

The impact of monetary control techniques used on banking sector

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Acknowledgement | City College, Department of Management Studies, Bangalore-560070. | The Impact of Monetary Control Techniques used on Banking Sector

ABSTRACT The objectives of monetary policy have undergone a change in emphasis over the years. The objectives of monetary policy in India were: to accelerate economic development in an environment of reasonable price stability; to develop appropriate institutional set up to aid this process. By influencing the cost, volume, and direction of credit, monetary policy has been encouraging sectoral and overall development and supporting programme aimed at social justice. The containment of inflationary pressures without jeopardizing the growth potential has been the main objective of monetary policy, but over the years, the former has assumed an overriding importance. Since the mid of the 1980s, monetary policy has an explicitly added concern, namely to promote efficiency in the operations of the financial system and to effect appropriate structural changes in it. The monetary policy is now geared towards reducing the rigidities, introducing flexibility, encouraging diversification, promoting more

competitive environment and imparting greater discipline and prudence in the operations of the financial system. To achieve the objectives of monetary policy we have to implement different techniques of monetary control like Cash Reserve ratio, Statutory Liquidity Ratio etc. This paper focuses on the techniques used for monetary control in banking sector. Conceptual research type will be used for this study by referring the reliable information from suitable sources. Outcome of this paper is related to know the impact of techniques used for monetary control in banking sector. Keywords: Monetary Policy, CRR, SLR, Bank Rate, Open Market Operation, Repo rate

INTRODUCTION The financial system deals in other people's money therefore, their confidence, trust and faith in it is crucially important for its smooth functioning. Financial regulation is necessary to generate, maintain and promote this trust. The Reserve Bank of India, as the central of the country, is the centre of the Indian financial and monetary system. It started functioning from April 1, 1935 on the terms of the Reserve Bank of India Act, 1934. It is responsible for forming, implementing, and monitoring the monetary policy time to time depending on the performance or conditions of financial market in India. The objectives of monetary policy have undergone a change in emphasis over the years. In planned economy they were very much similar to the objectives of economic planning. The primary and secondary objectives of economic planning in India were many, but in a nutshell, they were aimed at growth, stability, and social justice. The keynote of monetary policy may be said to be controlled expansion of bank credit and money supply, with special attention to seasonal requirements for credit. The Bank has been directing its attention to ensure that credit expansion takes

place in the light of price variations without affecting the output, particularly the industrial output adversely. In other words, the objective has been one of disinflation without deflation. The containment of inflationary pressures without jeopardizing the growth potential has been the main objective of monetary policy, but over the years, the former has assumed an overriding importance. There appears to be a general consensus today that the primary objective of monetary policy should be domestic price stability. Maintenance of price stability and ensuring availability of adequate credit to the productive sectors of the economy are the major objectives of monetary policy in India.

OBJECTIVES: - To understand the monetary control techniques used in Indian Financial Market. - To study the impact of monetary control techniques used on banking sector. - To know the relationship between monetary control techniques and banking system.

RESEARCH METHODOLOGY Type of Research - Conceptual type of Research is chosen for studying this paper. Data Collection - This Research Paper is done mainly by collecting and analyzing secondary data. The major sources of these data are from the website of Reserve Bank of India and other banking related websites. A fair amount of information is collected from magazines and other academic publications to obtain Knowledge working procedure regarding in this field.

LIMITATIONS - The study will be basically focusing on the impact of monetary control techniques used on banking sector but it is restricted to only on repo and reverse repo rates.

