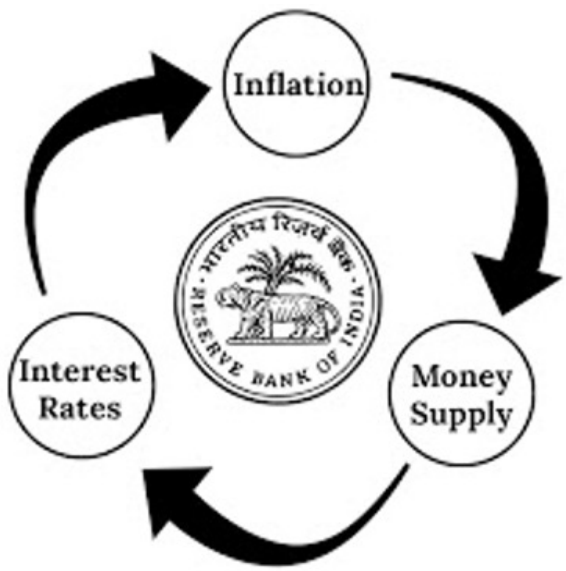
Monetary Policy

Topics Covered

- ***Definition of Monetary Policy***
- ***Objectives of Monetary Policy***
- ***Formulation of Monetary Policy***
- ***RBI and its Functions***
- ***Instruments of Monetary Policy***
- ***Liquidity Adjustment Facility***
- ***Reserve Ratios***
- ***Standing Deposit Facility***
- ***Marginal Standing Facility***
- ***Open Market Operations***
- ***Qualitative Tools of Monetary Policy***
- ***Quantitative Easing and Fed Tapering***
- ***Liquidity Trap and Liquidity Crunch***
- ***Monetary Transmission***
- ***Financial Repression***
- ***Urjit Patel Committee on Monetary Policy Reforms***

Monetary Policy is defined by the Reserve Bank of India as “the policy of the central bank with regard to the use of monetary instruments under its control to achieve the goals specified in the RBI Act, 1934.”

Monetary policy is concerned with the measures taken to regulate the supply of money, the cost and availability of credit in the economy there by determining the lending and borrowing rates of interest of the banks. In developed countries the monetary policy has been used for overcoming depression and inflation as an anti-cyclical policy.



However, in developing countries it has to play a significant role in promoting economic growth. It helps in Controlling the Supply of Money and Credit by the Central Bank by using various instruments of Monetary Policy.

Objectives of Monetary Policy:

- Promote Growth and Stability of an Economy
- Maintain Price Stability/Control Inflation
- Maintain Exchange Rate Stability

Expansionary Monetary Policy:

- Expansionary monetary policy is when a central bank uses its tools to stimulate the economy. That increases the money supply, lowers interest rates and increases aggregate demand. That boosts growth as measured by gross domestic product. It usually diminishes the value of the currency, thereby decreasing the exchange rate. It is the opposite of contractionary monetary policy.
- A policy by monetary authorities to expand money supply and boost economic activity, mainly by keeping interest rates low to encourage borrowing by companies, individuals and banks. An expansionary monetary policy can involve quantitative easing, whereby central banks purchase assets from banks. This has the effect of lowering yields on bonds and creating cheaper borrowing for banks. This, in turn, boosts banks' capacity to lend to individuals and businesses. An expansionary monetary policy also risks ramping up inflation.
- Expansionary monetary policy could also be termed a 'loosening of monetary policy'. It is the opposite of 'tight' monetary policy.

Q) If the interest rate is decreased in an economy, it will
(a) Decrease the consumption expenditure in the economy
(b) Increase the tax collection of the Government
(c) Increase the investment expenditure in the economy
(d) Increase the total savings in the economy

Contractionary Monetary Policy

- A contractionary monetary policy is a macroeconomic strategy used by a central bank to decrease the supply of money in the market in an effort to control inflation. The money supply is controlled by adjusting interest rates, purchasing government securities on the open market, and adjusting government spending.

- A contractionary policy is used to decrease the money supply, by increasing interest rates to discourage borrowing and decreasing government spending to reduce the availability of money. This leads to higher interest rates, lower income, and a drop in demand, production, and employment.
- The monetary authorities exercises a contractionary monetary policy only when it seeks to slow down inflation or depress an impending economic bubble. This forces banks to charge higher interest rates to anticipate the lower money supply, businesses contract their borrowing and cease expansion. This leads to higher unemployment and lower demand as consumer spending is depressed and the economy is tightened to the extent of recession.

Q) With reference to inflation in India, which of the following statements is correct?

(a) Controlling the inflation in India is the responsibility of the Government of India only

(b) The Reserve Bank of India has no role in controlling the inflation

(c) Decreased money circulation helps in controlling the inflation

(d) Increased money circulation helps in controlling the inflation

Q) Supply of money remaining the same when there is an increase in demand for money, there will be

(a) A fall in the level of prices

(b) An increase in the rate of interest

(c) A decrease in the rate of interest

(d) An increase in the level of income and employment

Expansionary Monetary Policy

Problem : Recession and Unemployment
Measures: (1) Central Bank buys securities through open market operations
(2) It reduces Cash Reserve Ratio(CRR)
(3)It lowers Bank Rate

↓

Money supply increases

↓

Interest rate falls

↓

Investment increases

↓

Aggregate demand increases

↓

Aggregate output increases by a multiple of the increase in investment

Contractionary Monetary Policy

Problem: Inflation
Measures: (1) Central Bank sells securities through open market operations
(2) It raises Cash Reserve Ratio(CRR) and Statutory Liquidity Rtio(SLR)
(3) It raises Bank rate
(4) It raises maximum margin against holding of stocks of goods

↓

Money supply decreases

↓

Interest rate raises

↓

Investment expenditure declines

↓

Aggregate demand declines

↓

Price level falls

Formulation of Monetary Policy

Monetary policy is devised and implemented by the Central Monetary Authority called RBI. Previously policy used to frame by the Reserve Bank Governor along with a Technical Advisory committee.

In that arrangement Governor used to have “veto” over the opinion of the Advisory Committee. So, this structure is replaced with Monetary Policy Committee (MPC) in 2016. This committee only frames the Policy but implementation is still by the RBI.

Monetary Policy Committee (MPC)

About MPC: The Monetary Policy Committee (MPC) is the body of the RBI, headed by the Governor, responsible for taking the important monetary policy decision about setting the repo rate. Repo rate is 'the policy instrument' in monetary policy that helps to realize the set inflation target by the RBI (at present 4%).

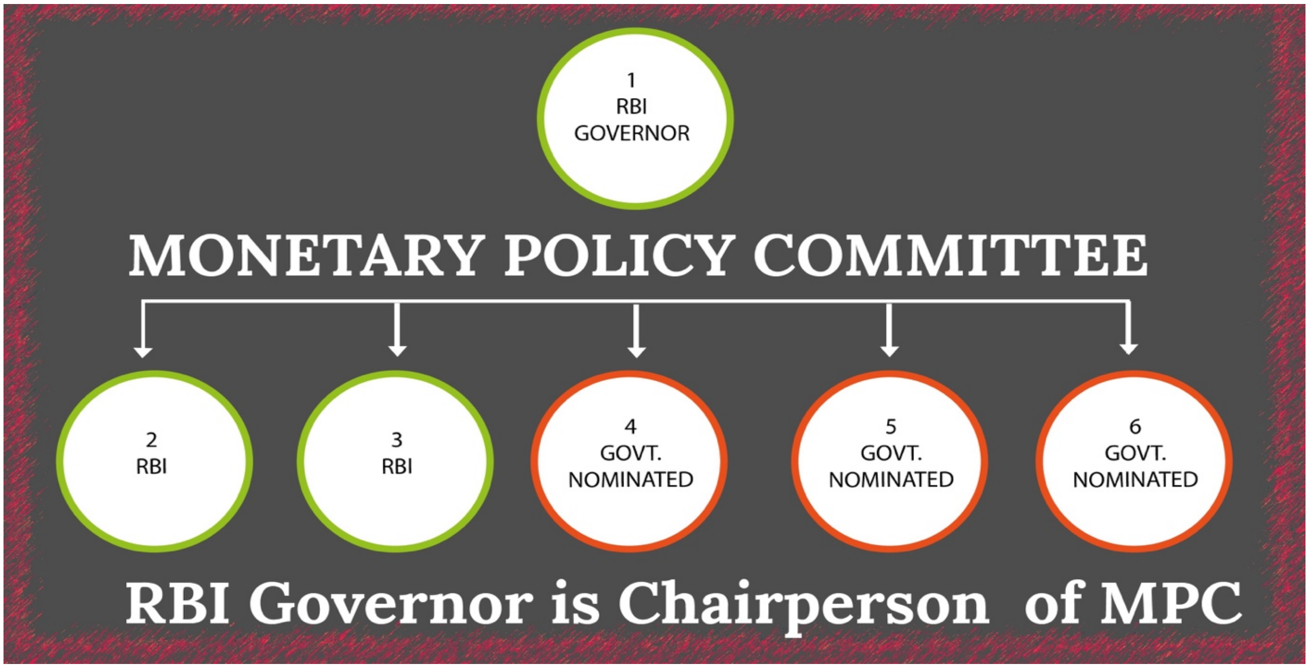
The MPC replaces the previous arrangement of Technical Advisory Committee. The Committee is to meet at least four times a year and make public its decisions following each meeting. There will be no reappointment of the committee.

