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EFFECT OF RBI'S MONETARY POLICY IN INDIA

DR. SUSHAMA SUBHASH DESHMUKH*

*Associate Professor & H.O.D., Commerce Department,
Mahila Mahavidyalay,Amravati, M.S., India.

ABSTRACT

In early 1990's the Indian economy had witnessed dramatic policy changes. The idea behind the new economic model known as Liberalization, Privatization and Globalization in India (LPG), was to make the Indian economy one of the fastest growing economies in the world. An array of reforms was initiated with regard to industrial, trade and social sector to make the economy more competitive. The economic changes initiated a dramatic effect on the overall growth of the economy. It also heralded the integration of the Indian economy into the global economy. The Indian economy was in major crisis in 1991 when foreign currency reserves went down to $1 billion and inflation was as high as 17%.

India gained highly from the LPG model as its GDP increased to 9.7% in 2007-2008. In respect of market capitalization, India ranks fourth in the world. But even after globalization, condition of agriculture has not improved. The share of agriculture in the GDP is only 17%. But seeing the positive effects of globalization, it can be said that very soon India will overcome these hurdles too and march strongly on its path of development.

Has Increasing Globalization Limited the Effectiveness of National Policies in India? In the wake of the global financial crisis, financial globalization has come under scrutiny once again. Critiques Of globalization have re-emphasized that globalization does not bring any additional gains than what can already come from free trade. In the context of increasing capital flows, it has been time and again pointed out by the critiques that gains from trade in goods (widgets) are of first order, while gains from trade in capital (dollars) are of second order. Another observation has been that countries have benefited most from free-market globalization are not those that have embraced it whole heartedly, but those that have adopted parts of it selectively. Contrarian arguments have been equally strong. Financial globalization and the various economic policies that could help developing economies effectively manage the process of financial globalization. They find that policies promoting sound macro economy, financial sector development, institutional quality and trade openness appear to help developing

countries derive the benefits of financial integration. While advanced economies face inflationary pressures from high commodity prices, EMEs face pressures from both strong domestic demand and high commodity prices. CPI inflation in the advanced economies is projected to increase from 1.6 percent in 2010 to 2.2 per cent in 2011, and in the EMEs from 6.2 per cent to 6.9 per cent.

INTRODUCTION

In early 1990's the Indian economy had witnessed dramatic policy changes. The idea behind the new economic model known as Liberalization, Privatization and Globalization in India (LPG), was to make the Indian economy one of the fastest growing economies in the world. An array of reforms was initiated with regard to industrial, trade and social sector to make the economy more competitive. The economic changes initiated a dramatic effect on the overall growth of the economy. It also heralded the integration of the Indian economy into the global economy. The Indian economy was in major crisis in 1991 when foreign currency reserves went down to $1 billion and inflation was as high as 17%.

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THE REAL ECONOMY

Growth rebounds strongly in 2010-11. Real GDP growth at factor cost increased to 8.5 per cent in 2010-11 from 8.0 per cent in 2009-10. At this pace, the real GDP growth rate increased for the second successive year. After the global crisis-induced sharp slowdown in 2008-09, the main impetus to growth during 2010-11 emanated from agriculture which rebounded to above-trend growth rate on the back of a normal Monsoon. Reflecting this, the contribution of the agriculture sector to overall GDP growth increased sharply in 2010-11. Services Sector continued to be the predominant driver of growth, though its growth was slightly lower than the average in the pre-crisis high growth phase of 2003-08.

Growth is expected to moderate to the trend level of about 8 percent in 2011-12. If global conditions worsen, downside bias to this projection may arise. This raises concern about sustainability of the high growth over the medium to long-term. The Planning Commission in its paper on Issues for the Approach to the Twelfth Plan (2012-17) proposed a growth target of 9.0-9.5 percent. A prerequisite for high growth is upfront removal of structural constraints with close attention on legal and institutional framework, as also execution and Governance. In short run, growth will have to contend with risks from low agricultural productivity, poor infrastructure, and high global commodity prices, Quality of corporate governance and low productivity. For implementation of the above factor effectively the monetary policy of the RBI is play an important role.

POLICY RATES AND RESERVE RATIOS AS DECLARED BY RBI

Policy rates, Reserve ratios, lending, and deposit rates as of 14 September, 2011	
Bank Rate	6.0%
Repo Rate	8.25%
Reverse Repo Rate	7.25%
Cash Reserve Ratio (CRR)	6.0%
Statutory Liquidity Ratio (SLR)	24.0%
Base Rate	9.50%–10.75%
Reserve Bank Rate	4%
Deposit Rate	8.50%–9.50%

BANK RATE

RBI lends to the commercial banks through its discount window to help the banks meet depositor's demands and reserve requirements. If the RBI wants to increase the liquidity and money supply in the market, it will decrease the bank rate and if it wants to reduce the liquidity and money supply in the system, it will increase the bank rate. As of 5 May, 2011 the bank rate was 6%.

CASH RESERVE RATIO (CRR)

Every commercial bank has to keep certain minimum cash reserves with RBI. RBI can vary this rate between 3% and 15%. RBI uses this tool to increase or decrease the reserve requirement depending on whether it wants to affect a decrease or an increase in the money supply. An increase in Cash Reserve Ratio (CRR) will make it mandatory on the part of the banks to hold a large proportion of their deposits in the form of deposits with the RBI. This will reduce the size of their deposits and they will lend less. This will in turn decrease the money supply. The current rate is 6%.

