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A Study of RBI Monetary Policy Framework

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ABSTRACT

Reserve Bank of India is the central bank of the country which regulates the banking and financial activities in the economy. It inter alia bears the responsibility of drafting and monitoring the monetary policy framework, by detailing the employment of appropriate monetary instruments to achieve the objectives as given under the Reserve Bank of India Act, 1934 ("Act"). A monetary policy, as provided under the Act, is a policy addressing the rising issues in Indian economy which is aimed for maintenance of price stability with simultaneous growth.

This research paper seeks to achieve a better understanding of this monetary policy framework as applicable in India while studying the development in objectives of the monetary policy and its scheme with special emphasis on role of instruments. The paper further aims to analyse the process of monetary policy, following it with a reflection on the contemporary changes in the light of the unprecedented pandemic of COVID-19.

Keywords: *Reserve Bank of India, RBI, Monetary Policy, Monetary Policy Framework, Instruments, COVID-19.*

I. INTRODUCTION

The Monetary policy is understood as a policy formulated by the central bank of a nation laying down the details of usage of monetary instruments which are under the central bank's control, in order to achieve the objectives as mentioned in the governing legislation ("**Monetary Policy**").

Preamble of the Reserve Bank of India Act, 1934 ("**RBI Act**") enunciates the necessity of having a modern Monetary Policy Framework so as to address the challenges and issues raised in a growing economy like ours. Over the course of time, the framework of Monetary Policy has indeed evolved with development of the Indian economy with respect to finance and macroeconomic conditions. It has been observed that, *"in practice, the nature of the framework is contingent upon two important considerations. First, the level of development of financial markets and institutions; and second, the degree of openness of the economy to trade and capital flows. In India, like most other countries, the Monetary Policy Framework has evolved*

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in response to and in consequence of financial developments and shifts in the underlying transmission mechanism".[2]

(A) Reserve Bank of India

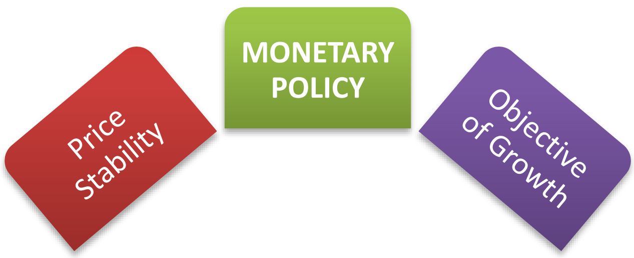
In Indian context, Reserve Bank of India ("**RBI**") is the central bank and is empowered to draft, implement and operate the monetary policy. RBI was established and incorporated on April 1, 1935, as a body corporate to manage the currency and carry on the business of banking under Section 3 of the RBI Act. It is entrusted with regulation of issuance of bank notes and maintenance of monetary stability in the country. It operates the system of currency and credit of the economy to the nation's advantage.[3] Initially established in Kolkata, the central office of RBI is in Mumbai since 1937. In this context, central office is understood as the office presided by the Governor of RBI.

Notably RBI has been privately owned in its earlier days. It is said to come under the complete ownership of the Government of India only after the process of nationalization in 1949.

The functions of RBI are categorised under different heads basis the nature of the functions. Formulation, implementation and monitoring of the monetary policy comes under the functions of RBI as a monetary authority.[4]

(B) Monetary Policy

Monetary Policy has been defined as *"the policy of the central bank, that is, the RBI, with regard to the use of monetary instruments under its control to achieve the goals specified in the RBI Act"*.[5] The prime objective of a Monetary Policy is maintenance of price stability and simultaneous attention to growth.[6]



[2] Deepak Mohanty, *Monetary Policy Framework in India: Experience with Multiple-Indicators Approach*, Reserve Bank of India, available at https://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=481 (last visited May 7, 2021).
[3] Preamble, Reserve Bank of India Act, 1934 (India).
[4] About Us, Reserve Bank of India, available at https://www.rbi.org.in/Scripts/AboutusDisplay.aspx#Offices (last visited May 5, 2021).
[5] Monetary Policy, Reserve Bank of India, available at https://www.rbi.org.in/scripts/FS_Overview.aspx?fn=2752 (last visited May 10, 2021).
[6] *Supra*, note 3.

