“impact of rbi monetary policy on banks”

Economics, Money

“ Impact of RBI Monetary Policy on Banks" A PROJECT SUBMITTED TO Prof. Mishu Tripathi Submitted By: Roll No. Name 21 Ambika Nadar 23 Nutan Panchal 25 Satyam Pandya Date of Submission: 7th Oct 2012 Management of Banks and Financial Services MFM SEM — V (Batch-: 2010 - 2013) [pic]

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CONTENT LIST | Sr. No. | Topic | Page No | | 1. | Introduction | 04 | | 2. | Research Methodology | 11 | | 3. | Monetary Measures and Tools | 12 | | 4. | Effectiveness of Monetary Policy in India | 17 | | 5. | Conclusion | 19 | | 6. | Bibliography | 20 |

1. INTRODUCTION 1. 1 WHAT IS 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 i) the

supply of money ii) availability of money iii) 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 2. WHY IT IS NEEDED? What monetary policy — at its best — can deliver is low and stable inflation, and thereby reduces the volatility of the business cycle. When inflationary pressures build up, it is monetary policy only which raises the short-term interest rate (the policy rate), which raises real rates across the economy and squeezes consumption and investment. The pain is not concentrated at a few points, as is the case with government interventions in commodity markets. Monetary policy in India underwent significant changes in the 1990s as the Indian Economy became increasing open and financial sector reforms were put in place. In the 1980s, monetary policy was geared towards controlling the quantum, cost and directions of credit flow in the economy. The quantity variables dominated as the transmission Channel of monetary policy. Reforms during the 1990s enhanced the sensitivity of price signals from the central bank, making interest rates the increasingly Dominant transmission channel of monetary policy in India. 1. 3 OBJECTIVES

OF MONETARY POLICY The objectives are to maintain price stability and ensure adequate flow of credit to the productive sectors of the economy. Stability for the national currency (after looking at prevailing economic conditions), growth in employment and income are also looked into. The monetary policy affects the real sector through long and variable periods while the financial markets are also impacted through short-term implications. There are four main 'channels' which the RBI looks at: - Quantum channel: money supply and credit (affects real output and price level through changes in reserves money, money supply and credit aggregates). - Interest rate channel. - Exchange rate channel (linked to the currency). - Asset price. Monetary decisions today take into account a wider range of factors, such as: - short term interest rates; - long term interest rates; - velocity of money through the economy; - exchange rate - credit quality - bonds and equities (corporate ownership and debt) - government versus private sector spending/savings - international capital flow of money on large scales - financial derivatives such as options, swaps and future contracts etc. 1. 4 TYPES OF MONETARY POLICY In practice, to implement any type of monetary policy the main tool used is modifying the amount of base money in circulation. The monetary authority does this by buying or selling financial assets (usually government obligations). These open market operations change either the amount of money or its liquidity (if less liquid forms of money are bought or sold). The multiplier effect of fractional reserve banking amplifies the effects of these actions. Constant market transactions by the monetary authority modify the supply of currency and this impacts other market variables such as short term interest rates and the

exchange rate. The distinction between the various types of monetary policy lies primarily with the set of instruments and target variables that are used by the monetary authority to achieve their goals. | Monetary Policy: | Target Market Variable: | Long Term Objective: | | Inflation Targeting | Interest rate on overnight debt | A given rate of change in the CPI | | Price Level Targeting | Interest rate on overnight debt | A specific CPI number | | Monetary Aggregates | The growth in money supply | A given rate of change in the CPI | | Fixed Exchange Rate | The spot price of the currency | The spot price of the currency | | Gold Standard | The spot price of gold | Low inflation as measured by the gold price | | Mixed Policy | Usually interest rates | Usually unemployment + CPI change | The different types of policy are also called monetary regimes, in parallel to exchange rate regimes. A fixed exchange rate is also an exchange rate regime; The Gold standard results in a relatively fixed regime towards the currency of other countries on the gold standard and a floating regime towards those that are not. Targeting inflation, the price level or other monetary aggregates implies floating exchange rate unless the management of the relevant foreign currencies is tracking exactly the same variables (such as a harmonized consumer price index). Inflation targeting Under this policy approach the target is to keep inflation, under a particular definition such as Consumer Price Index, within a desired range. The inflation target is achieved through periodic adjustments to the Central Bank interest rate target. The interest rate used is generally the interbank rate at which banks lend to each other overnight for cash flow purposes. Depending on the country this particular interest rate might be called the cash rate or something similar. The interest rate target is