STATUTORY LIQLUIDITY RATIO (SLR)

Apart from the CRR, banks are required to maintain liquid assets in the form of gold, cash and approved securities. Higher liquidity ratio forces commercial banks to maintain a larger proportion of their resources in liquid form and thus reduces their capacity to grant loans and advances, thus it is an anti-inflationary impact. A higher liquidity ratio diverts the bank funds from loans and advances to investment in government and approved securities.

In well-developed economies, central banks use open market operations--buying and selling of eligible securities by central bank in the money market--to influence the volume of cash reserves with commercial banks and thus influence the volume of loans and advances they can make to the commercial and industrial sectors. In the open money market, government securities are traded at market related rates of interest. The RBI is resorting more to open market operations in the more recent years.

THE POLICY STANCE

The Reserve Bank began exiting from the crisis driven accommodative policy in October 2009. Since then, the cash reserve ratio (CRR) has been raised by 100 basis points. Policy rates have been raised eight times - the repo rate under the LAF by 200 basis points and the reverse repo rate by 250 basis points. The effective tightening in policy rates has been of 350 basis points as the liquidity in the system transited from a surplus to a deficit mode.

The monetary policy stance in 2010-11 was calibrated on the basis of the domestic growth-inflation dynamics amidst persistent global uncertainties. Against the backdrop of global and domestic macroeconomic conditions, outlook and risks, the policy stance for 2011-12 has been guided by the following major considerations.

First, notwithstanding some moderation in the second half of the year, inflation has persistently remained much above the comfort level of the Reserve Bank. The sharp increase in non-food manufactured product inflation towards the latter part of the year suggests strong underlying demand pressures, which are helping producers to pass through input price increases. The uncertainty in global commodity prices poses a major risk to domestic inflation as the significant increase in global crude prices that has already taken place, is yet to be passed through to domestic prices. The impact of monetary tightening already undertaken by the Reserve Bank is still unfolding. However, considering the overall inflation scenario, there is a clear need to persist with the anti-inflationary stance.

Second, while the growth momentum remained relatively firm during 2010-11, signs of moderation emerged in the latter half of the year, particularly with respect to capital goods and investment activity. Growth is expected to decelerate from 8.6 per cent in 2010-11 to around 8 per cent in 2011-12, which should contribute to some easing of demand-side inflationary pressures, particularly in the second half, as the full impact of monetary tightening is realized. However, even as this trend unfolds, persistently high rates of inflation raise the risks of inflationary expectations becoming unhinged.

Against this backdrop, the stance of monetary policy of the Reserve Bank will be as follows:

- Maintain an interest rate environment that moderates inflation and anchors inflation expectations.
- Foster an environment of price stability that is conducive to sustaining growth in the medium-term coupled with financial stability.
- Manage liquidity to ensure that it remains broadly in balance, with neither a large surplus diluting monetary transmission nor a large deficit choking off fund flows.

India's growth-inflation dynamics are in contrast to the overall global scenario. The economy is recovering rapidly from the growth slowdown but inflationary pressures, which were triggered by supply side factors, are now developing into a wider inflationary process. As the domestic balance of risks shifts from growth slowdown to inflation, our policy stance must recognize and respond to this transition. While global policy co-ordination was critical in dealing with a worldwide crisis, the exit process will necessarily be differentiated on the basis of the macroeconomic condition in each country. India's rapid turnaround after the crisis induced slowdown evidences the resilience of our economy and our financial sector. However, this should not divert us from the need to bring back into focus the twin challenges of macroeconomic stability and financial sector development.

The Indian economy is estimated to have grown by 8.6 per cent during 2010-11. Agricultural growth was above trend, following a good monsoon. The index of industrial production (IIP), which grew by 10.4 per cent during the first half of 2010-11, moderated subsequently, bringing down the overall growth for April-February 2010-11 to 7.8 per cent. The main contributor to this decline was a deceleration in the capital goods sector. However, other indicators, such as the manufacturing PMI, tax collections, corporate sales and earnings growth, credit off-take by industry (other than infrastructure) and export performance, suggested that economic activity was strong. The Reserve Bank's forward looking Industrial Outlook Survey (IOS) shows a decline in the business expectations index for January-March 2011 after two quarters of increase.

SUMMARY

Has Increasing Globalization Limited the Effectiveness of National Policies in India? In the wake of the global financial crisis, financial globalization has come under scrutiny once again. Critiques Of globalization have re-emphasized that globalization does not bring any additional gains than what can already come from free trade. In the context of increasing capital flows, it has been time and again pointed out by the critiques that gains from trade in goods (widgets) are of first order, while gains from trade in capital (dollars) are of second order. Another observation has been that countries have benefited most from free-market globalization are not those that have embraced it whole heartedly, but those that have adopted parts of it selectively. Contrarian arguments have been equally strong. Financial globalization and the various economic policies that could help developing economies effectively manage the process of financial globalization. They find that policies promoting sound macro economy, financial sector development, institutional quality and trade openness appear to help developing countries derive the benefits of financial integration. While advanced economies face inflationary pressures from high commodity prices, EMEs face pressures from both strong domestic demand and high commodity prices. CPI inflation in the advanced economies is projected to increase from 1.6 percent in 2010 to 2.2 per cent in 2011, and in the EMEs from 6.2 per cent to 6.9 per cent.

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