(Pictorial representation of prime objective(s) of monetary policy)

Chapter IIIF of the RBI Act containing Section 45Z to 45ZO is wholly devoted to Monetary Policy. Section 45Z provides an overriding effect to the chapter over the other provisions of the Act. Chapter IIIF lays down the details for inflation target, constitution and eligibility details of the Monetary Policy, workings of the Monetary Policy Committee, Monetary Policy Report, and central government's power to make rules in regard to functioning, appointment and any other matter related to Monetary Policy and Monetary Policy Committee as may be prescribed.

II. Objectives of monetary policy

As noted, the prime objective of our Monetary Policy is maintenance of price stability and simultaneous attention to growth.[7] This particular objective has been introduced expressly in the RBI Act by way of Finance Act, 2016.[8]

In the initial years of RBI, Monetary Policy had aimed for maintenance of sterling parity with exchange rate, that is, it had worked towards ensuring the country reserves in the terms of sterling. India was one of the many countries of the former British Empire to do so. Regulation of liquidity was done by way of bank rate, cash reserve ratio ("**CRR**") and open market operations ("**OMOs**").[9]

From the time of independence, and up to three decades since, RBI worked in alignment with the five-year plans introduced by the central government. Once the banks were nationalized in 1969, RBI focused on regulating the credit to meet the requirements in relation to development of the country.

In 1982, Sukhamoy Chakravarty Committee was established under the chairmanship of Professor Sukhamoy Chakroborty, for suggestions to evaluate and develop the monetary system in India. It recommended adoption of the principle of money targeting for the Monetary Policy.[10] It was then observed that monetary demand was based on multiple factors.

With time and close to the liberalisation, privatisation and globalisation phase, RBI moved on and adopted multiple indicator approach in April 1998, where in *"quantity variables such as money, credit, output, trade, capital flows and fiscal position as well as from rate variables*

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[7] *Supra*, note 3.

[8] *Supra*, note 3.

[9] Jerry Mushin, *The Sterling Area*, EH.NET, available at https://eh.net/encyclopedia/the-sterling-area/ (last visited May 12, 2021).

[10] MONETARY POLICY FRAMEWORK: AN ANALYTICAL OVERVIEW, RESERVE BANK OF INDIA, available at https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?ID=406 (last visited May 4, 2021).

such as rates of return in different markets, inflation rate and exchange rate were analysed for drawing monetary policy perspectives".[11]

Basis the 2014 report of RBI's *"Expert Committee to Revise and Strengthen the Monetary Policy Framework"*, established under the guidance of Dr Urjit R. Patel, flexible inflation targeting was adopted for Monetary Policy. According to Section 45ZA of the RBI Act, inflation target, in terms of consumer price index, is determined by the central government in consultation with RBI, once in every five years.[12] On February 20, 2015, a Monetary Policy Framework Agreement was executed between the central government and RBI with objectives as mentioned in the amended preamble of the RBI Act. The flexible inflation targeting framework was formally implemented along with amendment to RBI Act in 2016, pursuant to this agreement. The inflation target was notified to be 4% with ± 2% tolerance band for the time period of August 5, 2016 to March 31, 2021.[13]

Further, it was notified that the inflation target may stand missed if *"(a) the average inflation is more than the upper tolerance level of the inflation target for any three consecutive quarters; or (b) the average inflation is less than the lower tolerance level for any three consecutive quarters"*.[14]

III. Major components of monetary policy

Monetary Policy is an amalgamation of a number of constituents, which assist in its proper execution:

(Key Constituents of Monetary Policy)

These major components work as well-oiled cogs in the machine that is the Monetary Policy.

Instruments[15] in this context refer to the tools that are controlled and used by RBI to accomplish

[11] DUA, *supra* note 8 at 121.
[12] Section 45ZA, Reserve Bank of India Act, 1934 (India).
[13] Kamal Narang, *RBI initiates process to review Monetary Policy Framework*, THE HINDU BUSINESS LINE, available at https://www.thehindubusinessline.com/money-and-banking/transmission-of-rate-cuts-to-improve-further-credit-growth-momentum-gathering-pace-shaktikanta-das/article30828544.ece (last visited May 2, 2021).
[14] *Supra* note 5.
[15] *Supra* note 5.

the operational targets. Tools are usually categorised as quantitative tools (like reserve ratios, OMOs, policy rate and bank rate) and qualitative tools (like margin requirements, consumer credit regulation, publicity and moral suasion).

