20. An Empirical Study of Indian Monetary Policy

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Abstract

Monetary policy is the policy of the Central Bank to control over the money supply for the realization of general economic goals. The country uses many monetary policies tools to achieve a balance between its goals of price stability and higher growth. The goal is to stabilize inflation at low level and maintaining growth rate. The paper aims to examine the monetary policy of the Reserve Bank of India for achieving the objectives using interest rate as a tool. The few statistical tools are used for to know the monetary policy behavior. The result advocates that the growth criterion is the most significant factor which affects the interest rate policy of the central bank. It also finds reduced interest is sign of developing economy. It is hypothecated that, the fiscal parameter turns out to be insignificant.

Keywords: Monetary Policy, Fiscal Deficit, Current Account Deficit. Budget, RBI

1. Introduction

Monetary policies analyzed in the context of maximization of welfare. This also stabilizes inflation at low level and maintain growth rate. Keynesian, Monetarists, New-Classical and New Keynesian and others contributed to the study of optimal monetary policy. Keynesian, Taylor rules have specified about the central banks role in adjusting the nominal interest rate in response to changes in inflation gap and output gap, and compared the Federal Reserve's actual path of interest rate to the rule-based interest rate.

Monetary policy is the policy of the Central Bank ie, Reserve Bank in India for maintaining its control over the money supply for the realization of general economic goals in the country. However this policy should not be restricted only to controlling the supply of money. It is also to accelerate economic development in an environment of reasonable price stability. The functions of the Reserve Bank are expanded from merely discharging the traditional central banking functions to performing an active, developmental and promotional role in meeting the demands of the expanding Indian economy.

The excess of money supply results in consistent inflationary pressure in the economy. RBI has the power of using instruments of monetary policy. RBI uses the variable reserve requirements to have control over the economy. RBI put conditions on commercial banks to

maintain with RBI a certain proportion of the total deposits. The cash reserve requirements are like 1) Cash Reserve ratio - CRR. This ratio ranges from 3% to 15% which refers certain percentage of total deposits should be invested in government securities and 2) Statutory liquidity ratio – SLR. This refers to that certain percentage of total deposits of banks to keep with itself in the form of cash reserves. This ratio ranges is up to 40%. Shri C. Rangarajan highlighted about the monetary policy as, the monetary policy measures have the résponse to fiscal policy. The cost of credit has to be adjusted to meet effective inflation situation in the country

2. Features of the Monetary Policy in India

a. **Active Policy:** The monetary policy of the Reserve Bank was not so active before 1951 in India. The bank rate remained stable at around 3% up to 1951. Later it started using measuring credit control policy.

b. **Overall Expansion:** The Reserve Bank of India play very important role money circulation in the country. The overall responsibility of RBI is to see that overall expansion money supply with credit restriction. So that inflation should be in control.

C. **Seasonal Variations:** Money is required on a regular basis for certain industries whereas it is required on seasonal basis for agriculture sector. Money expansion is required for the seasonal needs of financing production. Therefore RBI adopts and expansionary credit policy during busy seasonand tightens the liquidity pressures during the slack season.

d. **Tight and dear Monetary Policy:** RBI keeps on controlling the inflation by bank rates. It uses normally tight and dear monetary policy. Tight monetary policy implies, the rate of growth of money supply is restricted whereas in case of dear money policy, the bank rate is increased which leads to hike in interest rates of loans by banks.

3. Objectives of Monetary Policy

The primary objective of central banks is to manage inflation and the second is to increase the employment opportunities.

4. Research Methodology

The study focuses on study of Secondary data collected from various books, national & international journals, government reports, publications from various websites which has been published and focused on various aspects of RBI monetary policy.

5. Types of Monetary Policy

The Reserve Bank of India uses certain tools to meets its monetary policy objectives

- **Interest Rate** – RBI control the inflation in the country by increasing or decreasing the repo rate and reverse repo rates. Bank reduces interest rates, buy securities from member banks to increase liquidity.
- **Selling Securities** – Govt. or Central Government sell securities through ope market operations to have control over the economy.
- **Expansionary Monetary policy** - This is used to lower unemployment and avoid the position of recession.

6. Monetary Policy V/s Fiscal Policy

The government's fiscal policy and the monetary policy of the central bank should have cordial relation.

Majority of the state governments and central government reduces tax burden of the people and also announces many subsidies, interest wave off etc which lead to inflation. So monetary policy of the RBI plays a very important role in this regard. The great recession of US put its economy into panic where the nation debt exceeded the debt to GDP ratio of 100%. This led to injecting more money into the economy by the government.

7. The Monetary Policy Committee – MPC

The Government of India has appointed monetary policy committee in 2016 to bring transparency and accountability in fixing India's Monetary Policy.

The Committee is responsible for fixing the benchmark rate of interest in the country. The meetings of the MPC be held at 4 times a year and announce its decisions after such meeting.

The committee involves six members headed by Governor of Reserve Bank of India. Threeofficials of the central bank along with three external members nominated by the Government are in the committee. Decisions are taken based on majority and in case of tie, the Governor has the casting vote. The current mandate (up to the year 2021) of the committee is to maintain 4% annual inflation ranging from 2% to 6%.

The MPC is to administer the inflation targeting monetary policy determining the policy rate like repo rate, reverse repo rate, CRR; SLR to control inflation.

