Monetary Policy: A Study based upon the effect of change in monetary policy on the Indian financial market

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ABSTARCT:

In India the main objective of credit control policy by Reserve Bank of India (RBI) in the era of planned economic development was to achieved 'growth with stability'. In the context of this objective RBI adopts 'controlled credit expansion' policy which means the main long term objective of banks monetary policy is to expand credit. But to control this credit expansion according to the present need and circumstances of our economy RBI has made different solution. Since January 2015, the RBI has cut policy rates by a cumulative 125 basis points (bps), while banks have cut one-year deposit rates by an average 130 bps and lending by 50 bps, which includes the base rate cuts in the month of September. On 29 September 2015, when RBI declare its new rates of monetary policy many commercial bank(i.e. ICICI Bank, Yes Bank, Kotak Mahindara and Allahabad Bank etc.) joined this changes and also change their interest rate which is directly affect Indian market. This paper is reveals the effect of new monetary policy on the Indian market.

Keywords: Monetary policy, interest rate, stability and expansion

I. INTRODUCTION:

The Reserve Bank of India (RBI) as an central bank started its operations on 1 April 1935 under the Reserve Bank Act, 1934. The bank was set up based on the recommendations of the 1926 Royal Commission on Indian Currency and Finance, also known as the Hilton–Young Commission. The RBI originally set up as a shareholders bank with the initial capital of Rs. 5 Crore in which Government of India (GOI) had 5% share and British Government had 95% share. The original share capital was divided into shares of Rs.100 each fully paid. The main reason of RBI establishment was to:

- Regulate the issue of bank note
- Maintain reserve with a view to securing monetary stability and
- To operate the credit and currency system of the country to its advantage.

Though originally privately owned, since nationalisation in 1949, the Reserve Bank is fully owned by the Government of India. At the time of RBI establishment it's headquarter was established at Calcutta but in 1937 it is shifted to Mumbai. RBI owns four subsidiary body: NHB (National Housing Bank), NABARD (National Bank for Agricultural and Development), DICGC (Deposit Insurance and Credit Guarantee Corporation), BRBNMPL (Bhartiya Reserve Bank Note Mudran Private Limited).

As the time increases importance of RBI also increases and Government of India with the recommendation of various committees expand its scope and functions.

Functions of Reserve Bank of India:

The Preamble of RBI explains the basic function of RBI:

1. **Monetary Authority:** Monetary authority or monetary policy refers to the use of instruments under RBI control to regulate availability, cost and user of money and credit and providing the citizens the appropriate available monetary facilities. Central bank does this to maintain pricing stability, low & stable inflation as well as promoting economic growth of country.
2. **Issuer of Currency**: Reserve bank of India is the sole body who is authorized to issue currency in India. While coins are minted by GoI, the RBI works as an agent of GoI for distributing and handling of coins. RBI also works to prevent counterfeiting of currency by regularly upgrading security features of currency. For printing currency, RBI has four facilities at Dewas, Nasik,Mysore , Salboni & Nadiad. RBI is authorized to issue notes up to value of Rupees ten thousand.
3. **Banker and Debt Manager to Government**: Just like individual need a bank to carry out their financial transactions effectively & efficiently, Government also need a bank to carry out its financial transactions. RBI serves this purpose for GoI. As banker to GoI, RBI maintains its accounts, receive payments into & make payments out of these accounts. RBI also helps GoI to raise money from public via issuing bonds & government approved securities.
4. **Banker to Banks**: RBI also works as banker to all the scheduled commercial banks. All the banks in India maintain accounts with RBI which help them in clearing & settling interbank transactions and customer transactions smoothly & swiftly. Maintaining accounts with RBI help banks to maintain statutory reserve requirements. RBI also acts as lender of last resort for all the banks. and the most important role is that it provide loan section up to 6%
5. **Regulator of the Banking System:** RBI has the responsibility of regulating the nation's financial system. As a regulator and supervisor of Indian banking system it ensures the financial stability & public confidence in banking system. RBI use methods like On-site inspections, off-site surveillance, scrutiny & periodic meetings to supervising new bank licenses, setting capital requirements and regulating interest rates in specific areas. RBI is currently focused on implementing Basel III norms.
6. **Manager of Foreign Exchange**: With increasing integration of the Indian economy with the global economy arising from greater trade and capital flows, the foreign exchange market has evolved as a key segment of the Indian financial market and RBI has an important role to play in regulating & managing this segment. RBI manages forex and gold reserves of the nation. On a given day, the foreign exchange rate reflects the demand for and supply of foreign exchange arising from trade and capital transactions. The RBI's Financial Markets Department (FMD) participates in the foreign exchange market by undertaking sales / purchases of foreign currency to ease volatility in periods of excess demand for/supply of foreign currency.
7. **Regulator and Supervisor of the Payment and Settlement Systems:** Payment and settlement systems play an important role in improving overall economic efficiency. The Payment and Settlement Systems Act of 2007 (PSS Act gives the Reserve Bank oversight authority, including regulation and supervision, for the payment and settlement systems in the country. In this role, we focus on the development and functioning of safe, secure and efficient payment and settlement mechanisms. Two payment systems National Electronic Fund Transfer (NEFT) and Real Time Gross Settlement (RTGS) allow individuals, companies and firms to transfer funds from one bank to another. These facilities can only be used for transferring money within the country. NEFT operates on a deferred net settlement (DNS) basis and settles transactions in batches. The