Operating targets can be understood as variables that are financial in nature and are controlled by RBI through instruments. These variables inspire the daily operations of the RBI. Their impact can be seen on intermediate targets and they assist in achieving the final goals of the Monetary Policy. As of now, following RBI's policy, weighted average call rate is the operating target for the Monetary Policy. [16]

Intermediate targets[17] are relatively closer to Monetary Policy as compared to operational targets, however as the name suggests they are intermediate and not final in nature. As operational targets affect the Monetary Policy, Monetary Policy affects intermediate targets. Variables like short-term and long-term interest rates and monetary aggregates come under intermediate targets.

Goals are the ultimate final objectives of the Monetary Policy. They can range anywhere from exchange rate stability to economic growth to price stability.

These major components of the Monetary Policy play an important role in implementation and ultimate fulfilment of goals.

It is observed that the abovementioned framework has been applicable in the phase firstly from 1985-1998 and later in the phase of 2016 onwards. In the period between the two that is between 1998 to 2016 RBI had employed multiple indicator approach for the Monetary Policy. Under the multiple indicator approach, though the ultimate goals were the same as in the phase of 1985-1998 and phase of 2016 onwards, multiple indicator approach had varied range of variables and thus, lacked specification.

IV. INSTRUMENTS OF MONETARY POLICY

Instruments are understood as the tools used in the proper execution of the Monetary Policy. Depending on their nature, the instruments are broadly qualified in two categories: Quantitative instruments and qualitative instruments. Quantitative instruments or general instruments or traditional instruments directly focus on and regulate the volume or quantity of money in whole of the country's economy. Qualitative instruments or selective instruments are more persuasive in nature and usually have impact in a specified sector of the country's economy. While

[16] *Supra* note 5.
[17] DUA, *supra* note 8 at 124.

quantitative instruments affect the total volume of the money supply, qualitative instruments affect the direction of flow or movement of money.

(A) Quantitative Instruments

1. **Cash Reserve Ratio –** Cash Reserve Ratio ("**CRR**") is defined as *"the average daily balance that a bank is required to maintain with the RBI as a share of such per cent of its Net Demand and Time Liabilities ("**NDTL**") that the RBI may notify from time to time in the Gazette of India"*[18]. This amount is to be maintained by the scheduled banks (that is, the banks enumerated in Second Schedule of RBI Act) with the RBI as cash.
2. **Statutory Liquidity Ratio –** Statutory Liquidity Ratio ("**SLR**") is defined as *"the share of NDTL that a bank is required to maintain in safe and liquid assets, such as, unencumbered government securities, cash and gold. Changes in SLR often influence the availability of resources in the banking system for lending to the private sector"*[19].
3. **Open Market Operations –** OMOs refer to selling and purchasing of government securities by the RBI in the open market for absorbing and injecting liquidity into the market. RBI executes OMOs via commercial banks and do not involve the public directly.
4. **Bank Rate –** Bank Rate is *"the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers"*.[20] This rate is made public by the RBI timely under the RBI Act[21] and is determined in alignment with Marginal Standing Facility rate and changes in accordance with the same.
5. **Liquidity Adjustment Facility –** Liquidity Adjustment Facility ("**LAF**") is *"a facility extended by RBI to the scheduled commercial banks (excluding regional rural banks) and primary dealers to avail of liquidity in case of requirement or park excess funds with RBI in case of excess liquidity on an overnight basis against the collateral of government securities including state development loans"*[22]. LAF helps RBI to manage liquidity on a daily basis, and can be overnight or for a term.[23] It was recommended by the Narasimham Committee Report on Banking Reforms in 1998. This facility covers repo rate and reverse repo rate. *Repo rate* is *"the (fixed) interest rate at which the RBI provides overnight*

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[18] *Supra* note 5. See Section 42(1), Reserve Bank of India Act, 1934 (India) and Section 18, Banking Regulation Act, 1949 (India).
[19] *Supra* note 5. See Section 24(2A), Reserve Bank of India Act, 1934 (India).
[20] *Supra* note 5.
[21] Section 49, Reserve Bank of India Act, 1934 (India).
[22] GOVERNMENT SECURITIES MARKET IN INDIA – A PRIMER, RESERVE BANK OF INDIA, available at https://m.rbi.org.in/scripts/FS_FAQs.aspx?Id=79&fn=2757#6 (last visited May 14, 2021).
[23] TERM REPO UNDER THE LIQUIDITY ADJUSTMENT FACILITY – OPERATIONAL GUIDELINES, RESERVE BANK OF INDIA, available at https://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=8501 (last visited May 11, 2021).