Structure of the MPC

The Monetary Policy Committee (MPC) is formed under the RBI with six members. Three of the members are from the RBI while the other three members are appointed by the government.

Members from the RBI are the Governor who is the chairman of the MPC, a Deputy Governor and one officer of the RBI.

The government members are appointed by the Centre on the recommendations of a search-cum-selection committee which is to be headed by the Cabinet Secretary.



Under MPC, the governor has a casting vote and doesn't enjoy veto power (there was veto power for him under TAC). Decisions will be taken on the basis of majority vote.

Responsibilities of MPC:

To administer the inflation targeting monetary policy regime through determining the policy rate or repo rate to contain CPI based inflation target of 4% with a bandwidth of +/- 2%.

In case the inflation target is failed to achieve (2% higher or lower than the set target of 4% for continuous three quarters), the RBI has to give an explanation to the government about the reasons, the remedial actions and the estimated time for realizing the target.

To publish a Monetary Policy Report every six months, elaborating inflation forecasts and inflation sources for the next six to eighteen months.

Q) Which of the following statements is/are correct regarding the Monetary Policy Committee (MPC)?

1. It decides the RBI's benchmark interest rates.
2. It is a 12-member body including the Governor of RBI and is reconstituted every year.
3. It functions under the chairmanship of the Union Finance Minister.

Select the correct answer using the code given below:

(a) 1 only

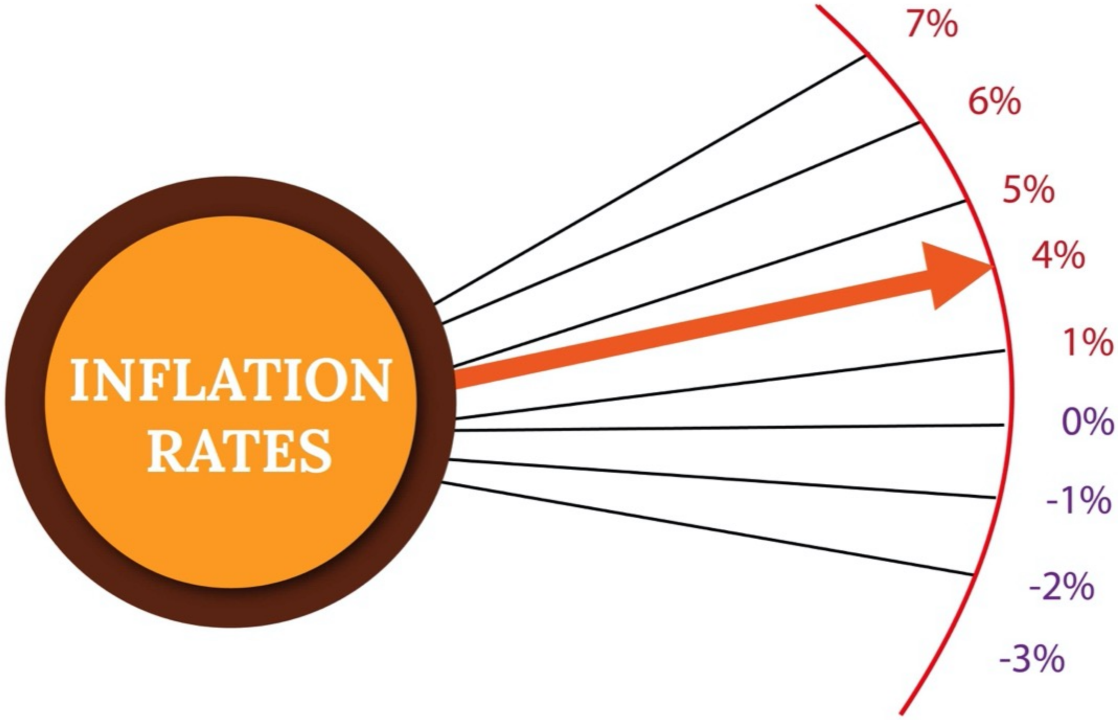
(b) 1 and 2 only

(c) 3 only

(d) 2 and 3 only

Inflation Targeting:

What is the time period for a set target: The Central Government, in consultation with the RBI, determines the inflation target in terms of the Consumer Price Index (CPI), once in every five years. This target would be notified in the Official Gazette. The current target will end on March 31, 2021.



INFLATION TARGETING

How frequently MPC announces Policy Rates: Bi-monthly with the first such policy was announced on April 1, 2014. It was one of the measure announced by the panel headed by RBI deputy governor Urjit Patel.

Reserve Bank of India (RBI):

The Reserve Bank of India is the central bank of the country. Central banks are a relatively recent innovation and most central banks, as we know them today, were established around the early twentieth century.

The Reserve Bank of India was set up on the basis of the recommendations of the Hilton Young Commission. The Reserve Bank of India Act, 1934 (II of 1934) provides the statutory basis of the functioning of the Bank, which commenced operations on April 1, 1935.

The Bank was constituted to

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

The Bank began its operations by taking over from the Government the functions so far being performed by the Controller of Currency and from the Imperial Bank of India, the management of Government accounts and public debt. The existing currency offices at Calcutta, Bombay, Madras, Rangoon, Karachi, Lahore and Cawnpore (Kanpur) became branches of the Issue Department. Offices of the Banking Department were established in Calcutta, Bombay, Madras, Delhi and Rangoon.

Burma (Myanmar) seceded from the Indian Union in 1937 but the Reserve Bank continued to act as the Central Bank for Burma till Japanese Occupation of Burma and later up to April, 1947. After the partition of India, the Reserve Bank served as the central bank of Pakistan up to June 1948 when the State Bank of Pakistan commenced operations. The Bank, which was originally set up as a shareholder's bank, was nationalised in 1949.

An interesting feature of the Reserve Bank of India was that at its very inception, the Bank was seen as playing a special role in the context of development, especially Agriculture.

When India commenced its plan endeavours, the development role of the Bank came into focus, especially in the sixties when the Reserve Bank, in many ways, pioneered the concept and practise of using finance to catalyse development.

The Bank was also instrumental in institutional development and helped set up institutions like the Deposit Insurance and Credit Guarantee Corporation of India, the Unit Trust of India, the Industrial Development Bank of India, the National Bank of Agriculture and Rural Development, the Discount and Finance House of India etc. to build the financial infrastructure of the country.

With liberalisation, the Bank's focus has shifted back to core central banking functions like Monetary Policy, Bank Supervision and Regulation, and Overseeing the Payments System and onto developing the financial markets.

Key Landmarks in the journey of RBI (don't mug-up.., just for reference)

- In 1926, the Royal Commission on Indian Currency and Finance recommended creation of a central bank for India.
- In 1927, a bill to give effect to the above recommendation was introduced in the Legislative Assembly, but was later withdrawn due to lack of agreement among various sections of people.
- In 1933, the White Paper on Indian Constitutional Reforms recommended the creation of a Reserve Bank. A fresh bill was introduced in the Legislative Assembly.
- In 1934, the Bill was passed and received the Governor General's assent
- In 1935, Reserve Bank commenced operations as India's central bank on April 1 as a private shareholders bank with a paid up capital of rupees five crore. In 1942 Reserve Bank ceased to be the currency issuing authority of Burma (now Myanmar).
- In 1947, Reserve Bank stopped acting as banker to the Government of Burma.

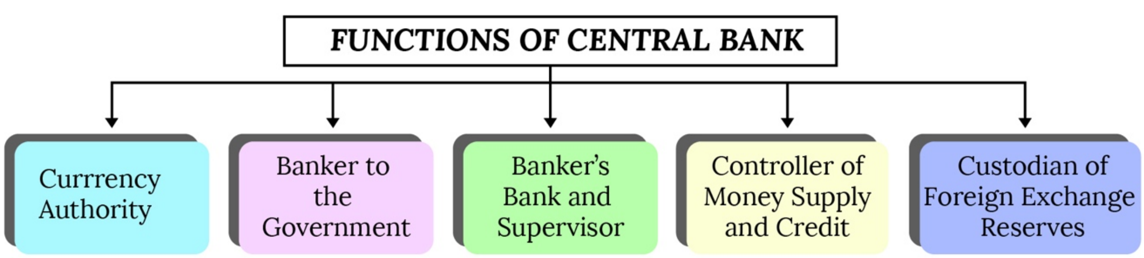
- In 1948, Reserve Bank stopped rendering central banking services to Pakistan.
- In 1949, the Government of India nationalized the Reserve Bank under the Reserve Bank (Transfer of Public Ownership) Act, 1948.
- In 1949, Banking Regulation Act was enacted.
- In 1951, India embarked in the Planning Era.
- In 1966, the Cooperative Banks came within the regulations of the RBI.
- In 1966, Rupee was devaluated for the first time.
- In 1969, Nationalization of 14 Banks was a Turning point in the history of Indian Banking.
- In 1973, the Foreign Exchange Regulation act was amended and exchange control was strengthened.
- In 1974, the Priority Sector Advance Targets started getting fixed.
- In 1975, Regional Rural Banks started
- In 1985, the Sukhamoy Chakravarty and Vaghul Committee reports embarked the era of Financial Market Reforms in India.
- In 1991, India came under the Balance of Payment crisis and RBI pledged Gold to shore up reserves. Rupee was devaluated.
- In 1991-92, Economic Reforms started in India.
- In 1993, Exchange Rate became Market determined.
- In 1994, Board for Financial Supervision was set up.
- In 1997, the regulation of the Non-Banking Financial Companies (NBFC) got strengthened.
- In 1998, Multiple Indicator Approach for monetary policy was adopted for the first time.
- In 2000, the Foreign Exchange Management Act (FEMA) replaced the erstwhile FERA.
- In 2002, The Clearing Corporation of India Ltd Started operation.
- In 2003, Fiscal Responsibility and Budget Management Act (FRBMA) enacted.
- In 2004, Market Stabilization Scheme (MSS) was launched.