REVIEW OF LITERATURE RBI1 report on Monetary Policy (2011) has mentioned that, three factors have shaped the outlook and monetary strategy for 2011-12. First, global commodity prices, which have surged in recent months, are likely to, at best, remain firm and

may well increase further over the course of the year. Second, headline and core inflation have significantly overshoot even the most pessimistic projections over the past few months. In terms of the likely trajectory of inflation over the year, the first suggests that high inflation will persist and may get worse. The second raises concerns about inflationary expectations becoming unhinged. The third factor, countering these forces, is the likely moderation in demand, which should help reduce pricing power and the extent of pass-through of commodity prices. (Article: Economic times indiatimes dated 25/10/2011) This is the 13th rate rise since March 2010 by the Reserve Bank of India, even though the bank battles to keep India's growth story intact amid weakening global environment. Inflation, which has been the major reason behind the RBI aggressive stance, has remained above 9 percent for 10 straight months. Food inflation climbed to 10.60% for the week ending October 8 from the same period a year earlier, according to government data. The WPI, India's most closely watched inflation gauge, stayed well above the RBI's comfort zone at more than 9% in September. 1 Reserve Bank of India 2 Wholesale Price Index The RBI's rate hikes have helped to some extent in the moderation of inflation, but the inflation rate is still in an uncomfortable zone going by the RBI's mandated range for inflation. (Article: Times of India dated 14/02/2012) After a gap of nearly nine years, the Reserve Bank has increased the bank rate by 3.50 percentage points to 9.5 percent with immediate effect. "The increase should be viewed and understood as one-time technical adjustment to align the bank rate with the MSF3 rate rather than a change in the monetary policy stance," RBI said in a notification, adding the new rate will be effective from February

13. (Article: www.allbankingsolutions.com dated 24/01/2012) “ RBI in its Third Quarter Review of Monetary Policy on 24th January, 2012, announced reduction in the CRR4 of scheduled banks by 50 basis points i. e. from existing 6. 0 percent to 5. 5 percent of their NDTL5 effective the fortnight beginning January 28, 2012. ” MONETARY POLICY (Source: RBI Monetary Policy Statement 2011-12) The Annual Policy for 2011-12 is set in conditions significantly different than they were a year ago. Last year’s policy was made in an environment of incipient domestic recovery amidst uncertainty about the state of the global economy, a perception that was reinforced with the precipitation of the Greek sovereign debt crisis a few weeks later. While signs of inflation were visible, they were driven primarily by food. However, food price pressure spilling over into more generalised inflation was clearly a risk as the recovery consolidated and domestic resource utilisation rose to levels which stretched capacities. Throughout the year, the goal of monetary policy was to nurture the recovery in the face of persistent global uncertainty while trying to contain the spillover of supply-side inflation.

ROLE OF RBI The Reserve Bank of India is the Indian central bank. The RBI’s most important goal is to maintain monetary stability - moderate and stable inflation - in India. The RBI uses monetary policy to maintain price stability and an adequate flow of credit. Rates which the Indian central bank uses for this are the bank rate, repo rate, reverse repo rate and the cash reserve ratio. Reducing inflation has been one of the most important goals for some time. Other important tasks of the Reserve Bank of India are: - To maintain the population’s confidence in the system, to safeguard the interests of those who have entrusted their money and to

supply cost-effective banking systems to the population; - Providing loans to commercial banks in order to maintain or grow the Gross National Product; - To manage foreign currency controls: facilitating exports, imports and international payment traffic and developing and maintaining the trade in foreign currencies in India;

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Marginal Standing Facilities 4 Cash Reserve Ratio 5 Net Demand Time Liabilities - Acting as the government's banker; - Acting as the banks' banker; - Issuing money (the rupee) and adequately ensuring a high quality money supply. MONETARY CONTROL TECHNIQUES 1. Bank Rate Policy: The standard rate at which the RBI is prepared to buy or rediscount bills of exchange or other commercial papers eligible for purchase under the provisions of the Act of RBI. Thus the RBI, rediscounts the first class bills in the hands of commercial banks to provide them with liquidity in case of need. This rate is subjected to change from time to time in accordance with the economic stability and its credibility of the nation. The bank rate signals the central bank's long-term outlook on interest rates. If the bank rate moves up, long-term interest rates also tend to move up, and vice-versa. Banks make a profit by borrowing at a lower rate and lending the same funds at a higher rate of interest. If the RBI hikes the bank rate (this is currently 9.5 percent), the interest that a bank pays for borrowing money (banks borrow money either from each other or from the RBI) increases. It, in turn, hikes its own lending rates to ensure it continues to make a profit. 2. Open Market Operation: It means of implementing monetary policy by which a central bank controls the short term interest rate and the supply of base money in