liquidity to banks against the collateral of government and other approved securities under the LAF" whereas *reverse repo rate* is *"the (fixed) interest rate at which the RBI absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF"*.[24]

6. **Marginal Standing Facility –** Introduced in May, 2019, Marginal Standing Facility ("**MSF**") is *"a facility under which scheduled commercial banks can borrow additional amount of overnight money from the RBI by dipping into their SLR portfolio up to a limit at a penal rate of interest"*[25]. Due to its penal nature, MSF is higher than repo rate.

Following table lays down the manner in which these tools are used by the RBI in Monetary Policy against inflation and deflation. In this regard, it should be noted that the Monetary Policy employed against inflation is called Contractionary or Dear Money Policy and the Monetary Policy employed against deflation is called Expansionary or Cheap Money Policy.

S. No.	Types of Tools	Dear Money Policy	Cheap Money Policy
1.	Cash Reserve Ratio	Increase CRR	Decrease CRR
2.	Statutory Liquidity Ratio	Increase SLR	Decrease SLR
3.	Open Market Operations	RBI sells securities	RBI buys securities
4.	Bank Rate	Increase Bank Rate	Decrease Bank Rate
5.	Repo Rate	Increase Repo Rate	Decrease Repo Rate
6.	Reverse Repo Rate	Value is dependent on Repo Rate	
7.	Marginal Standing Facility	Value is dependent on Repo Rate	

(B) Qualitative Instruments

1. **Fixing Margin Requirements –** Margin is *"proportion of the loan amount which is not financed by the bank"*, and marginal requirement is *"the difference between the market value of the assets and its maximum loan value"*.[26] If inflation is to be curbed, margin requirement is increased in a Monetary Policy, and if deflation is to be curbed margin requirement is decreased in a Monetary Policy.

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[24] *Supra* note 5.
[25] *Supra* note 5.
[26] Pragyandeepa, *Monetary Policy Techniques: General and Selective Methods*, ECONOMICS DISCUSSION, available at https://www.economicsdiscussion.net/money/monetary-policy-techniques-general-and-selective-methods/4688 (last visited May 7, 2021).

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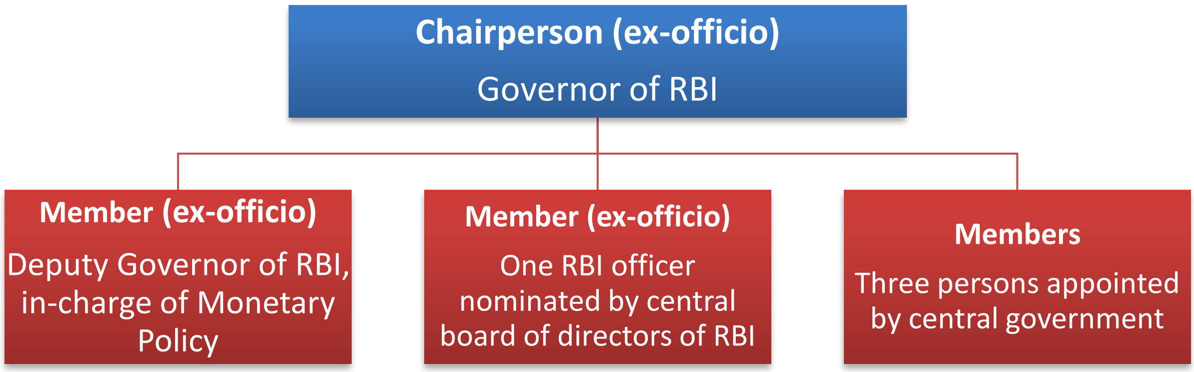
2. **Consumer Credit Regulation** – Herein supply of credit to consumers is regulated depending on the case that is if the Monetary Policy is to curb inflation, supply of credit is reduced and if the Monetary Policy is to curb deflation, supply of credit is increased. This is done by way of changes in easy monthly instalments and down-payments among other things.[27]
3. **Publicity** – RBI resorts to publicity as a tool to educate and influence the public and their opinion by publishing and disseminating adequate relevant information for enabling them to make informed decisions. This can be done by way of various publications.
4. **Moral Suasion** – Moral suasion refers to the persuasion and pressure put by RBI on banks *inter alia* by way of guidelines and directives, to ensure that monetary policy is executed properly. This pressure is sans any sanction or penalty.
5. **Direct Action** – At times, RBI takes action on the banks in case of deviant behaviour. It may impose penalties and curtail banking activities apart from taking actions in relation to credit borrowing of the banks.

