Know the Monetary Policy in Detail for Bank Exams

In the world of banking, a solid grasp of monetary policy is indispensable, and for those aspiring to excel in bank exams, it's an essential component of success. Understanding the intricacies of monetary policy, from the manipulation of interest rates to the broader economic implications, can be a game-changer in your preparation. With a profound knowledge of how central banks regulate the money supply and influence financial stability, you'll not only ace your bank exams but also be better equipped to navigate the dynamic landscape of the banking industry.

This comprehensive guide will delve into the nuances of monetary policy, providing you with the insights needed to excel in your banking career and examinations. Get ready to elevate your financial acumen and boost your chances of success with a deep dive into the world of monetary policy. But before reading this blog, you have to understand the Work and Functions of Reserve Bank of India (RBI). You can check the blog by clicking on the embedded link. So, let's first understand what is **Monetary Policy Committee (MPC)**.

Monetary Policy Committee (MPC)

Monetary Policy is the policy that is adopted by Country's Central bank to promote sustainable economic growth in the country by controlling money supply. The Monetary Policy Committee decides the benchmark of Interest Rates in India to control Inflation considering the various aspects that can affect money supply in any economy. It is constituted under the Sub-section (1) of Section 45ZB of RBI Act, 1934 and it is defined in Section 2(iii)(cci) of same act.

Monetary Policy Committee conducts bi-monthly review and changes the bank rates according to the prevailing situations in the economy.

[Source: The Economic Times]

Members of Monetary Policy Committee

Here is the chart of members of Monetary Policy Committee to clear the hierarchy of the MPC.

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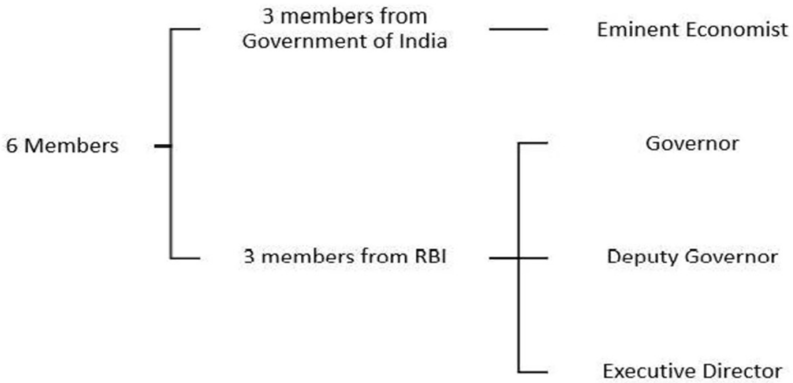

Current members of Monetary Policy Committee:

The current members of the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) are:

1. **Shaktikanta Das** (Chairperson): Governor of the Reserve Bank of India
2. **Michael Debabrata Patra** (Vice Chairperson): Deputy Governor of the Reserve Bank of India
3. **Shashanka Bhide**: Senior Advisor, National Council of Applied Economic Research (NCAER)
4. **Ashima Goyal**: Professor, Indira Gandhi Institute of Development Research (IGIDR)
5. **Jayanth R. Varma**: Professor, Indian Institute of Management, Ahmedabad (IIM-A)
6. **Mridul K. Saggar**: Executive Director, RBI

[Source: Mint]

So, after having a basic understanding of the Monetary Policy Committee, let's try to understand the **tools of Monetary Policy**.

Tools of Monetary Policy

The tools of monetary policy are instruments used by central banks to influence a nation's money supply, interest rates, and overall economic stability. These tools include open market operations, where central banks buy or sell government securities to control the money supply; reserve requirements, which mandate how much banks must hold in reserves; and the discount rate, the interest rate at which banks can borrow from the central bank.

Through these mechanisms, central banks can effectively manage inflation, economic growth, and financial stability. Careful utilization of these tools is essential in steering a nation's monetary policy to achieve its economic goals.

There are mainly two tools of the Monetary Policy:

1. Quantitative Tools
2. Qualitative Tools

Let's discuss the **Quantitative Tools** first.