settlement takes place for all transactions received till a particular cut-off time. It operates in hourly batches — there are 12 settlements from 8 am to 7 pm on weekdays and SIX between 8 am and 1 pm on Saturdays. Any transaction initiated after the designated time would have to wait till the next settlement time. In RTGS, transactions are processed continuously, all through the business hours. RBI’s settlement time is 9 am to 4:30 pm on weekdays and 9 am to 2:00 pm on Saturdays.

8. **Developmental Role:** This is one of the most critical role RBI plays in building country's financial structure. Key tools in this effort include Priority sector lending such as Agriculture, micro and small enterprise (MSE), housing and education. RBI work towards strengthening and supporting small local banks and encourage banks to open branches in rural areas to include large section of society in banking net.

II. MONETARY POLICY

Monetary policy is the management of money supply and interest rates by central banks to influence prices and employment. Monetary policy works through expansion or contraction of investment and consumption expenditure. Monetary policy is the process by which the government, central bank (RBI in India), or monetary authority of a country controls the supply of money, availability of money and Cost of money or rate of interest , in order to attain a set of objectives oriented towards the growth and stability of the economy. Monetary theory provides insight into how to craft optimal monetary policy. Monetary policy is referred to as either being an expansionary policy, or a contractionary policy, where an expansionary policy increases the total supply of money in the economy, and a contractionary policy decreases the total money supply. Expansionary policy is traditionally used to combat unemployment in a recession by lowering interest rates, while contractionary policy involves raising interest rates in order to combat inflation. Monetary policy is contrasted with fiscal policy, which refers to government borrowing, spending and taxation

The Techniques of Monetary Policy by which RBI Can Control Money and Credit:
The Monetary policy has two techniques to control the cash and credit:

- Direct Techniques
- Indirect Techniques

Direct Techniques: The direct techniques of monetary policy directly affect the bank’s liquidity. It includes CRR, SLR and Refinance Facility or bailout money.

1. **Cash Reserve Ratio (CRR):** CRR is that certain percentage of banks NDTL (Net Demand and Time Deposit) or simply total deposits which banks are required to keep with the RBI in form of reserve or balance and this instrument can change the money supply overnight. If the CRR is higher it will make lower the banks liquidity and vice versa.
2. **Statutory Liquid Ratio (SLR):** Every bank has to keep certain proportion of their NDTL (Net Demand and Time Deposit) or simply total deposits in addition to CRR in form of liquid assets or in non-cash assets such as G-Sec, precious metals, approved securities, gold and bond etc. This also has a bearing on money supply.
3. **Refinance facility or Bailout Money:** Refinance by RBI ia meant to help individuals, corporations as well as the overall economy of the country. There are various types of refinance offered by RBI. Reserve Bank of India permitted the banks to offer refinance on various loans like home, auto etc. However, refinance companies have the restriction to use floating provisions instead of specific provisioning. Refinance by RBI is also offered to boost the growth of SMEs (Small and

Medium Enterprises), especially those which are currently facing credit crunch. RBI also offers refinance facility to help out the exporters. In 2008, RBI offered credit lines of ` 5,000 crore to Export-Import Bank of India (Exim Bank) to support the export sector.