V. Monetary Policy – The Process

(A) Formation of Monetary Policy Committee

As noted, Monetary Policy is dealt with under Chapter IIIF of the RBI Act. Section 45ZB provides for constitution of Monetary Policy Committee. It is responsible for determination of the policy rate required for achievement of the inflation target. RBI is mandatorily bound by the decisions of the Monetary Policy Committee. Policy rate is *"the rate for repo transactions"*[28]. Structure of the Monetary Policy Committee is as follows:



[27] Rajiv Khanna, *RBI Monetary Policy 2021*, BANK BAZAAR, available at https://www.bankbazaar.com/finance-tools/emi-calculator/monetary-policy.html (last visited May 8, 2021).
[28] Section 2(cccci), Reserve Bank of India Act, 1934 (India).

(Composition of Monetary Policy Committee)

Monetary Policy Committee is mandated to meet a minimum of four times a year and RBI is mandated to publish the resolutions adopted by the committee, on conclusion of each of the meetings.[29]

(B) Working of Monetary Policy Committee

Monetary Policy Committee is assisted by the Monetary Policy Department of RBI in drafting of the Monetary Policy. Consideration is given to the views of the major stakeholders along with the analytical work of the RBI for determining policy repo rate. Monetary policy is operationalized by Financial Markets Operations Department by way of liquidity management operations on daily basis. Alignment of the operating target of the weighted average call money rate with repo rate is ensured by Financial Markets Committee in its daily meetings for review of liquidity conditions.[30]

It is observed that Monetary Policy Committee was constituted in 2016, replacing its predecessor, the Technical Advisory Committee which was constituted in 2005.[31] RBI was advised on Monetary Policy by Technical Advisory Committee before 2016, wherein the committee was only an advisory committee.

(C) Monetary Policy Report

A Monetary Policy Report is in the form of a document which is published by RBI bi-annually, wherein *"(a) the sources of inflation; and (b) the forecasts of inflation for the period between six to eighteen months from the date of publication of the document"* are explained.[32]

(D) Failure in Maintenance of Inflation Target

In case of failure to maintain the inflation target, RBI is mandated to report to the central government the following[33]:

"(a) the reasons for failure to achieve the inflation target;(b) remedial actions proposed to be taken by the Bank; and (c) an estimate of the time-period within which the inflation target shall be achieved pursuant to timely implementation of proposed remedial actions."

(E) Monetary Policy Transmission

The policy rate is determined basis the developing macroeconomic situation, and liquidity is

[29] Section 45ZI, 45ZK and 45ZL, Reserve Bank of India Act, 1934 (India).
[30] *Supra* note 5.
[31] DUA, *supra* note 8 at 127.
[32] Section 45ZM, Reserve Bank of India Act, 1934 (India).
[33] Section 45ZN, Reserve Bank of India Act, 1934 (India).

accordingly adjusted to tie money market rates on or around the repo rate. The changes in repo rate reach the entire financial system by way of money market, subsequently impacting aggregate demand which is a major determining factor in growth and inflation. This process of transmission of the impact of Monetary Policy on the whole of the economy is called Monetary Policy Transmission.

After the announcement of repo rate, the operating framework works towards daily liquidity management so as to tie the operating target of weighted average call rate as per the repo rate. Though continual updates are made to the operating framework basis development in financial market and monetary conditions, it is ensured that the essence of Monetary Policy is maintained.

Transmission of Monetary Policy may take place by way of five channels, namely, asset price channel, exchange rate channel, expectations channel, credit channel and interest rate channel. Monetary Policy in India majorly uses the interest rate channel.

Two factors play important role in execution of Monetary Policy – *"first is how far the signals sent out by the central bank are picked up by the commercial banks (also known as 'inner leg') and the second is how far the signals sent out by the banking system influence the real sector (also known as 'outer leg')"*.[34] Speed and degree of change in both subsequently impact the efficiency of the Monetary Policy.

VI. IMPACT OF COVID-19 ON MONETARY POLICY

Over the course of last one year, RBI has taken proportionate measures to relieve the economy of the effect of the unprecedented pandemic, that is, COVID-19.

