Monetary Policy

Seminar on Fiscal & Monetary Policy
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Dr. (CA) Abhijit Phadnis

Overview of presentation

- Concept of money
- Monetary aggregates
- Understanding RBI Balance Sheet
- Monetary & fiscal policy
- Monetary policy objectives
- Monetary Policy Instruments
- Evolution of monetary policy in India
- Dr. Urjit Patel Committee Recommendations

Concept of money

- Commodity money
- Bank money
  - Cheques
- Fiat money or paper money
  - Legal tender of a country

Money for policy makers

Money is a set of liquid financial assets the variation in the stock of which could impact on aggregate economic activity

Role of Money

- Medium of exchange
- Measure of value, unit of account
- Store of value

Issuance of currency in India

Reserve Bank of India is authorized to issues all notes other than Rupee One which is issued by the Government of India

RBI also acts as the agent of the Government for coins & Re 1 notes

Demand & Supply of Money

- Demand
  - Transaction demand
    - Inflation
    - GDP growth
  - Speculative or Asset demand
    - Inverse relationship with interest rates
- Supply
  - Money supply multiplier

Money multiplier India

Rs. Billion	M3	M0	Multiplier
FY 2013*	80319.2	14582.1	5.51
FY 2012	73592.0	14271.7	5.16
FY 2011	65041.2	13768.2	4.72
FY 2010	56027.0	11556.5	4.85
FY 2009	47947.8	9879.6	4.85
FY 2008	40178.6	9282.7	4.33
FY 2007	33100.4	7088.6	4.67

*As of December 2012

Let us understand what this M0 & M3 is!

Definition of monetary aggregates: India

Term	Definition
M0	**Reserve Money** Currency + Reserves held by banks with RBI
M1	**Narrow Money:** Currency + Demand Deposits
M2	M1 + Post Office Savings Deposits
M3	**Broad Money:** M2 + Time Deposits
M4	M3 + Postal Time Deposits

Let us understand M0 (Reserve Money) from the RBI Balance Sheet

RBI Balance Sheet

Liabilities

- Currency
- Deposits:
  - Governments
  - Banks
- Loans
- Other Liabilities
- Capital Account
  - Paid Up Capital
  - Reserves

Assets

- Gold
- Loans & Advances to
  - Government
  - Banks
- Investments
  - Government Securities
  - Foreign Assets
- Other Assets

Reserve Money (M0)

Liabilities

- Currency
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Reserve Money*

ITEM		Rs. Billion
	31.3.2013	24.1.2014
Reserve Money	**15,148.9**	**16,236.8**
Components (i+ii+iii)		
i) Currency in Circulation	11909.8	12787.0
ii) Bankers' Deposits with RBI	3206.7	3427.0
iii)`Other' Deposits with RBI	32.4	22.8
Sources (i+ii+iii+iv-v)		
i) Net RBI Credit to Government	5905.8	6601.4
ii) RBI Credit to Banks and Commercial Sector	434.1	381.4
iii) Net Foreign Exchange Assets of RBI *	15580.6	17821.9
iv) Govt.'s Currency Liabilities to the Public	153.4	165.6
v) Net Non-Monetary Liabilities of RBI	(6925.0)	(8733.5)

* Drawn from the liabilities of both ‘issue department’ and ‘banking department’ of RBI, though their balance sheets are published separately

Assets held against creation of money

- Gold Coin and Bullion
  - (a) Held in India
  - (b) Held outside India
- Foreign Securities
- Rupee Coins (since issued by GoI, not RBI)
- Government of India Rupee Securities
- Eligible Internal Bills of Exchange
- Eligible Commercial Paper

Monetary and fiscal policy

- With emergence of Keynesianism since great depression of 1930s, monetary policy sub-served fiscal policy right upto the 60s
- In the early 70s, inflation almost touched double digits in the U.S., while growth stagnated
- This stagflation in the 70s prompted emergence of monetarism

Keynesian view of monetary policy

- Keynesians advocate using monetary policy in an activist role
- Most effective when economy near full employment as changes in money supply bring swift changes
- Monetary policy more effective in ‘pulling’ strings rather than ‘pushing’ strings
- During recession or depression, it is fiscal policy which is more effective than a loose monetary policy

Monetarists' view

- Monetarism arose sequel to the Keynesian failure to resolve the conflicting problems of inflation & unemployment arising out of stagflation
- For monetarists, there is no 'activist' role for either fiscal or monetary policy
- According to the father of monetarism, Milton Friedman, the problems of both inflation & recession can simply be traced to the rate of growth of money supply
- Growth of money supply should be aligned to growth in GDP
- Their view was tried for 3 years in the late 70s & early 80s, while money supply was aligned the inflation still soared