Indirect Techniques:

The Indirect techniques of monetary policy can affect the banks as well as public. It includes bank rate, repo rate, reverse repo rate, open market operation etc.

1. **Bank Rate:** The bank rate is also known as the discount rate, is the rate of interest charged by the RBI for providing funds or loans to the banking system. This banking system involves commercial and co-operative banks, Industrial Development Bank of India, IFC, EXIM Bank, and other approved financial institutes. Funds are provided either through lending directly or rediscounting or buying money market instruments like commercial bills and treasury bills. Increase in Bank Rate increases the cost of borrowing by commercial banks which results into the reduction in credit volume to the banks and hence declines the supply of money. Increase in the bank rate is the symbol of tightening of RBI monetary policy.
2. **Repo Rate and Reverse Repo Rate:** Repo rate is the rate at which RBI lends to commercial banks generally against government securities. Reduction in Repo rate helps the commercial banks to get money at a cheaper rate and increase in Repo rate discourages the commercial banks to get money as the rate increases and becomes expensive. Reverse Repo rate is the rate at which RBI borrows money from the commercial banks. The increase in the Repo rate will increase the cost of borrowing and lending of the banks which will discourage the public to borrow money and will encourage them to deposit. As the rates are high the availability of credit and demand decreases resulting to decrease in inflation. This increase in Repo Rate and Reverse Repo Rate is a symbol of tightening of the policy.
3. **Open Market Operations:** An open market operation is an instrument of monetary policy which involves buying or selling of government securities from or to the public and banks. This mechanism influences the reserve position of the banks, yield on government securities and cost of bank credit. The RBI sells government securities to control the flow of credit and buys government securities to increase credit flow. Open market operation makes bank rate policy effective and maintains stability in government securities market.
4. **Marginal standing facility (MSF):** Marginal standing facility (MSF) is a window for banks to borrow from the Reserve Bank of India in an emergency situation when inter-bank liquidity dries up completely. Banks borrow from the central bank by pledging government securities at a rate higher than the repo rate under liquidity adjustment facility or LAF in short. The MSF rate is pegged 100 basis points or a percentage point above the repo rate. Under MSF, banks can borrow funds up to one percentage of their net demand and time liabilities (NDTL).

As of September 2015 inflation rate was 6%, CRR 4%, SLR 21.5%, Bank Rate 7.75%, Repo Rate 6.75%, Reverse Repo Rate 5.75% and MSF Rate was 7.75%

III. RESEARCH METHODOLOGY

To analyse the affect of interest rates change by RBI on Indian financial market with special reference to banking sector i have collected the data from various secondary sources like websites, bi-monthly reports, journals and newspaper etc.

Objectives:

The objective of the study is to measure the effect of changes in interest rates by RBI to Indian financial market.

IV. ANALYSIS AND FINDINGS

On 29 September RBI governor Dr. Raghuram G. Rajan announced in the RBI's fourth Bi-monthly reports that on the basis of an assessment of the current and evolving macroeconomic situation, it has been decided to:

- reduce the policy repo rate under the liquidity adjustment facility (LAF) by 50 basis points from 7.25 per cent to 6.75 per cent with immediate effect;
- keep the cash reserve ratio (CRR) of scheduled banks unchanged at 4.0 per cent of net demand and time liability (NDTL);
- continue to provide liquidity under overnight repos at 0.25 per cent of bank-wise NDTL at the LAF repo rate and liquidity under 14-day term repos as well as longer term repos of up to 0.75 per cent of NDTL of the banking system through auctions; and
- continue with daily variable rate repos and reverse repos to smooth liquidity.
- Consequently, the reverse repo rate under the LAF stands adjusted to 5.75 per cent, and the marginal standing facility (MSF) rate and the Bank Rate to 7.75 per cent.

