBI, Wikipedia, Chart
Data Source: investing.com

Statutory Liquidity Ratio (SLR)

- The minimum percentage of deposits (NDTL) that needs to be maintained by commercial banks, before offering credit to customers.
- The reserve is maintained in approved securities like liquid assets, cash, gold, treasury bills, unencumbered government securities, etc.
- The limit of SLR for commercial banks is decided by the RBI. The current SLR rate in 2023 is 18%, however banks usually hold more than the required SLR percentage. The maximum limit for the SLR is 40% in India.
- It is a monetary policy tool to manage inflation and liquidity and helps keep banks solvent and fulfil their depositors' demands as and when they arise.

Higher Inflation

Statutory Liquidity Ratio (SLR) is increased, to restrict the lending capacity of banks.

Lower Inflation

Statutory Liquidity Ratio (SLR) is decreased, to infuse cash into the system and increase the lending capacity of banks. This helps banks offer loans at better rates and improve borrowings.

Disclaimer: The above information is for illustrative purposes only.

CRR vs. SLR

Cash Reserve Ratio

- CRR is kept in the form of cash.
- No interest is paid on CRR reserves.
- CRR funds are kept with the RBI.
- It helps to infuse or absorb liquidity into the banking system.

Statutory Liquidity Ratio

- SLR is in the form of liquid asset like government securities, bonds etc.
- SLR reserves earn interest income.
- SLR funds are kept by banks as liquid assets in their own vaults.
- As banks maintain usually higher SLR reserves, it helps to keep a bank solvent. It means that at any point in time, banks are capable of paying back their liabilities. This increases depositor’s confidence, that their money is safe.

Date	SLR (%)
22 February 2013	23.00
20 December 2013	23.00
14 June 2014	22.50
09 August 2014	22.00
14 June 2015	22.50
09 August 2015	22.00
07 February 2015	21.50
02 April 2016	21.25
09 July 2016	21.00
01 October 2016	20.75
07 January 2017	20.50
24 June 2017	20.00
14 October 2017	19.50
05 January 2019	19.25
13 April 2019	19.00
06 July 2019	18.75
12 October 2019	18.50
05 December 2019	18.50
04 January 2020	18.25
17 April 2020	18.00
19 March 2021	18.00
18 March 2022	18.00
10 March 2023	18.00
06 April 2023	18.00

Did You Know

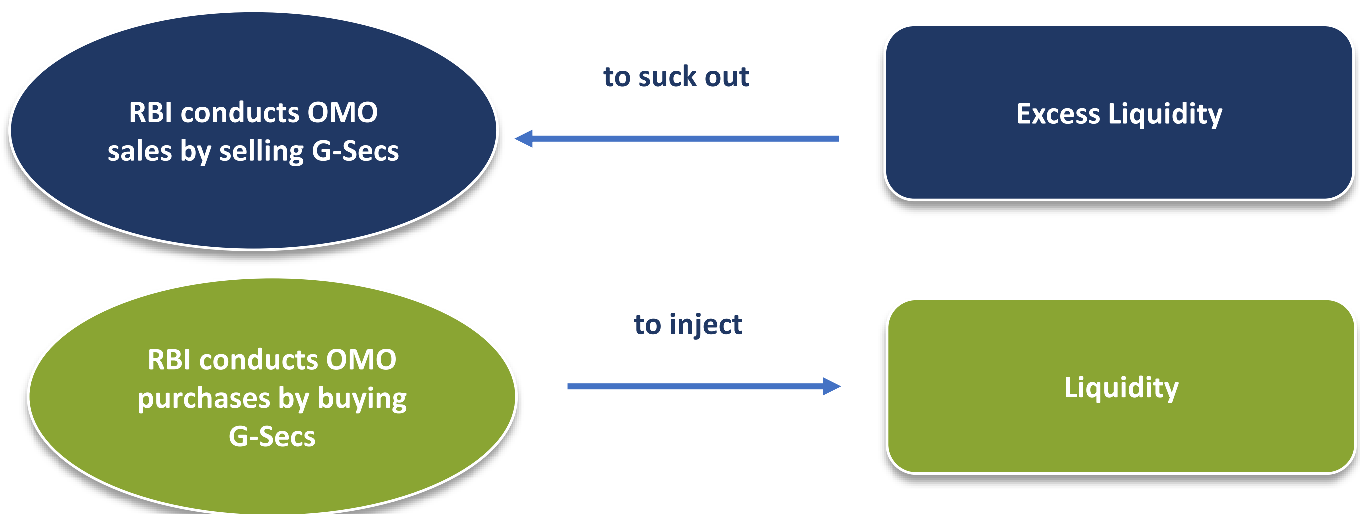
The highest ever SLR rate was 38.5% in Sep’ 1990.

Disclaimer: The above information is for illustrative purposes only.

