CA Course

Paper No. 8B - Economics for Finance

Unit 3-MONETARY POLICY

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Learning Outcomes

At the end of this unit, you will be able to:

- Define monetary policy and describe its objectives
- Different components of the monetary policy framework
- The analytics of monetary policy
- Monetary Policy Transmission Mechanisms and its types
- The operating procedures and instruments of monetary policy, and
- The organizational structure for monetary policy decisions

Definition & Objectives of Monetary Policy

- Monetary policy Definition
- **objectives**
- Price Stability
- Exchange rate Stability
- Full Employment
- High Rate of Economic Growth
- Ensure Equilibrium in BOP

Analytics of Monetary Policy

- The policy tools such as monetary policy is intended to influence various macro economic variables such as
- aggregate demand,
- price level,
- consumption,
- investment,
- income (National income),
- quantity of money and credit and interest rates in the economy.
- Monetary policy Transmission Mechanism refers to how policy actions of RBI affect the output (GDP), price level, employment ,aggregate demand income etc

Mechanisms of Monetary Policy

- There are six different mechanisms through which monetary policy influences the national income , price level etc. These are

1. The interest rate channel
2. The exchange rate channel
3. The quantum channel (relating to money supply and credit) and
4. The Standard Asset Price Channel (via equity and real estate prices
5. Balance sheet channel of Monetary policy
6. The expectations channel

Interest Rate channel of Monetary Policy
assume RBI cuts repo rate to promote the growth when economy is hit by serve slow down/ recession then it leads to

- Cut in repo rate
- Commercial banks borrow will go up
- Lending rate falls
- Public and Business borrow
- Investment increases
- Output increases
- Employment increases
- Income increases
- Consumption increases

Exchange Rate Channel of Monetary Policy

- In open economies changes in short term interest rate or repo will have impact on the exchange rate.
- Assume Repo rate or short term is higher in India in comparison with US then capital flys into India resulting in appreciation of rupee. Then exchange value of between Rupees and $ will get affected
- Change in exchange in will impact the relative prices of exports and imports goods and services
- Assume US short term interest rate is constant , RBI increases the repo rate then there will be capital inflow resulting rupee appreciation making imports cheaper and exports costly
- suppose repo rate is decreased then opposite of above will happen.
- Thus exchange rate will impact individuals, investors, trade firms and even government

The Quantum Channel (relating to Money supply and Credit)

- The Quantum Channel complements and amplifies the interest rate channel.
- This credit channel operates through availability of credit which in turn affects the output, employment, income , AD and price level etc

The Standard Asset Price Channel

- Policy induced in increase in the short term nominal interest rates makes debt instruments more attractive than equities
- Investors prefer debt instruments over equity resulting in falling in equity prices
- If stock prices fall after a monetary tightening it leads to reduction in household financial wealth leading to fall in consumption, investment, output and employment

The Balance Sheet (BOS) Channel of Monetary Policy

- If repo rate is high then cost of credit rises for a firm then the strength of its BOS deteriorates.
- A direct impact happens when increase in lending rate resulting in repayment problem for the firm at a floating rate
- An indirect impact is when increase in interest rate will reduce the capitalized value of firm’s assets

The Expectation channel

- Finally, changes in monetary policy may have impact on people’s expectations about inflation and therefore on aggregate demand.
- This in turn affects employment, income, aggregate demand, price level and output in the economy

Operating Procedures and Instruments

- The operating framework relates to aspects of implementation of monetary policy It primarily involves three objectives

1. Choosing the operating target- Inflation
2. Choosing intermediate target- Economic stability
3. Choosing policy instrument – tools which can control the credit

Instruments of Monetary Policy

- The following are the instruments employed by RBI

1.Cash Reserve Ratio (CRR -4%) :

2.Statutory Liquidity Ratio (SLR -18%)

3.Repo rate (4%)

4.Reverse Repo rate (3.35%)

5.Bank rate or discount rate (4.25%)

6.Marginal Standing Facility (4.25%)

7.Market Stabilization Scheme

8.Open Market Operations

9.Long term repo operation (TLTRO)