an economy, and thus indirectly the total money supply. In times of inflation, RBI sells securities to mop up the excess money in the market. Similarly, to increase the supply of money, RBI purchases securities. 3. Adjusting with CRR and SLR: By adjusting the CRR(Cash Reserve Ratio) and SLR(Statutory Liquidity Ratio) which are short term tools to be used to shortly regulate the cash and fund flows in the hands of the People, banks and Government, the RBI regularly make necessary adjustments in these rates. These variations in the rates will easily have a greater control over the cash flow of the country.

i) CRR (Cash Reserve Ratio): All commercial banks are required to keep a certain amount of its deposits in cash with RBI. This percentage is called the cash reserve ratio. The current CRR requirement is 5.5 percent. This serves two purposes. It ensures that a portion of bank deposits is totally risk-free and secondly it enables that RBI control liquidity in the system, and thereby, inflation by tying their hands in lending money ii) SLR (Statutory Liquidity Ratio): Banks in India are required to maintain 25 percent of their demand and time liabilities in government securities and certain approved securities. What SLR does is again restrict the bank's leverage in pumping more money into the economy by investing a portion of their deposits in government securities as a part of their statutory liquidity ratio requirements. 4. Lending Rate: Lending rates are the ratios fixed by RBI to lend the money to the customers on the basis of those rates. The higher the rate means the credit to the customers is costlier. The lower the rate means the credit to the customers is less which will encourage the customers to borrow money from the banks more that will facilitate the more money flow in the hands of the public. 5. Repo Rate: Repo rate is the rate at which banks borrow funds from

the RBI to meet the gap between the demands they are facing for money (loans) and how much they have on hand to lend. If the RBI wants to make it more expensive for the banks to borrow money, it increases the repo rate; similarly, if it wants to make it cheaper for banks to borrow money, it reduces the repo rate.

6. Reverse Repo Rate: The rate at which RBI borrows money from the banks (or banks lend money to the RBI) is termed the reverse repo rate. The RBI uses this tool when it feels there is too much money floating in the banking system. If the reverse repo rate is increased, it means the RBI will borrow money from the bank and offer them a lucrative rate of interest. As a result, banks would prefer to keep their money with the RBI (which is absolutely risk free) instead of lending it out (this option comes with a certain amount of risk).

POLICY RATES AND RESERVE RATIOS:

Bank Rate	9.50%		Repo Rate	8.50%		Reverse Repo Rate	7.50%		Cash Reserve Ratio (CRR)	4.75%		Statutory Liquidity Ratio (SLR)	24.0%		Base Rate	10.00%—10.75%		Deposit Rate	8.50%—9.25%
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TABLE 1. Policy rates, Reserve ratios, lending, and deposit rates as of 9th March, 2012

ANALYSIS AND INTERPRETATION - REPO RATE When reference is made to the Indian interest rate this often refers to the repo rate, also called the key short term lending rate. If banks are short of funds they can borrow rupees from the Reserve Bank of India (RBI) at the repo rate, the interest rate with a 1 day maturity. If the central bank of India wants to put more money into circulation, then the RBI will lower the repo rate. The reverse repo rate is the interest rate that banks receive if they deposit money with the central bank. This reverse repo rate is always lower than the repo rate. Increases or decreases in the repo and reverse repo rate have an effect on the interest