Looking forward, inflation is likely to go up from September for a few months as favourable base effects reverse. The outlook for food inflation could improve if the increase in sown area translates into higher production. Moderate increases in minimum support prices should keep cereal inflation muted, while subdued international food price inflation should continue to put downward pressure on the prices of sugar and edible oil, and food inflation more generally. It is important that pro-active supply-side management by the government be in place to head off any food price pressures should they materialise, especially in respect of onion and pulses. The pass-through of the recent depreciation of the rupee will have to be carefully monitored, although benign crude prices should have an offsetting effect. Taking all this into consideration, inflation is expected to reach 5.8 per cent in January 2016, a shade lower than the August projection

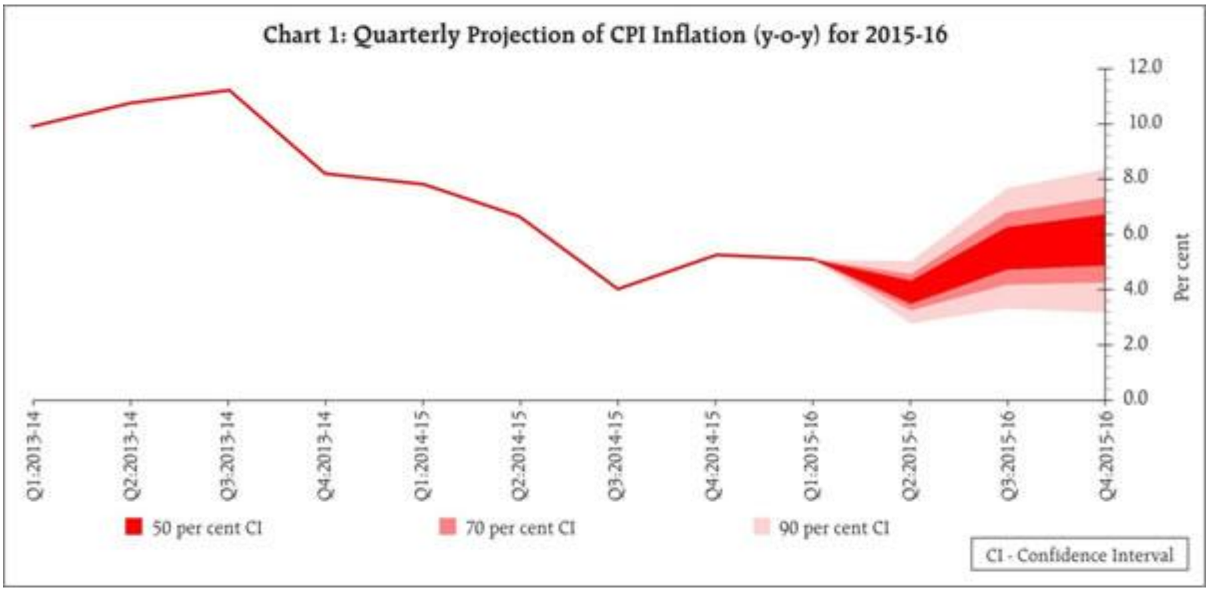

Chart 1: Quarterly Projection of CPI Inflation (y-o-y) for 2015-16

The modest pick-up in the growth momentum in the first half of 2015-16 benefited from soft commodity prices, disinflation, comfortable liquidity conditions, some de-clogging of stalled projects, and higher capital expenditure by the central government. Underlying economic activity, however, remains weak on account of the sustained decline in exports, rainfall deficiency and weaker than expected momentum in industrial production and investment activity. With global growth and trade slower than initial expectations, a continuing lack of appetite for new investment in the private sector, the constraint imposed by stressed assets on bank lending and waning business confidence, output growth projected for 2015-16 is marked down slightly to 7.4 per cent from 7.6 per cent earlier. Concurrent indicators also suggest that the new GDP series shows higher growth than would the old series, which necessitates recalibrating old measures of potential output and the output gap to the new series.