Instruments of Monetary Policy

- Bank Rate : Bank rate or discount rate is charged by central bank for lending funds to commercial banks.
- Assume X draws bills of exchange on Y for borrowing Rs 10,000. X keeps the bill of exchange and as a security and gives Rs 10000 to Y.
- Assume X needs money then he can discount the bill of exchange in the bank. Of course a bank pays to X less than bill amount . Assume again that a bank needs liquidity then it can rediscount the bill of exchange with RBI to raise the liquidity.
- The bank rate or discount rate is 4.25% In the past bank rate had been used as key policy rate in India . Now it was replaced by repo rate or short term interest rate. The bank rate coincides with MSF rate.

Monetary Policy Frame Work Agreement

- In 2015 The Government of India and Reserve Bank of India signed a new Monetary Policy Framework Agreement on the recommendations of a committee headed by RBI Deputy Governor Urjit Patel
- The objective of monetary policy framework is to primarily maintain price stability while keeping in mind the objective of growth
- As per the agreement, RBI would set the policy interest rates and would aim to bring inflation below 6 per cent by January 2016 and within 4 per cent with a band of (+/-) 2 per cent for 2016-17 and all subsequent years.

Monetary Policy Frame Work Agreement

- The central bank will be deemed to have missed its target if consumer inflation is at more than 6 percent or at less than 2 percent
- Govt retains CPI inflation target 4% for the period 1st April - 31st March 2026.
- If the central bank misses the inflation target, it will send a report to the government citing reasons and remedial actions
- India's retail inflation rose marginally to 6.95% in March (from6.01 % in Feb) 2022, above 4% and the upper limit target 6%
- First RBI would set the policy interest rates and would aim to bring inflation below 6 per and within 4 per cent with a band of (+/-) 2 per cent

Monetary Policy Committee

- The Monetary Policy Committee (MPC) is the body of the RBI, headed by the Governor, responsible for taking the important monetary policy decision about setting the repo rate to target inflation rate 4%
- The MPC was setup after a Memorandum of Understanding between the government and the RBI about the conduct of the new inflation targeting monetary policy framework in February 2015.
- First meeting of the MPC was held on October 4, 2016

Monetary Policy Committee

- **Structure of the MPC**
- The Monetary Policy Committee (MPC) is formed under the RBI with six members. **Three** of the members are from the RBI while the **other three** members are appointed by the government.
- Members from the RBI are the Governor who is the chairman of the MPC, a Deputy Governor and one officer of the RBI. The government members are appointed by the Centre on the recommendations of a s**earch-cum-selection committee** which is to be headed by the Cabinet Secretary.
- The Committee is to meet at least four times a year and make public its decisions following each meeting. There will be no reappointment of the committee.
- Under MPC, the governor has a casting vote and doesn't enjoy veto power. Decisions will be taken on the basis of majority vote.
- The main responsibility of the MPC is to administer the inflation targeting monetary policy regime through determining the policy rate or repo rate to contain inflation.

CURRENT MONTEARY POLICY COMMITTEE

For your GK

1. **Ashima Goyal,** Prof of Economics in the Indira Gandhi Institute for Development Research (IGIDR), New Delhi
2. **Shashanka Bide** senior advisor, research programmes at the National Council of   Applied Economic Research (NCAER),New Delhi
3. **Jayanth R. Varma** prof of finance and accounting at the Indian Institute of Management (IIM), Ahmedabad
4. **Shaktikanta Das,** Governor of RBI
5. **Michael Patra,** Deputy Governor of RBI
6. **Mridul Saggar**an executive director at RBI

Practice Questions

1. Comment on conflicting objectives of monetary policy.
2. Explain interest rate channel of monetary policy
3. What is MSF? When it is used by banks?
4. Explain the essence of Monetary policy Frame work
5. Comment on the role of monetary policy committee

True OR False Questions

1. Reverse repo is higher than repo rate
2. MSF rate is equal to Repo rate
3. RBI pays rate of interest to CRR
4. RBI inflation target is 6%
5. SLR is kept in cash and bonds equally
6. Decrease in repo rate will lead to capital outflow
7. Short term interest rate and bank rate are one and the same

THANK YOU