

RBI's monetary policy: Its impact and implications on money supply and inflation

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Abstract

Monetary Policy is a regulatory policy of Reserve Bank of India, through which it tries to exercise control over the money supply in the economy for the accomplishment of general economic objectives. It involves manipulation of money supply, the level & structure of interest rates & other conditions influencing the level of credit. The RBI fixes the bank rate which forms the foundation of the interest rates structure and reserve ratios, which in turn, determine the level of credit and money supply available, thereby playing an imperative role in the growth and development of an economy. Inflation beyond the threshold level makes growth expensive and calls for a change in policy. RBI authorities strive hard to curb the inflation by adopting several monetary policy measures, the significant amongst which are changes in Bank Rate, CRR & SLR which directly influence the money supply in the economy with immediate effect without creating many distortions in the market. In this regard, the paper aims to study the impact of changes in monetary policy over the last 6 years and the consequent effect of the same on money supply and the level of inflation in the economy.

Keywords: Monetary Policy, Reserve Bank of India, CRR, SLR, Economic Development, Inflation

1. Introduction

Reserve Bank of India was inaugurated on April 1 1935. Initially, the Reserve Bank was constituted as a shareholders' bank based on the model leading foreign central banks on that time. Reserve Bank of India started operating as a state owed central banking institution on January 1, 1949. RBI aims at the promotion of monetary integration of the economy by filling in the Credit gaps.

The preamble to the Reserve Bank of India Act, 1934 highlights the objectives of the Reserve Bank as "to regulate the issue of banking notes and the keeping of reserve with view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantages."

Monetary policy is the regulatory policy framed by Reserve Bank of India in order to accomplish macroeconomic objectives like liquidity, growth, consumption and inflation. It aims at managing the supply of money in order to meet the requirements of different sectors of the economy and to increase the pace of economic growth. It stimulates or discourages expenditure on goods and services and, accordingly, influences prices and economic activities by regulating the supply of money.

The RBI executes its monetary policy through various qualitative and quantitative instruments like open market operations, bank rate policy, reserve ratios, moral persuasion and others. These instruments help in controlling the money supply in the economy. The policy is both expansionary and contractionary in nature. An expansionary policy is attributed to increased supply of money and the reverse holds true for contractionary monetary policy.

1.1 Instruments of Monetary Policy in India

1.1.1 Bank rate

The Reserve Bank of India Act defines Bank Rate as 'the standard rate on which it is prepared to buy or rediscounts

bills of exchange or other commercial papers eligible for purchase under this Act. Therefore, Bank Rate is the discount rate at which the central bank lends to the other banks.

Normally, the Bank rate policy aims at influencing the level of economic activity, the cost and credit availability to the commercial banks, and the interest rates and money supply in the economy. There is a direct relationship between the bank rate and the market interest rates. Changes in the bank rate influence the entire interest rate structure, i.e. short-term as well as long term interest rates. A rise in the bank rate leads to a rise in the market interest rates leading to increase in the cost of borrowing. Likewise, a fall in the bank rate leads to fall in the market rates, causing the cost of borrowing to reduce, implying a cheap money policy.

1.1.2 Cash Reserve Ratio

Cash Reserve Ratio is the minimum amount of a bank's deposits to be held by commercial banks in the form of cash. Banks have to maintain a certain proportion of their total assets in the form of cash. This is done to meet the statutory reserve requirement and also to cater to day-to-day needs for fulfilling cash obligations. There is a positive relationship between CRR and liquidity or money supply in the economy.

1.1.3 Statutory Liquidity Ratio

Statutory Liquidity Ratio is the ratio of the liquid assets to time and demand liabilities. It is the minimum percentage of deposits that a bank is required to maintain with itself in the form of gold, cash or other unencumbered approved securities.

The dissimilarity between CRR and SLR is that cash reserves are kept with the Central Bank whereas statutory ratio is to be maintained by the concerned commercial banks. There is a direct relationship between CRR and liquidity or money supply in the economy. With increase in SLR, liquidity in the economy increases.

1.1.4 Money Supply

Money supply affects the economy in three different ways. First, money supply is used to control the inflation in an economy. On the demand side, whenever money supply in the economy increases, consumer-spending increases instantaneously in the economy because of increase money in the system. But supply can't vary in the short term, so there is a temporary mismatch of demand & supply in the economy which exerts an upward pressure on inflation. This argument assumes that demand drives supply, which is generally the case. On the supply side, due to an increase in demand, supply can only be increased by capacity additions. This results in increased cost of production which and is reflected through inflation.