In the meeting of Monetary Policy Committee held in March 2020, when the impact of COVID-19 was first taken into account, it was observed by Mr. Shaktikanta Das, that *"monetary policy needs to proactively arrest any deterioration in aggregate demand, and create enabling conditions for businesses to normalise production and supply chains"*[35].

Since then, RBI has reduced the policy repo rate from 5.15% to 4%, reverse repo rate from 4.9% to 3.35%, MSF from 5.4% to 4.25% and bank rate from 5.4% to 4.25%, as compared to the beginning of 2020.[36]

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[34] *Supra* note 10.

[35] MINUTES OF THE MONETARY POLICY COMMITTEE MEETING MARCH 24, 26 AND 27, 2020, RESERVE BANK OF INDIA, available at https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=49659 (last visited May 15, 2021).

[36] MONETARY POLICY REPORT – APRIL 2021, RESERVE BANK OF INDIA, available at https://m.rbi.org.in/Scripts/PublicationsView.aspx?id=19980 (last visited May 17, 2021).

RBI has further reduced the CRR requirement of the banks from 4% of NDTL to 3% of NDTL from March 28, 2020 to March 26, 2021.[37]

While observing that inflation is likely to remain elevated, except for temporary respite in the form of reduced prices of perishables in winters, it was mentioned in the latest Monetary Policy Statement published on February 5, 2021 that *"Monetary Policy Committee is to continue with the accommodative stance as long as necessary – at least during the current financial year and into the next financial year – to revive growth on a durable basis and mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward"*.[38]

VII. Conclusion

Monetary Policy, as a concept has evolved with the increasingly complex economy of ours. For the recent development, it has been almost four and a half years since flexible inflation targeting framework was formally implemented along with amendment to RBI Act in 2016, pursuant to Monetary Policy Framework Agreement and the inflation target was notified to be 4% with ± 2% tolerance band for the time period of August 5, 2016 to March 31, 2021.[39] Further, provision for Monetary Policy Committee was made in the RBI Act, which replaced the Technical Advisory Committee.[40]

It is to be noted that Monetary Policy Committee so introduced in 2016 has proved to be more stringent in comparison to its contemporaries. The internationally comparable voting process of Monetary Policy Committee reflects the holistic approach in the evaluation of the members.[41] Transparency and accountability is given preference by way of publication of resolutions adopted by the committee[42] and that of the proceedings of each of the meetings.[43]

Basis the study it can be inferred that while RBI has certainly come a long way in addressing the goals of price stability and simultaneous consideration for growth, there still remain certain issues which can be attributed to the following:

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[37] *Id.*

[38] Monetary Policy Statement, 2020 – 21 Resolution of the Monetary Policy Committee (MPC) February 3 – 5, 2021, Reserve Bank of India, available at https://rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=51077 (last visited May 12, 2021).

[39] *Supra* note 17.

[40] Section 45ZB, Reserve Bank of India Act, 1934 (India).

[41] Section 45ZI, Reserve Bank of India Act, 1934 (India).

[42] Section 45ZK and 45ZL, Reserve Bank of India Act, 1934 (India).

[43] Section 45ZL, Reserve Bank of India Act, 1934 (India).

1. Though inner leg of monetary transmission is comparatively faster than outer leg, however, it in itself is not quick enough as unlike US, RBI is not the primary source of supply of money in Indian economy.
2. Small saving instruments usually provide for higher rates of interest, and in case of slashing of rate of interest on bank deposits, customers move to them.
3. There is substantial lack of financial inclusion due to number of factors, due to which borrowers tend to seek private moneylenders instead of banks.
4. Workings of Monetary Policy and that of the fiscal policy is not coherent, subsequently affecting the efficiency of either.
5. Profitability of banks has been affected by high non-performing assets, because of which they keep the weighted average lending rate at a higher value in comparison of the marginal lending rate.
6. Economy is still not monetized in some of the rural areas, wherein barter system prevails over banking solutions.

Given the above, it is only imperative that a multi-dimensional approach comprising fiscal, monetary and other policy measures is adopted in these unprecedented times, to protect our economy and its growth. As highlighted in all Monetary Policy Statements published March 2020 onwards, it only the coordination between monetary and fiscal measures, with support of other policy measures that can significantly shield the economy in these testing times.

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