The composition of the current (January, 2019) monetary policy committee is;

1. Mr. Shaktikant Das - Governor of the Reserve Bank of India, Chairperson & Ex Officio
2. Mr. Viral V Achary - Deputy Governor of RBI, In charge of Monetary Policy & Member, Ex Officio
3. Mr. Micheal Patra - Officer RBI nominated by the Central Board, Member

4. Prof. Chetan Ghate – Professor Indian Statistical Institute (ISI) – Member;
5. Prof. Pami Dua - Director Delhi School of Economics – Member;
6. Prof. Dr. Ravindra H. Dholakia - Indian Institute of Management Ahmedabad – Member

Structure of the MPC

The Monetary Policy Committee (MPC) is structured as per the RBI with six members. In this committee there are three members from the RBI and others appointed by the government for 4 years only and no reappointment of the committee.

8. Interest and Inflation Rate

Interest is the amount of interest due per period. The total interest on an amount lent or borrowed depends on the principal sum, the interest rate, the compounding frequency, and the length of time over which it is lent, deposited or borrowed.

The consumer price index replaced the wholesale price index (WPI) in 2013, to measure inflation. The most important category in the consumer price index is Food and beverages (45.86 percent of total weight) in India, of which Cereals and products (9.67%), Milk and products (6.61%), Vegetables (6.04%), prepared meals, snacks, sweets, etc. (5.55%), Meat and fish (3.61%), and Oils and fats (3.56%) and so on.

Consumer prices are very volatile as it depends energy imports, the monsoon, difficulties transporting food items,

The Central Bank of India left its key rate steady at 6.5% in the second meeting held recently on 5th Dec., 2018. Policymakers stated the decision is consistent with a calibrated tightening that aims to achieve a 4% with 2% plus or minus inflation target and support growth. It is also decided to continue the reverse repo rate at 6.25% and the marginal standing facility rate and the Bank Rate at 6.75% each. Interest Rate in India averaged 6.66% from 2000 until 2018, reaching an all time high of 14.50 percent in August of 2000 and a record low of 4.25 percent in April of 2009.

Bank rate also referred to as the discount rate. It is charges on loans and advances to a commercial bank by central bank. Based monetary policy of the country, banks can borrow from the central bank based.

The repo rate is the rate at which the central bank ie, Reserve Bank of India lends short-term money to the commercial banks. The reverse repo rate is the rate at which commercial banks park surplus funds with the reserve bank. This is mostly done when there is surplus liquidity in the market.

Country	**Inflation Rate – Consumer Prices in %**				
	2013	**2014**	**2015**	**2016**	**2017**
Japan	0.35	−2.76	0.79	−0.12	0.47
Singapore	2.36	1.03	−0.52	−0.53	0.58
Zimbabwe	1.63	−0.21	−2.41	−1.56	0.91
France	0.86	0.51	0.04	0.18	1.03
China	2.63	2.00	1.44	2.00	1.59
Canada	0.94	1.91	1.13	1.43	1.60
New Zealand	1.13	1.23	0.29	0.65	1.85
Australia	2.45	2.49	1.51	1.28	1.95
United States	1.47	1.62	0.12	1.26	2.13
Nepal	9.04	8.37	7.87	8.79	3.23
India	**10.91**	**6.65**	**4.91**	**4.95**	**3.33**
Russia	6.76	7.82	15.53	7.04	3.68
Malaysia	2.11	3.14	2.10	2.09	3.87
Pakistan	7.69	7.19	2.53	3.77	4.09
Bangladesh	7.53	7.00	6.19	5.43	5.78
Zambia	6.98	7.81	10.11	17.87	6.58
Sri Lanka	6.91	3.18	3.77	3.96	7.70
Egypt	9.42	10.15	10.36	13.82	29.50
Angola	8.78	7.28	10.28	32.38	31.69
Sudan	29.96	36.91	16.91	17.75	32.35
Democratic Republic of the Congo	0.81	1.24	0.74	18.23	41.50
South Sudan	−0.04	1.66	52.82	378.85	187.85
Venezuela	40.64	62.17	121.74	254.96	1,087.51
World	**2.59**	**2.35**	**1.44**	**1.47**	**2.18**

Source: World Bank and the International Monetary Fund

The inflation in India is at around 4 which is as per the norms. Looking at the other countries, it is very higher side and difficult to control it. Inflation less than 2% is also not good for the development of the country. The ideal inflation should be at 4% with 2% plus or minus.

Bank Rates in Indian Banking - 2019

SLR Rate 19.5% CRR 4% MSF 6.75%

Repo Rate 6.25% Reverse Repo Rate 6% Base Rate 8.75% - 9.45%

9. Limitations of Monetary Policy

Monetary policy may not work as expected some times in the countries like India due to various reasons. Following factors explains about limitations of monetary policy.

1. Normally people do not employ alternative investment options. Majority of the people depends on saving accounts, fixed deposits, Public Provident Fund for investment. Commercial banks have large deposits from the people in terms of FD. RBI's monetary policy has little impact as RBI is not the main or even prominent money supplier for the commercial banks.
2. People in rural areas are out of banking activities and hence monetary policies do not have much impact on their financial activities.
3. Monsoon uncertainty and other natural calamity adversely affect food production which causes food inflation, hence monetary policy has no much impact on food inflation.

10. Conclusion

It is expected that, gross domestic product (GDP) growth decelerated mainly by a slowdown in private consumption. On the supply side, growth in manufacturing decelerated due to lower profitability of manufacturing firms. Fiscal discipline is important to create space for and crowd in private investment activity. The committees or authorities of Fiscal Policy and Monetary policy should have cordial relation and have mutual understanding to control the inflation. Government may announce many subsidiaries and pro election result policies but this leads to inflation which can't be controlled by monetary policies some times.

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