Second, money supply shares a positive relationship with the economy's growth. When an economy reaches full employment level, the growth in money supply is set off by growth in inflation, other things remaining equal. This happens because output can't rise after full employment and hence inflation increases as money supply increases.

Third, money supply affects interest rates structure of the economy. One variable can be used to control the other. Both can't be controlled concurrently. If RBI wants to peg the interest rate at a certain level, it has to supply whatever money is demanded at that level of interest rate. If it wants to fix the money supply at a certain level, the demand and supply of money will determine the interest rates.

Generally it is easier for RBI to regulate the interest rates through its open market operation. So, the money supply is allowed to fluctuate but RBI regulates it by manipulating the interest rates with the help of open market operations.

1.1.5. Inflation

Inflation is a rise in the general level of prices of goods and services in an economy over a period of time. When the general price level increases, each unit of currency buys fewer goods and services.

Consequently, inflation also reflects wearing down of the purchasing power of money which is a loss of real value in the internal medium of exchange and unit of account in the economy. A chief measure of price inflation is the inflation rate, the annualized percentage change in a general price index normally the Consumer Price Index.

2. Review of Literature

Globalization of the early 1990s is thought to have caused the loss of monetary-policy independence in India. Some studies found that India's monetary policy independence is anchored in the exchange-rate regime along with its state of foreign-exchange reserves, and not necessarily in globalization. India significantly followed US interest rates even in the absence of globalization in the 1960s when the country faced foreign-exchange constraints and maintained a fixed exchange rate.

From the mid-1970s to the early 1990s, India exercised monetary-policy independence under a floating exchange-rate regime. The loss of monetary-policy independence since the early 1990s is not attributable to globalization per se, but mainly to the stable exchange-rate policy of India, which heavily resembles the policy of the 1960s. (Paul, Biru Paksha, 2012)^[1]

Since the beginning of the 1990s, there have been many structural and economic reforms and subsequent transition to new policy regimes in India, which has made the analysis of monetary transmission gain importance. In the external constraints on monetary policy, a benchmark VAR model is used to examine the presence of bank lending channel, asset price channel, and exchange rate channel. The results suggest that bank lending channel plays an important role in the transmission of monetary policy, which aligns well with the theory, as India is a developing country. (Walia, Sai Vivek; Raju, G Raghavender, 2014)^[2]

India's government and the central bank have approved on overhaul of the monetary policy structure to place focus on inflation, a historic move for the economy as policymakers gear up for stronger growth momentum in coming years. Known to be pioneered by the Reserve Bank of New Zealand in 1990, inflation targeting is followed by several central banks in the developed world, such as the European Central Bank and the Federal Reserve, as well as many in the emerging markets. (Anonymous, 2015)^[3].

3. Objectives

The paper has following Objectives:

1. To understand the concept of monetary policy and money supply
2. To analyze the role of its instruments in influencing the money supply in economy
3. To analyze the extent to which money supply determines the level of inflation in the economy.

4. Research Methodology

Exhaustive literature survey regarding the topic and related concepts has been done. Secondary data has been collected from various sources including books, research papers, magazines and websites has been used for the purpose of study.

5. Scope of the study

The study covers a period of 6 financial years starting from 2011-2016 and analysis the impact of monetary policy on supply of money and inflation in Indian Economy.

6. Data Analysis and Interpretation

6.1. Impact of change in Bank Rate, CRR and SLR on Money Supply

Table 1

S. No	Years	Bank Rate %	Repo %	Reverse Repo %	Cash Reserve Ratio %	Statutory Liquidity Ratio %	Money Supply (Billion)	Growth in money supply in %
1	2016	6.75	6.25	5.75	4.00	20.75	28420.2	24.01
2	2015	7.75	6.75	5.75	4.00	21.50	22916.8	11.53
3	2014	9.00	8.00	7.00	4.00	22.00	20547	8.28
4	2013	8.75	7.75	6.75	4.00	23.00	18975.3	9.22
5	2012	9.00	8.00	7.00	4.25	23.00	17373.9	6.05
6	2011	9.50	8.50	7.50	6.00	24.00	16383.5	10.01

Source: Database on Indian Economy: RBI
<https://dbie.rbi.org.in/DBIE/dbie.rbi?site=statistics>

Table 1 clearly shows that with decrease in bank rate from 9.5 % in 2011 to 6.75 % in 2016, there has been an increase in money supply from 2011-2016. As CRR decreased from 6 % in 2011 to 4.25 % in 2012, and SLR decreased from 24 % to 23 in 2012, money supply increased from Rs 16383 billion to Rs 17373 billion in 2012. It further increased to 18975.3 billion in 2013, as CRR fell to 4 % and SLR at 23 %.