maintained for a specific duration using open market operations. Typically the duration that the interest rate target is kept constant will vary between months and years. This interest rate target is usually reviewed on a monthly or quarterly basis by a policy committee Price level targeting Price level targeting is similar to inflation targeting except that CPI growth in one year is offset in subsequent years such that over time the price level on aggregate does not move. Something similar to price level targeting was tried by Sweden in the 1930s, and seems to have contributed to the relatively good performance of the Swedish economy during the Great Depression. As of 2004, no country operates monetary policy based on a price level target. Monetary aggregates In the 1980s, several countries used an approach based on a constant growth in the money supply. This approach was refined to include different classes of money and credit (M0, M1 etc). In the USA this approach to monetary policy was discontinued with the selection of Alan Greenspan as Fed Chairman. This approach is also sometimes called monetarism. While most monetary policy focuses on a price signal of one form or another, this approach is focused on monetary quantities. Fixed exchange rate This policy is based on maintaining a fixed exchange rate with a foreign currency. There are varying degrees of fixed exchange rates, which can be ranked in relation to how rigid the fixed exchange rate is with the anchor nation. Under a system of fiat fixed rates, the local government or monetary authority declares a fixed exchange rate but does not actively buy or sell currency to maintain the rate. Instead, the rate is enforced by non-convertibility measures (e. g. capital controls, import/export licenses, etc.). In this case there is a black market exchange rate where the currency trades

at its market/unofficial rate. Under a system of fixed-convertibility, currency is bought and sold by the central bank or monetary authority on a daily basis to achieve the target exchange rate. This target rate may be a fixed level or a fixed band within which the exchange rate may fluctuate until the monetary authority intervenes to buy or sell as necessary to maintain the exchange rate within the band. (In this case, the fixed exchange rate with a fixed level can be seen as a special case of the fixed exchange rate with bands where the bands are set to zero.) Under a system of fixed exchange rates maintained by a currency board every unit of local currency must be backed by a unit of foreign currency (correcting for the exchange rate). This ensures that the local monetary base does not inflate without being backed by hard currency and eliminates any worries about a run on the local currency by those wishing to convert the local currency to the hard (anchor) currency. These policies often abdicate monetary policy to the foreign monetary authority or government as monetary policy in the pegging nation must align with monetary policy in the anchor nation to maintain the exchange rate. The degree to which local monetary policy becomes dependent on the anchor nation depends on factors such as capital mobility, openness, credit channels and other economic factors Gold standard The gold standard is a system in which the price of the national currency as measured in units of gold bars and is kept constant by the daily buying and selling of base currency to other countries and nationals. (i. e. open market operations). The selling of gold is very important for economic growth and stability. The gold standard might be regarded as a special case of the " Fixed Exchange Rate" policy. And the gold price might be regarded as a

special type of " Commodity Price Index". Today this type of monetary policy is not used anywhere in the world, although a form of gold standard was used widely across the world prior to 1971. For details see the Bretton Woods system. Its major advantages were simplicity and transparency. 2. RESEARCH METHODOLOGY 2. 1 OBJECTIVES OF THE STUDY 1. To study the changing role and importance of selected monetary instruments on banks in India 2. To examine the effectiveness of monetary policy in ensuring the banking operations in India 3. To find out to what extent monetary policy facilitated economic growth of banks in India and its general impact in the post- reform period 2. 2 DATA SOURCE AND METHODOLOGY This study is exclusively based on secondary data. Secondary data were collected from the RBI bulletin, RBI Annual Reports, The Hindu, Economic Times, & various websites on Internet etc. To examine the first objective, i. e. to study the changing role and importance of selected monetary instruments on banks in India, the major monetary instruments used after the reform period were taken into account and changes in the relative importance of each monetary technique was marked and their efficacy in the Indian context was studied. To examine the effectiveness of monetary policy in ensuring the banking operations in India and also to find out its role in facilitating economic growth, we studied the different monetary intermediate targets and its impact on the real economic variables in India. 3 MONETARY MEASURES AND TOOLS Analysis of latest RBI monetary policy by applying various measures and tools RBI Monetary Policy Statement 2012-13 3. 1 MONETARY MEASURES On the basis of the current assessment and in line with policy stance, the Reserve Bank announces the following policy measures. Repo Rate It has