- In 2004, Real Time Gross Settlement (RTGS) started working.
- In 2006, Reserve Bank of India was empowered to regulate the money, forex, G-Sec and Gold related security markets.
- In 2007, Reserve bank of India was empowered to regulate the money, forex, G-Sec and Gold related security markets.

Q) Consider the following statements
1. Reserve Bank of India was nationalized on 26 January, 1950
2 The borrowing programme of the Government of India is handled by the Department of Expenditure, Ministry of Finance
Which of the statements given above is/are correct?
(a) 1 only
(b) 2 only
(c) Both 1 and 2
(d) Neither 1 nor 2

Q) The accounting year of the Reserve Bank of India is:
(a) April-March
(b) July-June
(c) October-September
(d) January-December

Functions of Central Bank



1. Bank of issuing or currency: The central bank of the country has the monopoly of issuing notes or paper currency to the public. Therefore, the central bank of the country exercises control over the supply of currency in the country. In India with the exception of one rupee notes which are issued by the Ministry of Finance of the Government of India, the entire note is done by the Reserve Bank of India.

Central banks have been following different methods of note issue in different countries. The central bank is required by law to keep a certain amount of gold and foreign securities against the issue of notes. In some countries, the amount of gold and foreign securities bears a fixed proportion, between 25 to 40 per cent of the total notes issued. In other countries, a minimum fixed amount of gold and foreign currencies is required to be kept against note issue by the central bank.

Seigniorage

Seigniorage is a fancy term for the profits governments make by minting currency. It is the difference between the face value of a currency note or coin, and its actual production cost. For instance, if the cost of printing a Rs. 2,000- note is about Rs.4, printing one such note and putting it into circulation fetches a profit of Rs. 1,996. Usually central banks 'earn' this profit and transfer it to the Government.

It is normal to assume that whenever government issues new currency, the RBI will pocket a profit. Higher denomination notes earn higher profits. However, things are different in the case of coins where the cost of minting can is usually equal to the face value, and can fluctuate based on the price of base metal.

2. Banker to the banks: The central bank acts as a banker to the commercial banks in the following manner:

- Custodian of the cash reserves of the commercial banks (CRR).

- Lender of the last resort in the sense that if commercial banks fail to generate enough cash from its own sources it approaches the central bank as a last resort. The central bank in turn may grant loans and advances to the needy banks.
- The central bank also acts as central clearing house for the commercial banks.

All other banks in the country are found by law to keep a fixed portion of their total deposits as reserves with the central bank. These reserves help the central bank to control the issue of credit by commercial banks. They in return can depend up on the central bank for support at the time of emergency.

This help may be in the form of a loan on the strength of approved securities or through rediscounting of bills of exchange. Thus the central bank is the lender of last resort for other banks in difficult times.

In India, the Central Bank's function as the "lender of last resort" usually refers to which of the following?

1. Lending to trade and industry bodies when they fail to borrow from other sources
2. Providing liquidity to the banks having a temporary crisis
3. Lending to governments to finance budgetary deficits

Select the correct answer using the code given below
a) 1 and 2
b) 2 only
c) 2 and 3
d) 3 only

In India, scheduled banks have to keep deposits with the Reserve Bank not less than 5% of their current demand deposits and 2% of their fixed deposits as reserves. In return they enjoy the privilege of rediscounting their bills with the Reserve Bank as well as securing loans against approved securities when needed.

Clearing function is also performed by the central bank for the banks. Since banks keep cash reserves with the central bank, settlement between them may be easily effected by means of debts and credits in the books of the central bank. If clearing go heavily against some bank, its cash reserves with the central bank will fall below the prescribed limit and therefore the bank concerned will have to make up the deficiency.

Q) The Reserve Bank of India regulates the commercial banks in matters of
1. Liquidity of assets
2. Branch expansion
3. Merger of banks:
4. Winding-up of banks
Select the correct answer using the codes given below.
(a) 1 and 4 only
(b) 2,3 and 4 only
(c) 1,2 and 3 only
(d) 1,2,3 and 4

Q) The Reserve Bank of India (RBI) acts as a bankers' bank. This would imply which of the following?
1. Other banks retain their deposits with the RBI.
2. The RBI lends funds to the commercial banks in times of need.
3. The RBI advises the commercial banks on monetary matters.
Select the correct answer using the codes given below:
(a) 2 and 3 only
(b) 1 and 2 only
(c) 1 and 3 only
(d) 1,2 and 3

3. Banker to the government: As a banker to the government the central bank carries out all banking businesses on behalf of both the central government and the state governments.

It maintains current account of the government for keeping cash balances and also making and receiving payments on behalf of the government. It provides loans and advances to the government. It also acts as financial advisor to the government.

Q) Consider the following statements:
1. The Reserve Bank of India manages and services Government of India Securities but not any State Government Securities.
2. Treasury bills are issued by the Government of India and there are no treasury bills issued by the State Governments.
3. Treasury bills offer are issued at a discount from the par value.
Which of the statements given above is/are correct?
(a) 1 and 2 only
(b) 3 Only
(c) 2 and 3 only
(d) 1,2 and 3

4. Controller of credit and money supply: The chief objective of the central bank is to maintain price and economic stability. For controlling inflationary and deflationary pressures in the economy the central bank adopts quantitative and qualitative measures of credit control.

Quantitative methods aim at controlling the cost and quantity of credit by adopting bank rate policy, open market operations, and by variations in reserve ratios of commercial banks.

Qualitative methods control the use and direction of credit. These involve selective credit controls and direct action.

5. Custodian of the stock of gold and foreign exchange reserves of the nation: The central bank keeps and manages the foreign exchange reserves of the country. An important function of a central bank is to maintain the exchange rate of the national currency.

For example, the Reserve Bank of India has the responsibility of maintaining the exchange value of the rupee. When a country has adopted flexible exchange rate system under which value of a currency is determined by the demand for and supply of a currency, the value of a currency, that is, its exchange rate with other currencies is subject to large fluctuations which are harmful for the economy.

Under these circumstances, it is the duty of the central bank to prevent undue depreciation or appreciation of the national currency. Since 1991 when the rupee has been floated, the value of Indian rupee, that is, its exchange rate with US dollar and other foreign currencies has been left to be determined by market forces.

RBI has been taking several steps from time to time to stabilize the exchange rate of rupee, especially, in terms of US dollar. There are several ways by which RBI can manage or maintain the exchange rate of the rupee.

- If due to speculative activities of foreign exchange operators, the rupee starts depreciating fastly, RBI can intervene in the market. It can use its reserves of dollars and supply dollars in the market from its own reserves. With the increase in the supply of dollars, the rupee will be prevented from depreciation. It may however be noted that the success of this step depends on the amounts of dollar reserves with RBI.
- Another method by which RBI can manage the exchange rate of rupee is adopting measures which will reduce the demand for dollars. Some

importers, foreign investors, foreign exchange operators try to avail of cheap credit facilities of banks and borrow rupee funds from the banks and try to convert them into dollars. This raises the demand for dollars and leads to the depreciation of the Indian rupee. Such a situation occurred in July-September, 1998. RBI intervened and raised the Cash Reserve Ratio (CRR) and increased its repurchase rates. This succeeded in mopping up the excess liquidity with the banks and reduced their lending capacity. This led to the reduction in the demand for dollars and helped in preventing the rupee from depreciating.

Q) Consider the following statements regarding Reserve Bank of India
1. It is a banker to the Central Government
2. It formulates and administers monetary policy
3. It acts as an agent of the Government in respect of India
4. It handles the borrowing programme of Government of India
Which of these statements are correct?
(a) 1 and 2
(b) 2,3 and 4
(c) 1,2,3 and 4
(d) 3 and 4

Instruments of Monetary Policy:

The instruments which RBI uses for conducting monetary policy can be classified as

- Quantitative methods
- Qualitative methods

In any economy the total amount of money stock in the economy is much greater than the volume of high powered money. Commercial banks create this extra amount of money by giving out a part of their deposits as loans or investment credits.

That means the total amount of deposits held by all commercial banks in the country is much larger than the total size of their reserves. If all the account-holders of all commercial banks in the country want their deposits back at the same time, the banks will not have enough means to satisfy the need of every accountholder and there will be bank failures.

The Reserve Bank of India plays a crucial role here. In case of a crisis like the above it stands by the commercial banks as a guarantor and extends loans to ensure the solvency of the latter.