CRR remained stable at 4 % from 2013 onwards till present and SLR decreased from 23 % in 2013 to 20.75 % in 2016, resulting in increase in the level of money supply in the economy from Rs 18975.3 billion in 2013 to Rs 28420.2 in 2016.

The Money Supply (M1) was Rs. 16383.5 billion during the year 2011. It increased by Rs. 1490.8 billion as compared to the year 2010. In percentage terms, the growth was 10.01% during the period.

The Money Supply (M1) was Rs. 17373.9 billion during the year 2012. It increased by Rs. 990.4 billion as compared to the year 2011. In percentage terms, the growth was 6.05% during the period.

The Money Supply (M1) was Rs. 18975.3 billion during the year 2013. It increased by Rs. 1601.4 billion as compared to the year 2012. In percentage terms, the growth was 9.22% during the period.

The Money Supply (M1) was Rs. 20547 billion during the year 2014. It increased by Rs. 1571.7 billion as compared to the year 2013. In percentage terms, the growth was 8.28% during the period.

The Money Supply (M1) was Rs. 22916.8 billion during the year 2015. It increased by Rs. 2369.8 billion as compared to the year 2014. In percentage terms, the growth was 11.53% during the period.

The Money Supply (M1) is Rs. 28420.2 billion in the current year 2016. It increased by Rs. 5503.4 billion as compared to the year 2015.

In percentage terms, the growth was 24.01% during the period. The maximum annual growth in Money Supply (M1) of Rs. 5503.4 billion has been recorded during the year 2016.

6.2. Effect of Increase in Money supply on Inflation

Table 2: The inflation rate is based upon the consumer price index (CPI).

Sr. No	Years	Money Supply M1 (Billion)	Inflation Rate Annual %	Inflation Rate Average %
1	2016	28420.2	2.97	5.48
2	2015	22916.8	6.32	5.88
3	2014	20547	5.86	6.37
4	2013	18975.3	9.13	10.92
5	2012	17373.9	11.17	9.30
6	2011	16383.5	6.49	8.87

Source: <https://www.statbureau.org/en/india/inflation>

Table 2: shows that there has been a general trend of increasing money supply from 2011 to 2016. As money supply increases from Rs 16383.5 Billion in 2011 to 17373.9 Billion Rs in 2012, the annual Inflation rate increases from 6.49 % to 11.17 % in the same period. Annual inflation decreased in 2013 and 2014 although the money supply increased. In the year 2015 as money supply increased from 20547 in 2014 to 22916 in 2015, inflation rate increased from

5.86 % to 6.32%. Year 2016 is marked with highest level of money supply at 28420.2 billion and lowest rate of annual inflation at 5.48%.

7. Conclusion

Monetary policy has its own limitations and its instruments do not always bring about the expected results. In India, greater money supply need not necessarily cause inflation and reduced money supply need not always reduce inflation either. In fact as observed in the paper, inflation has decreased over the years even when money supply has been increased. This points out that money supply alone does not affect inflation, there could be other factors like; velocity of circulation, the state of the economy and the growth in productive capacity (the Long Run Aggregate Supply LRAS). According to the Economic Survey which was tabled in the parliament by Finance Minister in 2015, decline in inflation was due to lower food and fuel prices. The survey pointed out that the most important factors causing restraint on inflation include both international and domestic factors. International factors like continual decline in crude prices and elasticity in the global prices of edible oils and coal, helped moderate headline inflation. The quick crucial steps taken by the government also helped in controlling the persistent inflation, predominantly the food inflation. The sizeable decline in inflation was observed in commodities where the government had taken effectual measures like allocation of additional 5 million tonnes of rice to BPL and APL families and 10 million tonnes of wheat under open market sales, execution of the National Food Security Act, and judicious increase in the minimum support price also helped in curbing inflation. Therefore it becomes pertinent to re-examine the application of the belief that inflation is necessarily a monetary phenomenon, calling for an altogether a different and a new postulate.

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