been decided to reduce the repo rate under the liquidity adjustment facility (LAF) by 50 basis points from 8. 5 per cent to 8. 0 per cent with immediate effect. Reverse Repo Rate The reverse repo rate under the LAF, determined with a spread of 100 basis points below the repo rate, stands adjusted to 7. 0 per cent with immediate effect. Marginal Standing Facility In order to provide greater liquidity cushion, it has been decided to: raise the borrowing limit of scheduled commercial banks under the marginal standing facility (MSF) from 1 per cent to 2 per cent of their net demand and time liabilities (NDTL) outstanding at the end of second preceding fortnight with immediate effect. Banks can continue to access the MSF even if they have excess statutory liquidity ratio (SLR) holdings, as hitherto. The MSF rate, determined with a spread of 100 basis points above the repo rate, stands adjusted to 9. 0 per cent with immediate effect. Bank Rate The Bank Rate stands adjusted to 9. 0 per cent with immediate effect. Cash Reserve Ratio The cash reserve ratio (CRR) of scheduled banks has been retained at 4. 75 per cent of their NDTL. 3. 2 GUIDANCE The reduction in the repo rate is based on an assessment of growth having slowed below its post-crisis trend rate which, in turn, is contributing to a moderation in core inflation. However, it must be emphasised that the deviation of growth from its trend is modest. At the same time, upside risks to inflation persist. These considerations inherently limit the space for further reduction in policy rates. Moreover, persistent demand pressures emerging from inadequate steps to contain subsidies as indicated in the recent Union Budget will further reduce whatever space there is. In this context, it must be pointed out that, while revisions in administered prices may adversely impact headline inflation, the appropriate

monetary policy response to this should be based on whether the higher prices translate into generalised inflationary pressures. Although the likelihood of a pass-through depends on the strength of the pricing power in the economy, which is currently abating, the risk of a pass-through cannot be ignored altogether. Overall, from the perspective of vulnerabilities emerging from the fiscal and current account deficits, it is imperative for macroeconomic stability that administered prices of petroleum products are increased to reflect their true costs of production. On liquidity, conditions are steadily moving towards the comfort zone of the Reserve Bank, as reflected in the decline in banks’ borrowings from the LAF and the behaviour of money market rates. The increase in the MSF limit will provide additional liquidity comfort. However, should the situation change, appropriate and proactive steps will be taken with the objective of restoring comfort zone conditions. 3. 3 EXPECTED OUTCOMES The policy actions taken are expected to: stabilise growth around its current post-crisis trend; contain risks of inflation and inflation expectations re-surging; and enhance the liquidity cushion available to the system. Mid-Quarter Review of Monetary Policy 2012-13 The next mid-quarter review of Monetary Policy for 2012-13 will be announced through a press release on Monday, June 18, 2012. First Quarter Review of Monetary Policy 2012-13 The First Quarter Review of Monetary Policy for 2012-13 is scheduled on Tuesday, July 31, 2012. 3. 4 FINANCIAL INCLUSION PLAN FOR BANKS It was indicated in the Monetary Policy Statement of May 2011 that all public and private sector banks had prepared and submitted their board approved three-year financial inclusion plans (FIPs). These contained self-set targets in respect of opening of rural brick and mortar branches; deployment

of business correspondents (BCs); coverage of unbanked villages with population above 2, 000 as also other unbanked villages with population below 2, 000 through branches/BCs/other modes; opening of no-frills accounts; kisan credit cards (KCCs) and general credit cards (GCCs) issued; and other specific products designed by them to cater to the financially excluded segments. A brief analysis of the progress made under FIPs of banks shows that penetration of banks in rural areas has increased manifold. As against 21, 475 brick and mortar branches of these banks in rural areas as in early March 2010, banks are now providing banking services in rural areas through 1, 38, 502 outlets comprising 24, 085 rural branches, 1, 11, 948 BC outlets and 2, 469 outlets through other modes. No-frills accounts have increased to around 99 million with an outstanding balance of above `87 billion with the addition of about 50 million new no-frills accounts since April 2010. Going forward, the focus will be more on the number and value of transactions in no-frills accounts and credit disbursed through information and communication technology (ICT) based BC outlets. For the purpose, banks have been advised that FIPs prepared by their head offices are disaggregated at respective controlling offices and further at branch levels. They were also advised to put in place a mechanism to monitor the progress at these levels periodically. 3. 5. REGULATORY AND SUPERVISORY MEASURES FOR COMMERCIAL BANKS Strengthening the Resilience of the Banking Sector Implementation of Basel III Capital Regulations As indicated in the SQR of October 2011, the Reserve Bank prepared the draft guidelines on Basel III — Implementation of Capital Regulations in India, which were placed on its website in December 2011, for comments/suggestions from