The most important role of RBI is as the controller of money supply and credit creation in the economy. The instruments which RBI uses for conducting monetary policy are as follows.

Quantitative methods of credit control

A. The Reserve Deposit Ratio: Reserve deposit ratio (RDR) is the proportion of the total deposits commercial banks keep as reserves. Banks hold a part of the money people keep in their bank deposits as reserve money and loan out the rest to various investment projects.

Reserve money consists of two things – vault cash in banks and deposits of commercial banks with RBI. Banks use this reserve to meet the demand for cash by account holders. Keeping reserves is costly for banks, as, otherwise, they could lend this balance to interest earning investment projects.

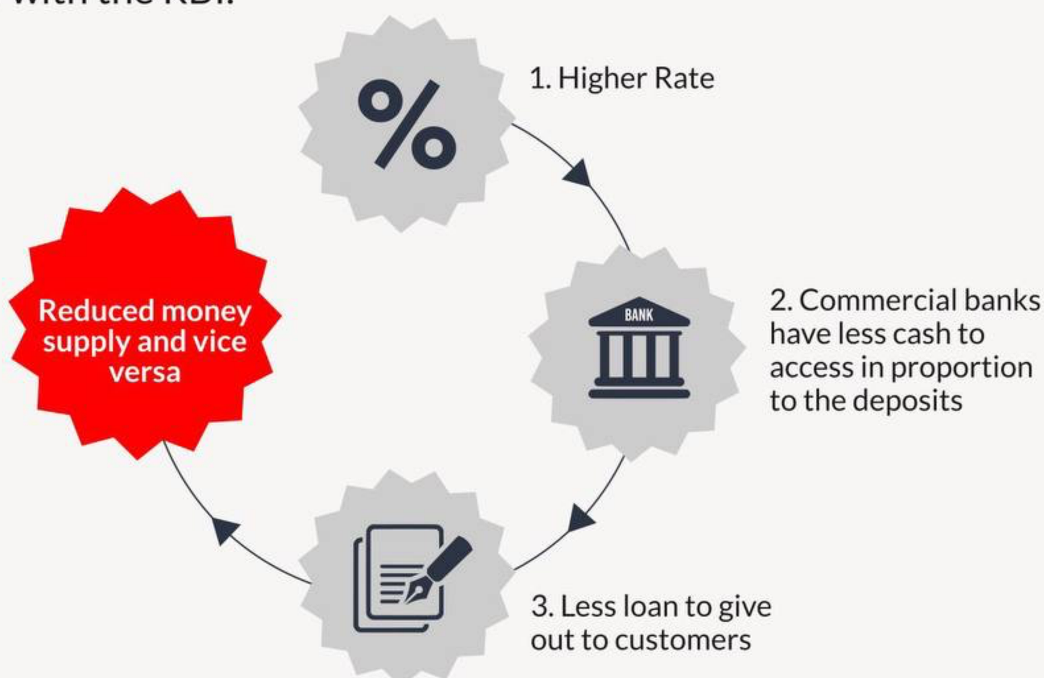
However, RBI requires commercial banks to keep reserves in order to ensure that banks have a safe cushion of assets to draw on when account holders want to be paid. RBI uses various policy instruments to bring forth a healthy RDR in commercial banks.

3. RESERVE RATIOS:

Commercial banks are meant to maintain a certain amount (in cash/gold/government bonds) with the RBI. This amount is calculated as **percentage of a bank's liabilities** which include savings accounts and fixed deposits in

I) CASH RESERVE RATIO (CRR):

Refers to the **minimum amount of liquid cash a bank has** to maintain with the RBI.

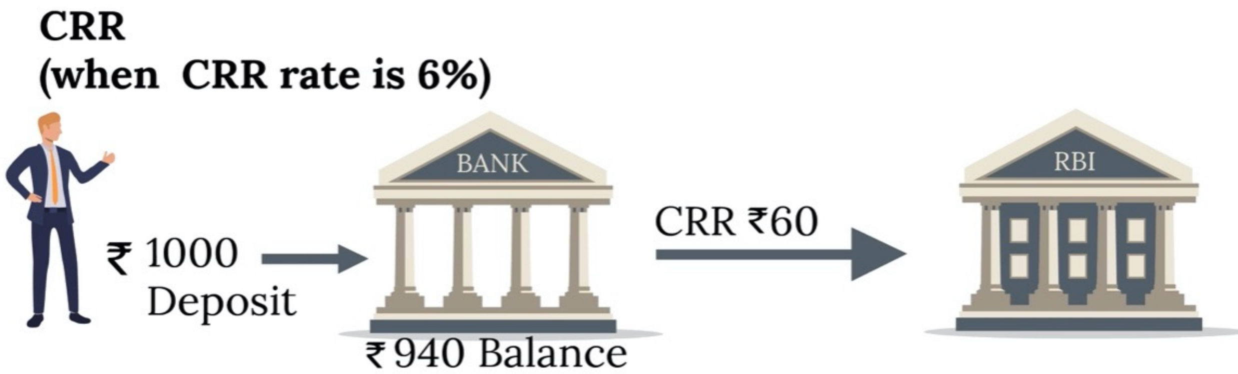


II) STATUTORY LIQUIDITY RATIO (SLR):

Similar to CRR; SLR is not only maintained in cash **but also in gold and government-approved securities** etc.

Q) The money multiplier in an economy increases with which one of the following?
(a) Increase in the cash reserve ratio
(b) Increase in the banking habit of the population
(c) Increase in the statutory liquidity
(d) Increase in the population of the country

1. Cash Reserve Ratio: Cash Reserve Ratio is money that banks park with the RBI for free, without receiving any interest on it. The CRR, is calculated as a percentage of each bank's net demand and time liabilities (NDTL).



Q) The banks are required to maintain a certain ratio between their cash in hand and total assets. This is called:
(a) SBR(Statutory Bank Ratio)
(b) SLR(Statutory Liquid Ratio)
(c) CRR(Cash Reserve Ratio)
(d) CLR(Central Liquid Reserve)

What is Net Demand and Time Liability (NDTL)?

NDTL is sum of demand and time liabilities (deposits) of banks with public and other banks wherein assets with other banks is subtracted to get net liability of other banks.

- Deposits of banks are its liability and consist of demand and time deposits of public and other banks.
- Demand deposits include all liabilities which are payable on demand and includes current deposits, demand liabilities portion of savings bank deposits, demand drafts, balances in overdue fixed deposits etc.
- Time deposits are those which are not payable on demand and includes fixed deposits, staff security deposits, time liabilities portion of savings bank deposits etc.
- Banks also invest in demand and time deposits of other banks and certificate of deposits. Banks also borrow from other banks in call market etc. This represents banks liability to other banks.
- NDTL is calculated and reported every fortnight Friday by banks.
- NDTL is used by banks for computation of CRR, SLR and now LAF.

Q) When the Reserve Bank of India announces an increase of the Cash Reserve Rate, what does it mean?

(a) The Commercial banks will have less money to lend

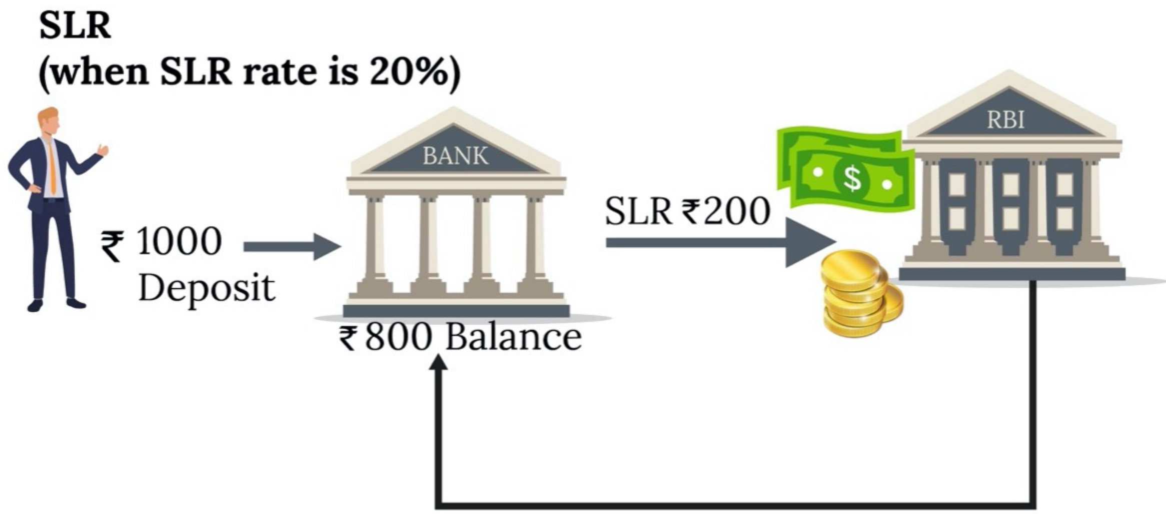
(b) The Reserve Bank of India will have less money to lend