rate on banking products such as loans, mortgages and savings. | 3rd May 2011 | 7. 25 | | 16th June 2011 | 7. 50 | | 26th July 2011 | 8. 00 | | 16th Sep 2011 | 8. 25 | | 25th Oct 2011 | 8. 50 | Table 2. Change in Repo rate for the FY 2011-12 If we consider changes in repo rate for the FY 2011-12, there is an increase in repo rate for five times. On 3rd May 2011 repo rate got increased to 7. 25 from 7 then next raise took place on 16th June 2012 within 45 days. Later repo rate got raised to 8 percent on 26th July 2011 within 20 days of time suddenly due to economic conditions. Again next raise in repo rate took place on 16th September from 8 percent to 8. 25 percent. Then the last raise in repo rate took place on 25th October 2011 from 8. 25 percent to 8. 5 percent. - REVERSE REPO RATE Reverse Repo rate is the rate at which Reserve Bank of India (RBI) borrows money from banks. Banks are always happy to lend money to RBI since their money is in safe hands with a good interest. An increase in Reverse repo rate can cause the banks to transfer more funds to RBI due to these attractive interest rates. It can cause the money to be drawn out of the banking system. Due to this fine tuning of RBI using its tools of CRR, Bank Rate, Repo Rate and Reverse Repo rate our banks adjust their lending or investment rates for common man. | 3rd May 2011 | 6. 25 | | 16th June 2011 | 6. 50 | | 26th July 2011 | 7. 00 | | 16th Sep 2011 | 7. 25 | | 25th Oct 2011 | 7. 50 | Table 3. Change in Reverse Repo rate for the FY 2011-12 If we consider changes in reverse repo rate for the FY 2011-12, there is an increase in reverse repo rate for five times. On 3rd May 2011 reverse repo rate got increased to 6. 25 from 6 then next raise took place on 16th June 2012 within 45 days. Later repo rate got raised to 7 percent on 26th July 2011 within 20 days of time suddenly due to economic

conditions. Again next raise in reverse repo rate took place on 16th September from 7 percent to 7.25 percent. Then the last raise in reverse repo rate took place on 25th October 2011 from 7.25 percent to 7.5 percent. Impact on Banks: Due to mandatory changes in both repo and reverse repo rate these are having impact on credit banking one side but when we consider reduce in CRR rate is giving an opportunity of having more liquidity funds with the bank. In this process lending rates have become still higher. FINDINGS & CONCLUSIONS After analyzing this paper we can conclude that during the FY 2011-12 the change in rates of monetary control techniques has taken place very often. Especially when we focus on repo rate and reverse repo rate during FY 2011-12 it has risen for five times. RBI hiked bank rate after 9 years to 9.5%. The bank rate has lost its significant as a monetary policy tool as the central bank presently signals stance through changes in repo, the rate at which banks borrow short-term funds from RBI. Cash reserve ratio (CRR) also got changed to 4.75 percent from 5.5 percent which gives more liquidity option to the banks. I want to conclude that there is an impact of monetary control techniques on banking system and there is a linear relationship between monetary control techniques & Banking system. With the changing framework of monetary policy in India from monetary targeting to an augmented multiple indicators approach, the operating targets and processes have also undergone a change. There has been a shift from quantitative intermediate targets to interest rates, as the development of financial markets enabled transmission of policy signals through the interest rate channel. While monetary policy formulation is a technical process, it has become more consultative and participative with

the involvement of market participant, academics and experts. Let me conclude by quoting ' Tomorrow belongs to people who prepare for it today'. I am sure that we all draw lessons from our past and prepare ourselves for the challenges that the future holds for us. BIBLIOGRAPHY Books: 1. L. M. Bhole & Jitendra Mahakud (2011). Financial Institutions and Markets. New Delhi, 5th edition, Mc Graw Hill Publication. 2. K. C. Shekhar & Lekshmy Shekhar (2005). Banking Theory & Practices. New Delhi, 19th edition, Vikas Publishing House Pvt Ltd. 3. Gordon & Natarajan (2005). Financial Markets and Services. Mumbai, 2nd revised edition, Himalaya Publishing House. Websites: 1. http://articles.timesofindia.indiatimes.com/2012-02-14/india-business/31058499_1_repo-rate-bank-rate-reference-rate 2. http://articles.timesofindia.indiatimes.com/2012-01-19/kochi/30642647_1_rates