Monetary Policy Objectives

Objective
Price stability
Currency stability
Economic growth
Promoting savings & investments
Controlled Extension of Bank Credit

Anchors of Monetary Policy

Anchor	Remarks
Exchange Rate	Diminishing appeal due to currency attacks and domestic vulnerability to external shocks, particularly from the anchor economy
Monetary Aggregates	Less predictability for demand for money and thus less accountability of the policy setting agency
Inflation	More widely accepted globally since late 80s, on the back of empirical evidence for low inflation as a precursor for sustainable growth
Multiple Indicators (GDP, IIP, Inflation, Exchange Rate)	Accountability issues for the policy setting agency since multiple targets may be difficult to achieve at the same time

Monetary Policy Instruments

Instruments
Reserve requirements Cash Reserve Ratio
Interest Rates Repo Rate
Buying & Selling of Bonds Open Market Operations

Evolution of Indian Monetary Policy

Soon after independence
Exchange rate as the anchor
40% note issue backed by Gold & Sterling
So called proportional reserve system

1957 onwards
Credit aggregates as the anchor
Minimum reserve system with Rs. 200 Cr. Of Bullion & foreign securities
Of which Rs. 115 Cr. Must be Gold
Bank rate and CRR main instruments

1971-1985
Neutralization of effects of loose fiscal policy became the priority
CRR was used as the instrument

1985 onwards
Dr. Sukhamoy Chakravarty Report
Broad money the target
Reserve money used as the instrument
Targets were rarely met as RBI had no control on the credit to government
High SLR, CRR, yet growth in money supply & inflation remained high

Evolution of Indian Monetary Policy

1991 onwards

Capital flows & exchange rate movements became new variables

Exposure to global business cycles

Monetary aggregates targeting became difficult

1997-98 onwards

CRR, SLR brought down to 9.5% & 25% respectively

Multiple Indicator approach: money, credit, output, trade, capital flows, fiscal position, rates of return in different markets, exchange rate, inflation rate drawn from RBI's surveys

2009-10 onwards

Stagflation scenario of weak growth but high inflation

Unclear signal to analysts about what RBI is targetting

Several committees have since recommended inflation targetting

Current Operating Framework of Monetary Policy

REPO RATE IS THE SINGLE POLICY RATE, 8% NOW

REPO RATE + 100 BP IS THE MARGINAL STANDING FACILITY RATE, 9%

REPO RATE - 100 BP IS THE REVERSE REPO RATE, 7%

Liquidity Management stands on two pillars

Pillar I: System level assessment of autonomous liquidity demands in the near term

Pillar II: Longer term growth in credit, deposits and broad money

Discretionary Liquidity Management By RBI based on assessment whether it is structural or frictional