(c) The Union Government will have less money to lend

(d) The Commercial banks will have more money to lend

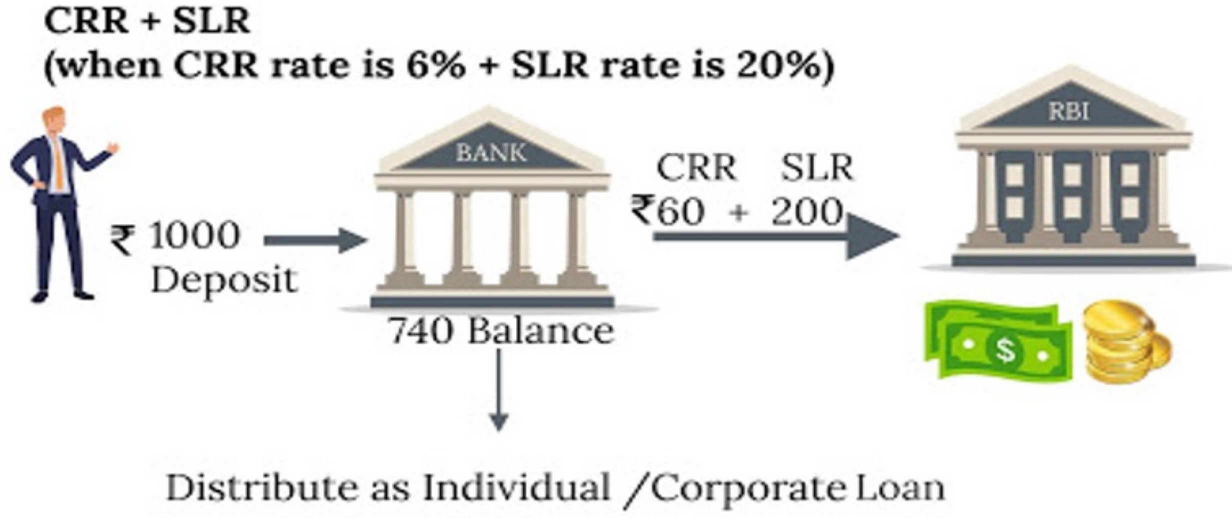
2. Statutory Liquidity Ratio: All commercial banks (and some other specified institutions) in the country have to keep a given proportion of their NDTL as liquid assets in their own vault. This is called statutory liquidity ratio.

The word statutory here means that it is a legal requirement and liquid asset means assets in the form of cash, gold and approved securities (government securities).The RBI itself gives periodic updates about which assets are qualified as liquid assets under SLR. Similarly, it also gives institution specific guidelines for SLR to be kept.



As the SLR is a statutory requirement and banks prefer to keep their SLR in the form of income earning securities, government can easily sell its bonds to the banks.

This means SLR has facilitated government's debt management programme. Securities above the SLR limit will be eligible from accommodation (temporary loan) under RBI's repo.



Q) Which of the following terms indicates a mechanism used by commercial banks for providing credit to the government?

(a) Cash Credit Ratio

(b) Debt Service Obligation

(c) Liquidity Adjustment Facility

(d) Statutory Liquidity Ratio

Q) When the Reserve Bank of India reduces the Statutory Liquidity Ratio by 50 basis points, which of the following is likely to happen?

(a) India's GDP growth rate increases drastically

(b) Foreign Institutional Investors may bring more capital into our country

(c) Scheduled Commercial Banks may cut their lending rates

(d) It may drastically reduce the liquidity to the banking system

Q) In the context of Indian economy, which of the following is are the purpose/purposes of 'Statutory Reserve Requirements'?
1. To enable the Central Bank to control the amount of advances the banks can create
2 To make the people's deposits with banks safe and liquid
3. To prevent the commercial banks from making excessive profits
4. To force the banks to have sufficient vault cash to meet their day-to-day requirements
Select the correct answer using the code given below.
(a) 1 only
(b) 1 and 2 only
(c) 2 and 3 only
(d) 1,2,3 and 4

3. Liquidity Adjustment Facility (LAF): LAF is a liquidity stabilizing platform introduced by the RBI to facilitate liquidity in the economy through the instruments of repo and reverse repo. The LAF was launched by the RBI in 2000; has two legs- the repo that aims to inject liquidity into the banking system and the reverse repo that is used to absorb liquidity from the banking system

a. **Repo Rate:** Technically, repo (Repurchasing Option) is a contract in which banks gives eligible securities such as Treasury Bills to the RBI while availing overnight loans with a commitment to buy them back. The interest rate charged on repo transactions is called repo rate.

Q) Consider the following statements:

1. The repo rate is the rate at which other banks borrow from the Reserve Bank of India.
2. A value of 1 for Gini Coefficient in a country implies that there is perfectly equal income for everyone in its population.

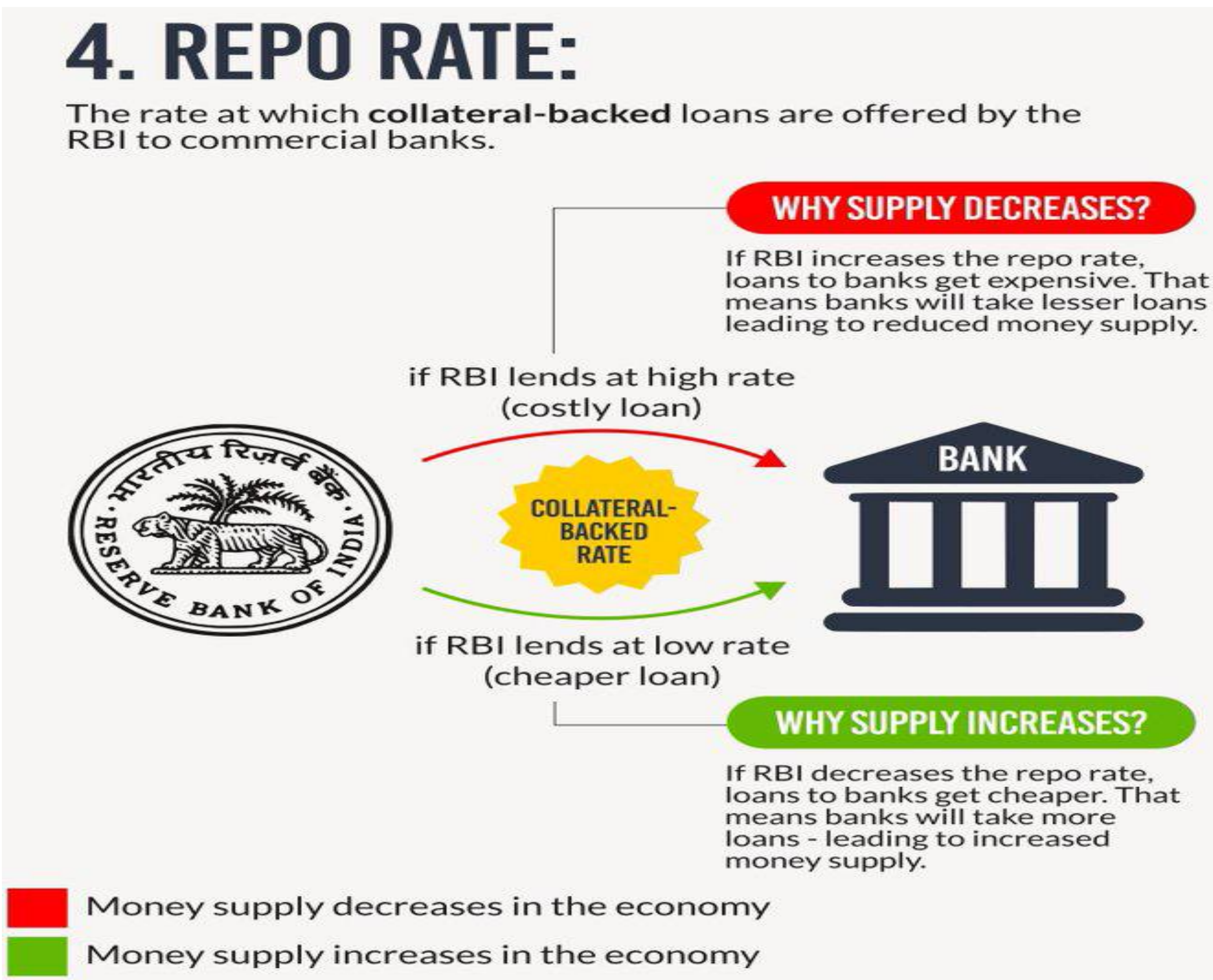
Which of the statements given above is/are correct?