various stakeholders. The draft guidelines provide for a roadmap for smooth implementation of Basel III capital regulations in terms of the transitional arrangements (phase-in) of capital ratios and grandfathering (phase-out) of ineligible capital instruments. The Reserve Bank is also in the process of estimating, on the basis of data collected from banks, the likely impact of the proposed Basel III norms on banks’ capital position and leverage. The estimation exercise, as also the comments/suggestions from various stakeholders, will form the basis for finalising the guidelines on capital regulations. It is proposed: to issue the final guidelines on the implementation of Basel III capital regulations by end-April 2012. Implementation of Liquidity Risk Management and Basel III Framework on Liquidity Standards Based on the documents Principles for Sound Liquidity Risk Management and Supervision as well as Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring published by the Basel Committee on Banking Supervision (BCBS) in September 2008 and December 2010 respectively, the Reserve Bank prepared draft guidelines on Liquidity Risk Management and Basel III Framework on Liquidity Standards, which were placed on its website in February 2012 for comments and feedback. The draft guidelines consolidate the various instructions/guidance on liquidity risk management that the Reserve Bank has issued from time to time in the past, and where appropriate, harmonises and enhances these instructions/guidance in line with the BCBS’s Principles for Sound Liquidity Risk Management and Supervision. They include enhanced guidance on liquidity risk governance, measurement, monitoring and the reporting to the Reserve Bank on liquidity

positions. The draft guidelines also cover two minimum global regulatory standards, viz., liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) as set out in the Basel III rules text. While the enhanced liquidity risk management measures are to be implemented by banks immediately after finalisation of the draft guidelines, the Basel III regulatory standards, viz., LCR and NSFR, will be binding on banks from January 1, 2015 and January 1, 2018, respectively. Till then, banks will have to comply with Basel III guidelines on a best effort basis. This will prepare banks for transition to the Basel III requirements. It is proposed: to issue the final guidelines on liquidity risk management and Basel III framework on liquidity standards by end-May 2012, after taking into account the suggestions/ feedback received. 4. EFFECTIVENESS OF MONETATRY POLICY IN INDIA The specter of inflation has led the Reserve Bank of India (RBI) to repeatedly raise interest rates and increase banks’ reserve requirements in classic monetary policy responses. The RBI also faces the challenge of simultaneously managing the exchange rate in the face of porous controls on international capital flows. While the exchange rate has depreciated recently as capital inflows have cooled, the hot button issue just a few months ago was whether the exchange rate should be kept from appreciating. Some economists argued for preventing exchange rate appreciation, and managing the inflationary impact of capital inflows by selling government bonds, thus soaking up excess liquidity. Others favored an “ export-competitive" exchange rate policy, but also argued that monetary policy was irrelevant as current inflationary symptoms were arising from temporary supply-side shocks. The “ radical" position (at least by Indian policy standards) has been that the RBI should focus on

fighting inflation, but give itself more room to do so by allowing the exchange rate to adjust to market conditions. One version of this stance is that raising the interest rate is less effective as an inflation-fighting policy than allowing the rupee to appreciate, as financial repression and underdeveloped financial markets keep interest rate changes from rippling through the economy strongly enough. There are several empirical analyses of the “ monetary transmission mechanism" in India. These suggest that the interest rate channel of monetary policy has strengthened since 1998, which should not come as a surprise since there has been considerable financial liberalization, accompanied by a revision of the RBI’s policy approach. This result comes out in an interesting fashion in a 2005 IMF study. The responses of firms to monetary tightening vary by size and, while greater in the period 1998-2003 versus the prior half-decade, seem to involve a reversal of initial cutbacks in corporate debt. Still, interest rates do affect firm borrowing behavior. A better feel for the aggregate impacts of monetary policy comes from an economy wide analysis. This suggests the interest rate is an effective inflation-fighting tool in India even though, as the authors say, “ the financial market in India is not yet matured. " The results even indicate that output recovers with a lag in the face of such interest rate increases. All this sounds quite good from the perspective of what policymakers are currently doing, though there is no modeling of inflation expectations in India that we are aware of, and that issue seems to also be driving monetary policy. In contrast to interest rate policy, in the SK time series estimations there is no long-run link between monetary aggregates and output, rendering such aggregates less reliable as targets or indicators for policymakers. Indian

monetary policy is still very accommodative and interest rates need to rise more to prevent global supply-side shocks from seeping into the broader economy. Wholesale price inflation, the most widely watched measure in India, touched 8. 24 percent in mid-May, far above the central bank's comfort zone of 5. 5 percent for 2008/09. The central bank held off outright rate increases for a year, opting instead to keep cash availability tight, as prices pressures largely came from supply constraints and record commodity prices rather than demand. The twin objectives of monetary policy in India have evolved as maintaining price stability and ensuring adequate flow of credit to facilitate the growth process. CONCLUSION Reserve Bank of India as a central governing authority in India has a complete control on the Indian Monetary Policy which affects all the sectors of Indian Industries. Banking sector is the prime sector which is highly affected by any act of RBI, any change in any tools by RBI results in the change in profitability of banks. Monetary policy affects banks directly and GDP and IIP indirectly through banks. BIBLIOGRAPHY www. rbi. org. in http://www. rbi. org. in/Scripts/Annualpolicy. aspx http://www. bankingindiaupdate. com http://en. wikipedia. org/wiki/Monetarypolicy