CRR, Open Market Operations, Limits for term & overnight Repos

Reserve Ratio History

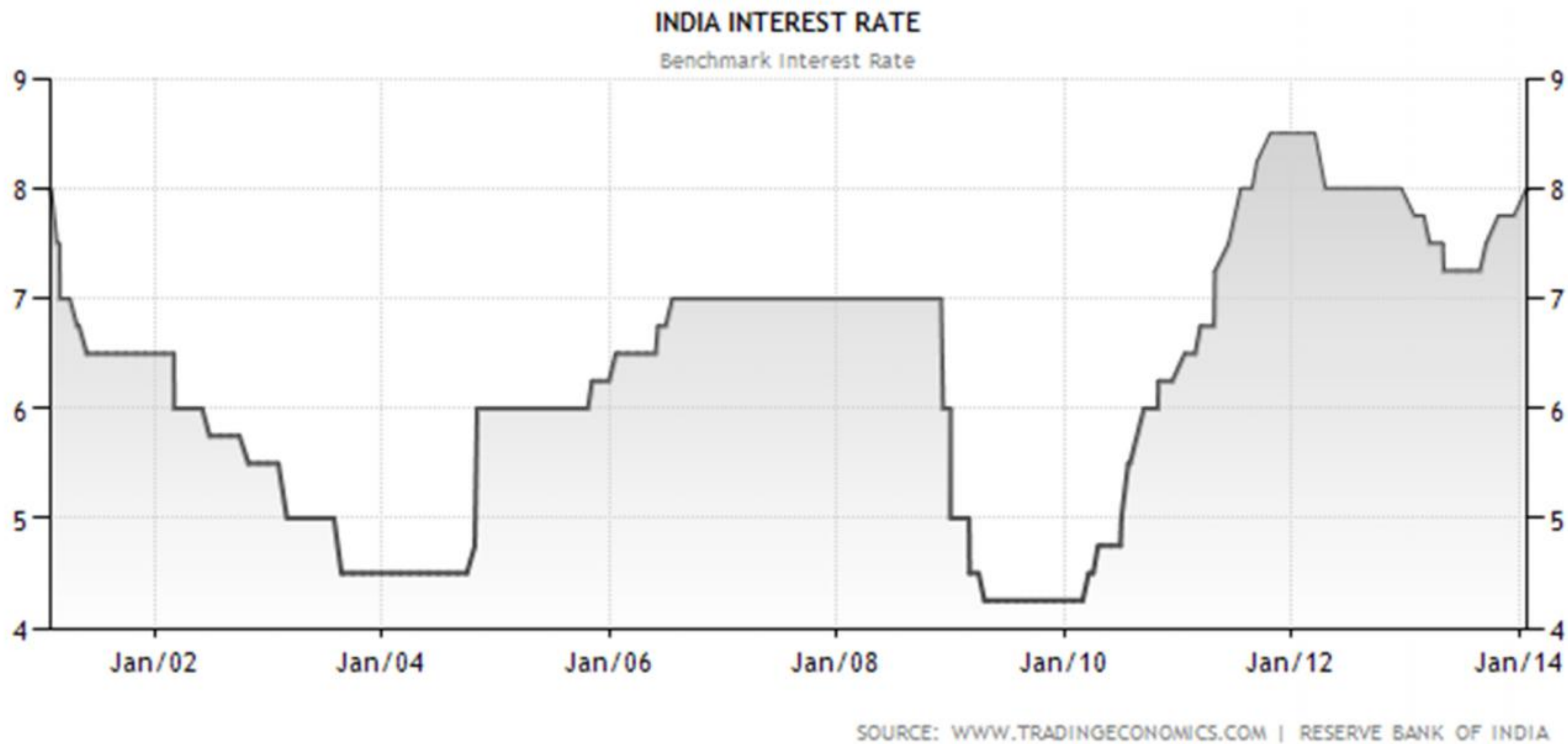
SLR

- 23.00% Since 11-08-2012
- 24.00% Since 18-12-2010
- 25.00% Since 07-11-2009
- 24.00% Since 08-11-2008
- 25.00 % Since 25-10-1997
- 31.50 % Since 29-10-1994
- 33.75 % During 1992-93
- TO
- 38.50%

CRR

- 4.00% Since 29-01-2013
- 4.25% Since 30-10-2012
- 4.50% Since 17-09-2012
- 4.75% Since 10-03-2012
- 5.50% Since 24-01-2012
- 6.00% Since 20-04-2010
- 15.00% During 1989-92

Repo Rate



INDIA INTEREST RATE
Benchmark Interest Rate
9
8
7
6
5
4
Jan/02
Jan/04
Jan/06
Jan/08
Jan/10
Jan/12
Jan/14
SOURCE: WWW.TRADINGECONOMICS.COM | RESERVE BANK OF INDIA

Monetary policy transmission issues

- Supply side constraints & influencers on inflation
  - Governance issues
- Fiscal profligacy: schemes which put money in hands of people without productivity
  - Impact on inflation
- Tax & interest distortions

Dr. Urjit Patel Committee Recommendations

- Inflation to be the nominal anchor
- CPI as the main indicator to be targeted
- Headline CPI number to be used
- CPI target: 4% +/- 2%, 8% in next 12 months, 6% in next 24 months
- Expectation that Fiscal deficit is brought down to 3% of GDP by 2016-17
- Expectation from the Government that administrative prices, wages and interest rates are eliminated as they are impediments to transmission
- Monetary policy should be vested in MPC, not the Governor alone
- RBI to place a bi-annual inflation report in the public domain
- Accountability of the MPC for failure to achieve the inflation target for 3 successive quarters
- Phased refinement of the operating framework for monetary operations
  - Shift focus from overnight to term repos: 14, 28, 56, 84 days
- Standing Deposit facility without collateral requirements to aid sterilization or sucking liquidity from the system
- Recommendations for removal of monetary policy impediments such as interest subvention, alignment of tax treatments of different fixed income instruments and also for reduction of SLR
- Open Market Operations should be delinked from Fiscal Operations & Management of G Sec Yields

THANK YOU