(a) 1 only

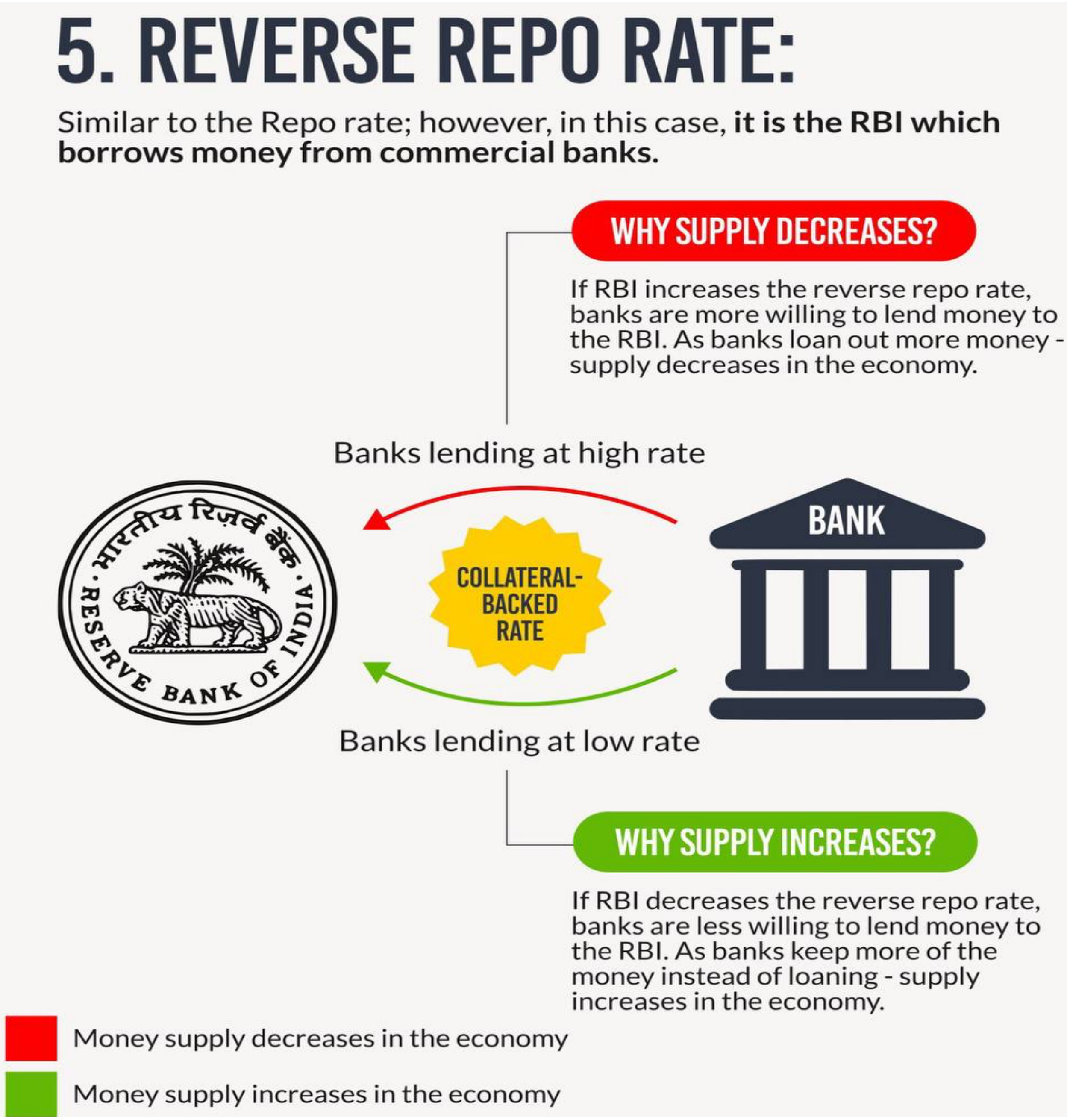
(b) 2 only

(c) Both 1 and 2

(d) Neither 1 nor 2



b. Reverse repo: On the other hand, reverse repo is an opposite contract under which banks can park their excess cash with the RBI by availing a rate of interest which is called reverse repo rate. Here, when the banks have excess money for the coming days, they can give it as a loan to the RBI.



Long Term Repo Operations(LTRO): RBI has announced a new liquidity facility under Long Term Repo Operations (LTRO) to inject liquidity in the banking system.

The new policy tool comes in the context of the RBI's limitations in cutting its policy rate as well as its desire to enhance liquidity of the banking system and promote lending activities of banks.

An interesting feature of the RBI's new effort is that the central bank will be injecting Rs 1 lakh crore into the banking system through auctions with long term maturity periods (compared to one day repos) of 1 year and 3 year.

Funds through LTRO will be provided at the repo rate. This means that banks can avail one year and three-year loans at the same interest rate of one day repo.

Usually, loans with higher maturity period (here like 1 year and 3 year) will have higher interest rate compared to short term (repo) loans. If the RBI is ready to give one-year and three year loans at the low repo rate, then there will be a clear pressure on banks to reduce their lending rates.

Hence, the most important effect of the LTRO in the system will be a decline in short term lending rates of banks.

There are two clear effects of LTROs:
1. It will enhance liquidity in the banking system by Rs 1 lakh crore
2. Since the interest rate is comparatively low, there will be a downward pressure on short term lending rates.

These two will bring the effect of a slightly easy monetary policy.

According to the RBI, the LTRO scheme will be in addition to the existing LAF and MSF (Marginal Standing Facility) operations. The LAF and MSF are the two sets of liquidity operations by the RBI with the LAF having a number of tools like repo, reverse repo, term repo etc.

Objectives of LTRO

- To assure banks about the availability of durable liquidity at reasonable cost relative to prevailing market conditions.
- Further encourage banks to undertake maturity transformation smoothly and seamlessly so as to augment credit flows to productive sectors.

While announcing the LTRO, the RBI also hinted that the current liquidity framework may be revised soon. The current liquidity framework involves LAF family instruments like repo, reverse repo, term repo etc and the Marginal Standing Facility.

Features of Long-Term Repo Operations (LTRO)

Following are the features of the LTRO:

- Maturity period (tenor): One-year and three-year tenors
- Total funds to be injected: Up to Rs 1,00,000 crores
- Interest rate: at the prevailing policy rate (Repo rate).
- Method of fund injection: CBS (E-KUBER) platform. The operations would be conducted at a fixed rate.
- Banks would be required to place their requests for the amount sought under LTRO during the window timing *at the prevailing policy repo rate*. Bids below or above policy rate will be rejected.
- If there is over-subscription of the notified amount, the allotment will be done on pro-rata basis. RBI will, however, reserve the right to inject marginally higher amount than the notified amount due to rounding effects.

- The minimum bid amount would be Rupees one crore and multiples thereof. There will be no restriction on the maximum amount of bidding by individual bidders.
- The eligible collateral and the applicable haircuts for LTRO will remain the same as applicable for LAF.
- All other terms and conditions as applicable to LAF operations for the LTRO.

Potential effects of the LTRO

Since, under LTRO, funds are provided at low interest rate of the reop rate, the overall short-term interest rate may come under pressure to register a decline. Similarly, the short-term yield also may fall. Altogether, there will be pressure on the banking system to reduce their lending rates.

How the LTRO is different from the existing term repo?

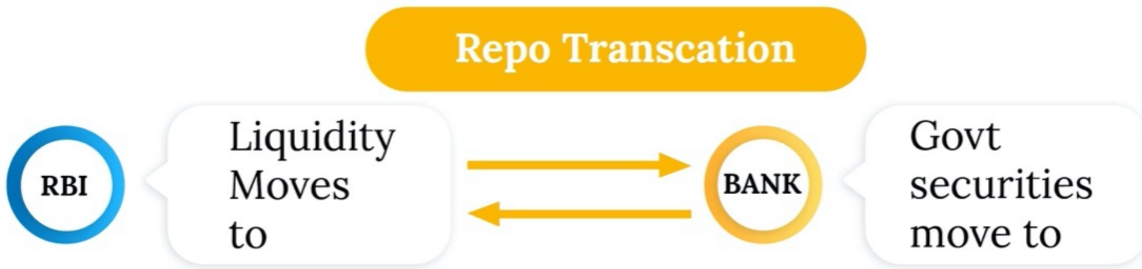
Already, the RBI is having term repo instrument to inject money into the banking system by providing higher than one day loans. The term structure is higher but less than 28 days. Interest rate will be higher than repo rate. In this context, following is a comparison between the term repo and LTRO.

Feature	LTRO	Term Repo
Interest rate	Fixed and at repo rate	Variable, depending upon auctions but higher than repo rate.
Term structure	1 year or 3 year	3 to 28 days
Individual bank's bid size	No restriction on the maximum amount of	0.75% of the banks' NDTL.

	bidding by individual bidders.	
Disbursal	Auction (e-Kuber)	Auction (e-Kuber)
Applicants	Scheduled commercial banks	Scheduled commercial banks
Collateral	Same as under LAF	Same as under LAF
Total injections	Limit to be determined by the RBI	Limit to be determined by the RBI

Repo rate is also called as policy rate: This means that it is the only policy instrument used to fight inflation or target inflation and thus to ensure price stability. Following factors make the repo rate important:

- The repo rate now acts as 'the policy rate' for the RBI that signals short term interest rate in the economy.
- As per the new inflation targeting monetary policy framework there is only one objective-price stability, one target-inflation and one instrument – repo rate.
- Over the time, the banking system's borrowing through the repo route has increased and now large volume of borrowing is made by the banks to meet their liquidity requirements. Similarly, the RBI has introduced several other arrangements like variable rate repo, marginal standing facility etc. to inject money into the banking system. Remember, when the borrowing through the repo route rises, the repo rate becomes very applicable adding to its capacity to influence the interest rate of the banking system. All these trends have added strength to repo rate as a monetary policy instrument.



4. Marginal Standing Facility (MSF): MSF rate is the rate at which banks borrow funds overnight from the Reserve Bank of India (RBI) against approved government securities. This came into effect in May 2011.