Monetary Policy Quantitative Tools

1. Cash Reserve Ratio: Commercial banks have to hold a certain minimum amount of deposit in the form of cash as reserves with the RBI. That percentage is called CRR. The cash required to be kept in reserves as against the bank's total deposits **(NDTL - Net Demand & Time Liabilities)**. The cash reserve is either stored in the bank's vault or is sent to the RBI. Banks can't lend the CRR money to anyone and banks even can't use that money for investment purposes. And Banks don't get any interest on that money from RBI. CRR comes under the Section 42 of RBI Act, 1934.

2. Statutory Liquidity Ratio (SLR): It is a minimum percentage of deposits that a commercial bank has to maintain with itself in the form of liquid cash, gold or other securities. The SLR is fixed by the RBI. CRR and SLR are the traditional tools of the central bank's monetary policy to control credit growth, flow of liquidity and inflation in the economy. The SLR comes under Section 24 (2A) of Banking Regulation Act, 1949.

3. REPO Rate: At which rate the central bank of a country lends money to commercial banks in the situation of shortfall of funds. Repo rate is used by monetary authorities to control inflation and liquidity in the market.

- The RBI has said that it will conduct a term repo of 1 year to 3 years but at the repo rate. **LTRO (Long Term Repo Operations)** means banks will beable to get more money at the repo rate. It is the special tool used by RBI for injecting the money. These Long-term Repo operations **(LTROs)** will be in addition to the existing liquidity adjustment facility (LAF) and marginal standing facility (MSF) operations. LTROs are conducted on the CBS – Core Banking Solution (E-KUBER) platform. The operations would be conducted at a pre-determined rate. The minimum bid amount is Rs.1 crore and multiples thereof. There will be no restriction on the maximum amount of bidding by individual bidders. This will help in reducing the interest rate in the market. Long Term Repo is also called Variable Repo Operation.
- **TLTRO (Targeted Long Term Repo Operations)** means Investing in a particular group through debt instrument. In TLTRO, bank can borrow money from RBI at repo rate for the period of 1 to 3 years by pledging government securities. These funds have to be invested in Commercial Papers, Corporate bonds, etc. and distributed in 31 targeted sectors. Those sectors are basically divided on the basis of stress faced during pandemic. **On-Tap TLTRO**, according to the new guideline bank will use that money as corporate loan rather than debt investment.
- For providing help to MSMEs, Small Businesses and other unorganized sectors, recently RBI introduced **SLTRO (Special Long Term Repo Operations)** for Small Finance Bank. In this SLTRO, firstly RBI conducts Special long term repo operation of 10,000 crore rupees at repo rate which will be given as fresh lending of up to 10 lakh rupees per borrower.

4. Reverse Repo Rate: At which rate the central bank borrows money from commercial banks within the country. In other words, Commercial banks lend their excess money to RBI. It is a tool of monetary policy which can be used to control the money supply in the country.

- **VRRR (Variable Rate Reverse Repo):** To remove the additional liquidity from the economy RBI introduced VRRR auction. RBI use VRRR auction on a continuous basis. RBI borrows some money at a fixed rate and some money at a variable rate. On 8 December 2021 RBI's Governor Shaktikanta Das has announced that Reserve Bank of India has rebalanced surplus liquidity in economy by shifting it out of the fixed rate overnight reverse repo into Variable Rate Reverse Repo (VRRR) auctions for long term maturity.

[Source: Paytm]

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5. Bank Rate: It is the minimum rate of interest, which a central bank charges while lending loans to domestic banks without any security. When any bank suffers funds deficiency, it can borrow money from RBI to continue its services. When Bank Rate is increased by the central bank, a commercial bank's borrowing costs hikes, which reduces the inflation in the market

6. 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. RBI introduced MSF in 2011-12 to help the banks in emergency situation. It is also called Overnight Lending Rate.

7. Liquidity Adjustment Facility: It is a tool of monetary policy used by the RBI that allows banks to borrow money through REPO agreements or to make loans to the RBI through Reverse Repo agreements. This arrangement is effective in managing liquidity pressures and assuring basic stability in the financial markets. In this scheme, REPO & Reverse REPO options are conducted by the RBI to control the temporary mismatch in the market.

8. Open Market Operations: Open market operations (OMO) refer to central bank buying or selling short- term securities in the open market in order to control the money supply in the market. In the case of Inflation, RBI will sell the Govt. Securities.