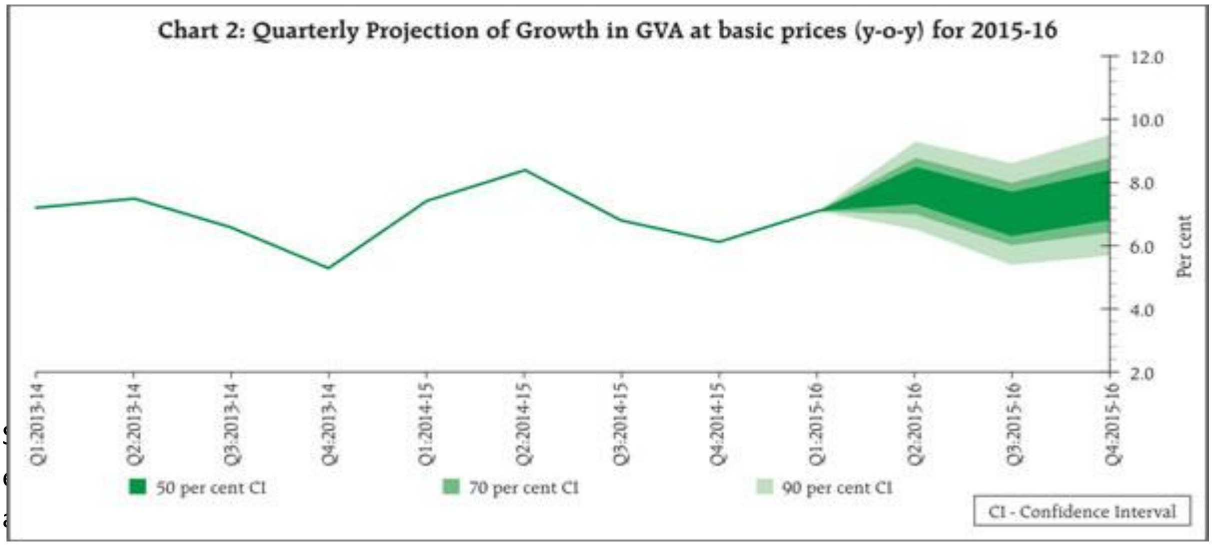

Chart 2: Quarterly Projection of Growth in GVA at basic prices (y-o-y) for 2015-16

increased by 9.61 percent to Rs 67,06,053 crore as against Rs 61,18,066 crore in the year-ago period. Deposits rose by 11.25 percent to Rs 91,63,815 crore in the reporting period from Rs 82,36,670 crore in the year-ago period.

In the previous fortnight, deposits registered a growth of 11.24 percent at Rs 89,59,357 crore from Rs 80,53,556 crore last year. Demand deposits stood at Rs 8,57,205 crore, up 10.79% from Rs 7,73,693 crore. Time deposits registered a growth of 11.30% at Rs 83,06,610 Crore.

V. CONCLUSION

After having a detailed analysis of above data that fourth bi-monthly review of monetary policy came with various opportunities with some amount of threats. It was the fourth time that the central bank lowered the repo rate this calendar. Nine of the 10 BSE bankex constituents settled higher. Private lenders, which were down up to 4 per cent in morning trade on the same day, entered up to 2 per cent higher. IndusInd Bank, Bank of Bank, HDFC Bank gained and Yes Bank gained 2.14 per cent, 1.66 per cent, 1.20 per cent and 1.16 per cent, respectively. SBI, Kotak Mahindra Bank and Federal Bank rose 1.02 per cent, 0.74 per cent, 0.62 per cent and 0.30 per cent, respectively. The 50 basis points cut took the RBI's repo rate to a four-year low. At 6.75 per cent, the repo rate is now at its lowest since May 2011.

While the Reserve Bank's stance will continue to be accommodative, the focus of monetary action for the near term will shift to working with the government to ensure that impediments to banks passing on the bulk of the cumulative 125 basis points cut in the policy rate are removed. RBI will continue to be vigilant for signs that monetary policy adjustments are needed to keep the economy on the target disinflationary path

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