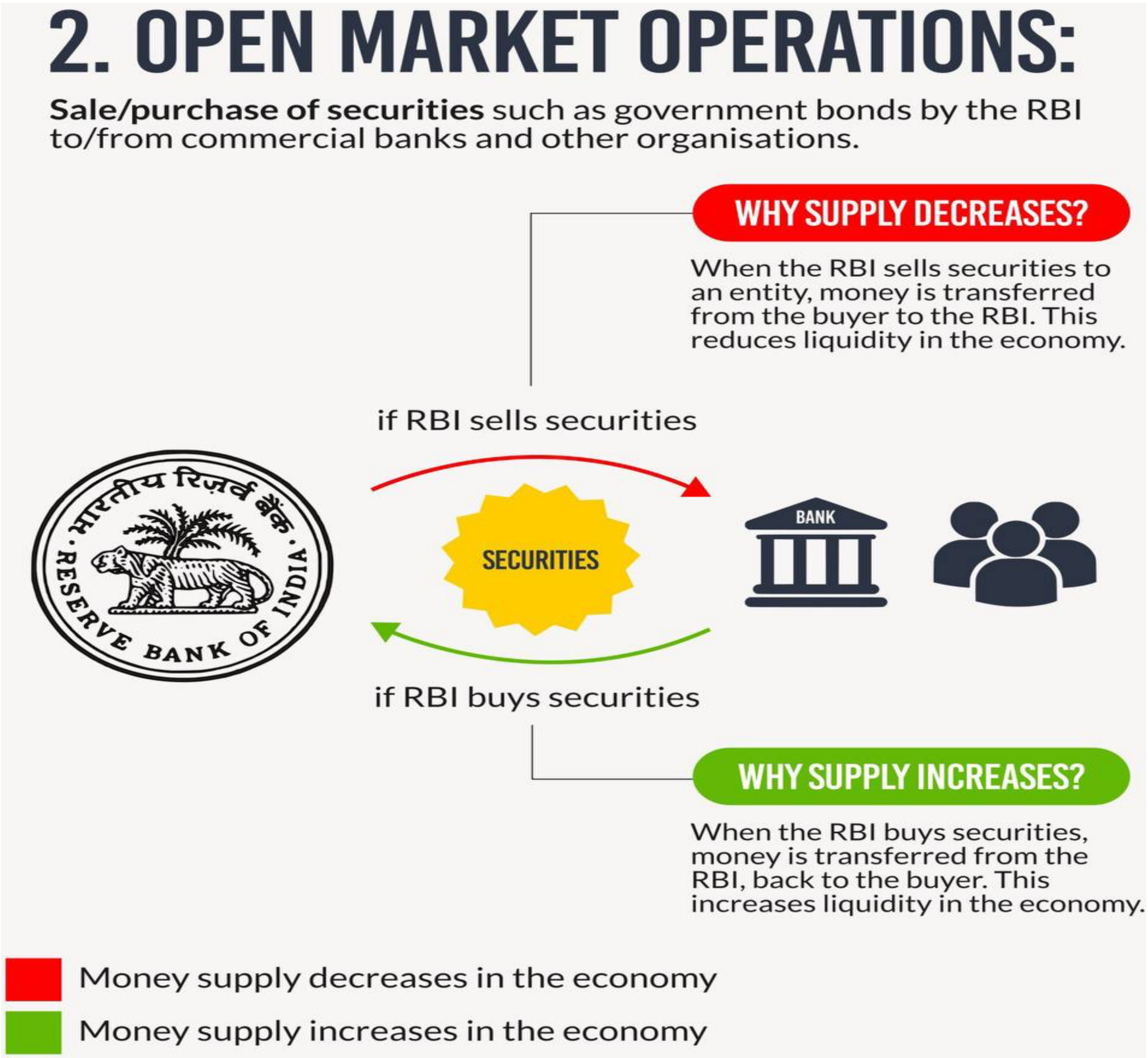
Under the Marginal Standing Facility (MSF), currently banks avail funds from the RBI on overnight basis below the stipulated SLR up to 2.5% of their respective Net Demand and Time Liabilities (NDTL) outstanding at the end of second preceding fortnight.

Q) The terms "Marginal Standing Facility Rate' and 'Net Demand and Time Liabilities', sometimes appearing in news, are used in relation to
(a) Banking operations
(b) Communication networking
(c) Military strategies
(d) Supply and demand of agricultural products

5. Open Market Operations: Open market operations refer to the policy of sale and purchase of government securities in the open market by the central bank.

The central bank sells and purchases these securities mainly to and from the public and commercial banks.

If the central bank wants to control inflation it sells securities in the market so that the excess liquidity may be transferred from public to the central bank. This measure controls the aggregate demand and inflation in the economy. The central bank starts purchasing securities in the market to boost aggregate demand and fight deflation in the economy.



Q) In the context of Indian economy, 'Open Market Operations' refers to
(a) Borrowing by scheduled banks from the RBI.
(b) Lending by commercial banks to industry and trade
(c) Purchase and sale of government securities by the RBI
(d) None of the above

Q) With reference to Indian economy, consider the following
1. Bank rate
2. Open market operations
3. Public debt
4. Public revenue
Which of the above is/are component/ components of Monetary Policy?
(a) 1 only
(b) 2,3 and 4
(c) 1 and 2
(d) 1,3 and 4

Standing Deposit Facility:

The RBI has come up with yet another esoteric concept. Standing Deposit Facility, proposed by the RBI and under examination by the Centre, is viewed as a strong tool to suck out the surplus liquidity and alleviate the banking system's problem of plenty.

This concept, first recommended by the Urjit Patel committee report in 2014.

What is it?

Standing deposit facility is a remunerated facility that will not require the provision of collateral for liquidity absorption. Stumped? Let's simplify this by going to the basics. Banks, at different points in time, may be short of funds or flush with money.

When they need money for the short-term, they borrow from the bankers' bank—RBI. Repo rate — that RBI sets at every monetary policy — is the rate at which banks borrow funds, for which they pledge government securities. What happens when banks have excess funds? They lend it to the RBI at the reverse repo rate that is lower than the repo rate. Here too, government securities act as collateral.

The demonetisation exercise has left banks flush with funds. The past two months, banks have been lending left, right and centre to the RBI under the reverse repo window. And with the RBI increasing the reverse repo rate by 25 basis points to 6 per cent in the April policy, banks now earn more on these funds.

In short, everyone is happy. So, why is the RBI toying with the idea of a new instrument to suck out liquidity? The worry is there may be only so much collateral to go around. Collateral may become a constraining factor if the central bank runs out of securities to absorb liquidity under the reverse repo window. Enter the Standing Deposit Facility. This will allow the RBI to absorb surplus funds from banks without collateral. Banks too continue to earn interest (though possibly lower than the existing reverse repo rate). In effect, it will empower the RBI to suck out as much liquidity as needed.

Why is it important?

But why does the RBI need an unbridled mechanism to manage liquidity? Liquidity plays a key role in transmission of policy rates. In a falling rate cycle, pass-through of rate cuts will happen quickly if there is sufficient liquidity, as banks will be able to lower deposit rates comfortably. The reverse holds true now. Excess liquidity has led to short-term market rates slipping below the RBI's policy repo rate.

Now, that's not nice from the point of view of the RBI; it would want to keep a tight leash on rates. The RBI would want its key policy rate, aka the repo rate, to be the operational rate.

Why should I care? The RBI's management of rates impacts the rates on your deposits and loans too. The immediate fallout of excess liquidity in the past few months has been the sharp cuts in bank deposit rates.

If the RBI curbs excess liquidity and halts the fall in short-term rates, then you, dear depositor, can breathe a sigh of relief. But for borrowers who have seen lending rates fall sharply the past year, the party may be over.