Now, let's look at the **Qualitative Tools** of the Monetary Policy.

Monetary Policy Qualitative Tools

1. Credit Rationing: It is a situation when bank limits the supply of loans to customers. Banks use credit rationing to control lending beyond the monetary base of the bank. Priority Sector Limits in different sectors:

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Priority Sectors	Limits (Up to)
Service Sector	Micro & Small Enterprises – 5 Crore
	Medium Enterprises – 10 Crore
Startups	50 Crore
Social Infrastructure	10 Crore
Export	40 Crore
Housing (Metro City)	35 Lakh
Housing (Other City)	25 Lakh
Housing Repair loan (Metro City)	Increased from 5 Lakh to 10 Lakh
Housing Repair loan (Other City)	Increased from 2 Lakh to 6 Lakh
Education	20 Lakh
Weaker Section	50 thousand (Per Individual borrower & SHG)
Renewable Energy	30 Crore for Companies
	10 Lakh for Individuals
Loan to Small & Marginal Farmers	2 Lakh for Individuals
Self Help Groups	1 Lakh per borrower of SHGs

[Source: Central Banking]

2. Marginal Requirement: Marginal requirement is the difference between current value of the security given for a loan and the value of loan granted. In case of deflation, RBI will reduce the marginal money requirement which will allow borrowers to avail more loans from commercial banks.

3. Moral Suasion: It is a step taken by the central bank for convincing and advising the commercial banks to follow the policies and act in the desired manner. It is a request by RBI to commercial banks to take specific measures as per the situation of economy.

4. Direct Action: In this step, RBI can punish and impose the restrictions on bank for not fulfilling the guidelines provided by the central bank & monetary policy committee. Prompt Corrective Action (PCA) is an example of Direct Action.

5. Credit Control: With the help of this tool of Monetary Policy, RBI can control inflation in the market by fixing the credit amount to be granted for commercial banks. Credit is given by limiting the amount available for each commercial bank. For controlling the inflation, the upper limit of loan can be fixed and banks have to be strict to that limit.

So, these are the qualitative tools. Now, let's look at **some basic concepts regarding RBI and its Monetary Policy**.

Some basic concepts regarding RBI and its Monetary Policy

What is MSS?

MSS stands for Market Stabilisation Scheme. RBI introduced this scheme to withdraw excess liquidity/money supply by selling government securities in the market. MSS is used when there is a situation of high liquidity in the market. MSS is used for monetary stability in the economy.

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What is SDF?

SDF stands for Standing Deposit Facility which allows RBI to absorb excess liquidity from the economy by absorbing liquidity from Commercial Banks without providing Government Securities in exchange. The aim of absorbing liquidity is to normalize the monetary circulation in the economy.

What is Operation Twist?

When RBI purchases and sells Government securities at the same time under Open Market Operation is known as Operation Twist. It is a method to manage finance in the market. Operation Twist is a program that was first introduced by Federal Reserves in the US in 1961.

What is G-SAP?

G-SAP stands for Government Securities Acquisition Program, a liquidity window with the help of which RBI buys sovereign papers to fill cash into the banking system. On this window, articles can also be sold to maintain liquidity equilibrium in the economy.

In conclusion, understanding the intricacies of monetary policy is not just a requisite for success in bank exams, but a critical skill for a career in the financial world. The nuanced interplay of central bank actions, interest rates, and their far-reaching impacts on an economy cannot be overstated. This comprehensive guide serves as a beacon, shedding light on the complexities of monetary policy. It empowers aspiring bankers and finance professionals to navigate the dynamic and often challenging terrain of financial regulation.

With this knowledge, not only can one master their exams, but they can also embark on a journey towards informed decision-making in the banking sector. The Monetary Policy Committee's role in determining benchmark interest rates, in conjunction with various instruments, plays a pivotal role in steering an economy's course. With this insight, you're better equipped to analyze economic trends and contribute to a sound financial future, both personally and professionally. In essence, mastering monetary policy is the key to unlocking a world of opportunities in the banking arena.

In our next blog, we will discuss in detail about the Banking System in India. Till then, Stay tuned!

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