Source: RBI, http://www.allbankingsolutions.com

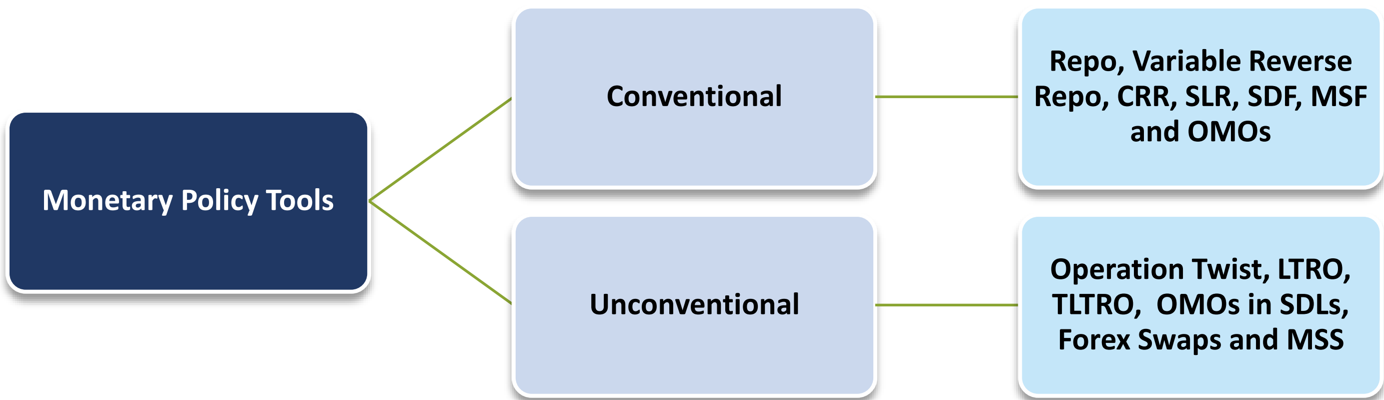
Open Market Operations (OMOs)

- Open market operation (OMO) is a monetary policy instrument of the RBI, where-in it outrightly purchases or sells government securities for either injecting or absorbing of durable liquidity in the banking system.
- Outright purchases or sale via OMOs are permanent in nature. It means when the RBI buys these securities, it is without any promise to sell them later. Similarly, when the central bank sells these securities, it is without any promise to buy them later.
- The main objective of OMOs is to smoothen liquidity conditions around the year, and it impact on interest rates and inflation.



What is meant by Unconventional Monetary Policy Tools?

Unconventional Monetary Policy tools are used when the central bank looks beyond the traditional instruments of monetary policy like Repo, Variable Reverse Repo, CRR, SLR, SDF, MSF and OMOs, to tide over a major crisis, and to mitigate any financial adversities.



Operation Twist: It is a term used for Special OMOs and refers to simultaneous purchase and sale of OMOs of same quantum. The term 'operation twist' is coined because such operations tend to twist the yield curve by bringing down yields of the long duration papers and increasing yields of the shorter duration papers, with the aim to narrow the spreads. RBI deployed this in India in the years - 2019, 2020, and 2021. Operation Twist was first used by the United States Federal Reserves in 1961 and then in 2011 to stimulate the US economy.

LTRO: Long Term Repo Operation (LTRO) was an unconventional monetary policy tool which allowed banks to borrow funds from Reserve Bank of India for tenors 1-year to 3-years at policy repo rate, against collateral of government securities with similar or higher tenure. It promoted borrowing at a reasonable cost for the banks. LTROs were used by the RBI in Feb' 2020 and March' 2020 to deal with liquidity crunch induced by Covid'19 pandemic and it helped inject liquidity to the tune of ~Rs. 1.25 lac crs. European Central Bank (ECB) during the European financial crisis first introduced the concept of LTROs, where-in the ECB had lent nearly € 1 trillion to various banks.

TLTRO: The RBI had announced Targeted Long Term Repo Operations (TLTROs) in Mar' 2020 to further push the credit flow in the economy. It is the same as LTRO with a difference, that the money borrowed by the banks under this scheme had to be deployed in investment-grade corporate bonds, commercial paper, and non-convertible debentures. It injected liquidity ~Rs. 1.12 lac crs in the banking system during the covid pandemic onslaught year.

OMO purchase of state development loans (SDLs): During Covid'19 pandemic, as the economic activities of state governments came to a stand-still, the spreads of SDLs with 10-year maturity over benchmark 10-year government securities had widened to ~60-70 bps. Hence RBI had conducted OMOs in SDLs as a special case and it helped lower the cost of borrowing for the state governments.

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Forex Swaps: It is a forex cum liquidity management tool whereby the central bank uses its currency to buy another currency or vice versa.

In a **Dollar–Rupee buy/sell swap**, the RBI buys US dollars (USD) from banks in exchange for Indian Rupees (INR) and immediately gets into an opposite deal with banks promising to sell USD at a later date. When there is shortage of liquidity in the system, such type of forex swap injects rupee liquidity in the system as the central bank buys dollars from the market and releases an equivalent amount in the rupees.

In a **Dollar–Rupee sell/buy swap**, the central bank sells USD in exchange for INR and promises to buy USD from banks after some years. When there is excess liquidity, conducting such type of a swap where-in the central bank sells dollars, and sucks out an equivalent amount in rupees, thus reducing the rupee liquidity in the system. Dollar inflow into the market also strengthens the rupee. For instance, RBI in March'22 conducted a 2-year sell/buy swap auction of ~$5 billion. This was done to bring down rupee liquidity in the system and to control inflation as crude oil prices were rising sharply in the wake of the Russia-Ukraine war.

Market Stabilization Scheme (MSS): Under MSS scheme, the RBI issues Market Stabilisation Bonds (MSBs) to withdraw the excess liquidity in the economy. The bills/bonds issued under MSS has all the attributes of the existing treasury bills and government securities. They are provided by the central government to the RBI for the dedicated purpose of withdrawing excess liquidity. These securities are issued by way of auctions by the RBI and timing, amount and tenure of such of security issuances gets decided by the central bank and notified to buyers accordingly. It was used during the demonetization era of 2016, to absorb excess liquidity.

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