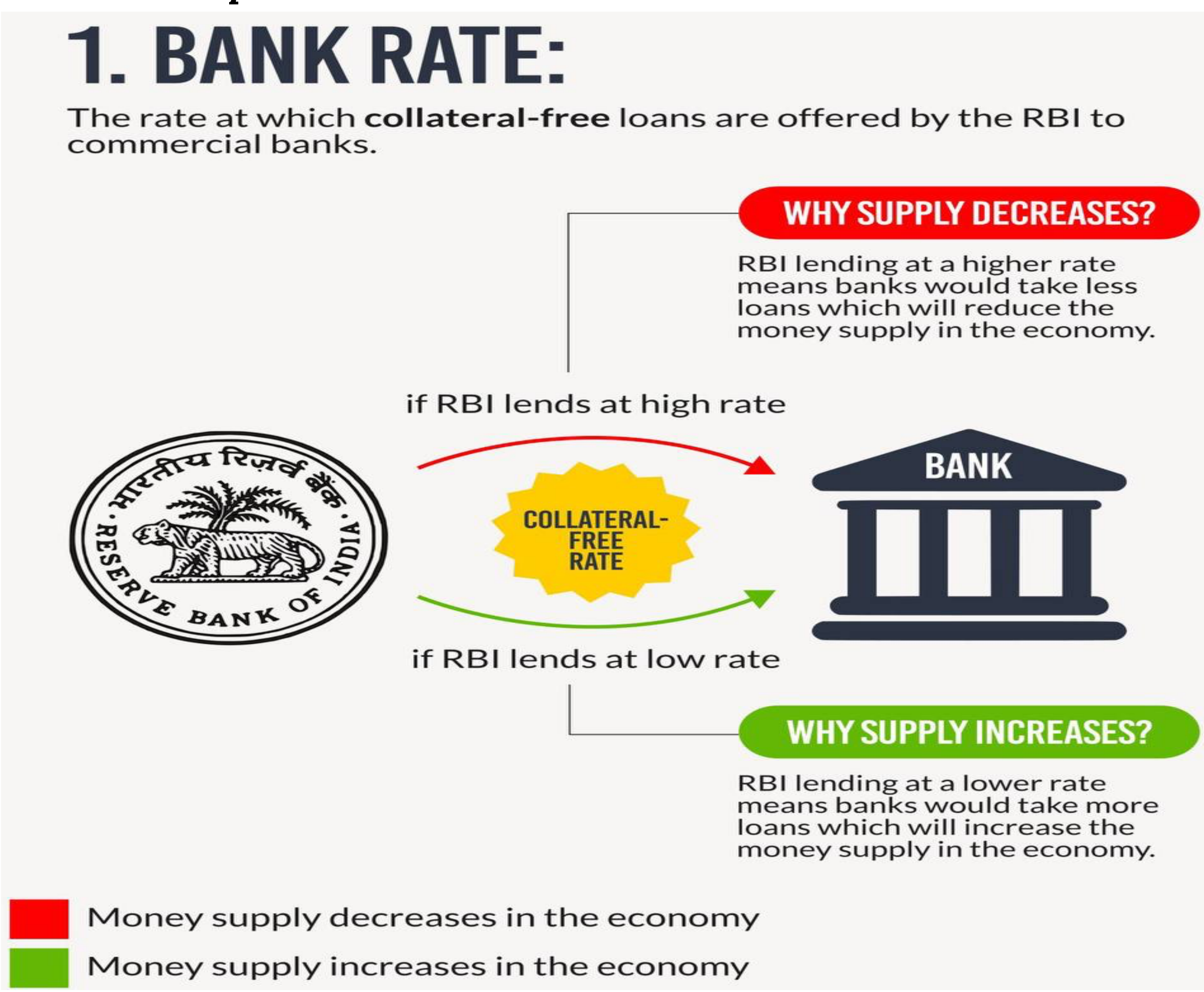
Difference between Standing Deposit Facility, Reverse Repo and MSF: Within the existing liquidity management framework, liquidity absorption through reverse repos, open market operations and the cash reserve ratio (CRR) are at the discretion of the Reserve Bank.

On the other hand, the use of standing facilities (MSF, SDF) would be at the discretion of banks. The difference between the Standing Deposit Facility and Reverse Repo is that there is no need for collateral under the SDF.

6. Bank rate: Bank rate is the rate at which RBI rediscounts bills of exchange or commercial bills submitted by banks. Here, when a commercial bank holds commercial bill, it means that the amount mentioned in the bill will be coming to the bank only at a later time. At the same time, the bank need money and it approaches the RBI. The central bank rediscounts the bill (gives the money mentioned in the bill) 28 days before the termination of the bill.

Effectively, this money given to the commercial bank through rediscounting is a loan provided by the RBI for 28 days. Hence, the RBI charges a rediscount rate from the commercial bank. This rediscount rate can be considered as the interest rate charged by the RBI like in the case of giving a loan for 28 days.

Generally the discounting rate is bit higher compared to all other advances, through this RBI is discouraging or penalizing Banks not to take recourse of this instrument. ***This type of higher discounting rate is also called as penal rate.***



Q) Bank Rate implies the rate of interest:
(a) paid by the Reserve Bank of India on the Deposits of Commercial Banks
(b) charged by Banks on loans and advances
(c) payable on Bonds
(d) at which the Reserve Bank of India discounts the Bills of Exchange

Q) The lowering of Bank Rate by the Reserve Bank of India leads to
(a) More liquidity in the market
(b) Less liquidity in the market
(c) No change in the liquidity in the market
(d) Mobilization of more deposits by commercial banks

Difference between repo rate and bank rate:

- The underlying security in the case of repo rate is eligible government securities. Eligible securities are securities mentioned by the RBI and held by a bank above the SLR limit. In the case of Bank rate, the underlying securities are commercial bills.
- The tenure of loans under the repo is one day as it is overnight loans. While in the case of bank rate the loan period is 28 days.
- The interest rate for repo is lower than the Bank rate.

Q) An increase in the Bank Rate generally indicates that the
(a) Market rate of interest is likely to fall
(b) Central Bank is no longer making loans to commercial banks
(c) Central Bank is following an easy money policy
(d) Central Bank is following a tight money policy

Q) Which of the following measures would result in an increase in the money supply in the economy?
1. Purchase of government securities from the public by the Central Bank
2. Deposit of currency in commercial banks by the public
3. Borrowing by the government from the Central Bank
4. Sale of government securities to the public by the Central Bank
Select the correct answer using the codes given below:
(a) 1 only
(b) 2 and 4 only
(c) 1 and 3
(d) 2,3 and 4

The Qualitative Credit Controls:

Under the selective or qualitative credit control methods, the RBI encourages flow of credit only to certain types of industries and discourages the use of bank credit for certain other purposes. Under this method, extension of credit to essential purposes is encouraged and to non-essential purposes is discouraged.

Hence these methods not only prevent the flow of credit into undesirable channels but also direct the flow of credit to useful channels.

The Banking Regulation Act, 1949 has given extensive power to the RBI to apply selective credit control. The following are the different methods of selective credit control methods adopted by the RBI.

6. CHANGE IN LOAN-TO-VALUE REQUIREMENTS:

LTV refers to the amount of loan sanctioned in proportion to the worth of collateral given.

RBI can influence credit available to different sectors via this tool.

For instance, if the LTV is 70%, you would get a ₹70 loan for ₹100 worth of collateral.

7. REGULATION OF CONSUMER CREDIT:

This refers to loan instalments, down payment amounts, loan duration, etc.

For instance, if banks increase the minimum down payment amount required to purchase an item, it will discourage buyers from purchasing. This helps control excess spending during inflation and vice versa.

8. SELECTIVE CREDIT CONTROL:

The RBI directs banks to tweak their lending to certain industries.

For instance, an industry such as sugar could borrow at low rates and hoard the commodity. This will increase sugar prices. The RBI asks banks to control credit to this industry to keep a lid on such practices.

9. MORAL SUASION:

It refers to suggestions made by the RBI to commercial banks to regulate credit in the economy.

It's the **RBI's way to influence banks to act** on things like reducing their lending rates.

However, not following these recommendations will not invite penalties.

10. DIRECT ACTION:

As the name suggests, **this is an extreme step** where RBI takes matters into its own hands.

The RBI may levy sanctions and impose forceful changes to ensure that the commercial bank takes decisions in line with the monetary policy.

1. Margin Requirements: The commercial banks grant loan to borrowers against some collateral securities whose value is more than the value of loans granted. The difference between the value of collateral securities and the amount of loan is called margin.
Increase in margin requirement reduces loan eligibility of the borrower which central uses at the time of inflation. During deflationary situation margin requirement is reduced to promote the growth of volume of credit/money in the economy.

2. Moral Suasion: Under this method central bank persuades and pressurises the commercial banks to adopt a credit policy which is in line with the overall objectives of the economy.

3. Credit Rationing: Under this method central bank fixes maximum ceiling of loans to be granted by the commercial banks either on aggregate basis or for a particular use. The rate of interest may vary across sectors or uses.

4. Regulation of Consumer Credit: Under the consumer credit system, a certain percentage of the price of the durable goods is paid by the consumer in cash. The balance is financed through the bank credit which is repayable by the consumer in instalments. The central bank can control the consumer credit by

- Changing the amount that can be borrowed for the purchase of the consumer durables and
- Changing the maximum period over which the instalments can be extended.

Limitations of Selective Credit Control Measures in India:

The RBI adopted many selective credit control measures to channelize the funds to productive sectors and restrict the financing to unproductive and speculative activities. However, the successful operation of these measures suffers from certain limitations. They are as follows:

1. Banks find it difficult to ensure that the borrowers utilize the amount for the purpose for which it is borrowed.
2. Non-banking financial institutions and indigenous bankers also play a significant role in financing trade and industry in India. But the RBI has no control over these institutions.

Q) Which one of the following is not an instrument of selective credit control in India?
(a) Regulation of consumer credit
(b) Rationing of credit
(c) Margin requirements
(d) Variable cash reserve ratios

Some Unconventional Tools of Monetary Policy:

Quantitative Easing: It is an occasionally used monetary policy, which is adopted by the government to increase money supply in the economy in order to further increase lending by commercial banks and spending by consumers.

The central bank infuses a pre-determined quantity of money into the economy by buying financial assets from commercial banks and private entities. This leads to an increase in banks' reserves.

The most successful QE effort was undertaken by the U.S. Central Bank of U.S. Reserve added almost $2 trillion to the money supply after most of the western countries caught in the web of 2008 sub-prime crisis. That's the largest expansion from any economic stimulus program in history.

As a result, the debt on the Fed's balance sheet doubled from $2.106 trillion in November 2008 to $4.486 trillion in October 2014. On December 18, 2013, the Fed began to taper its bond purchases by $10 billion per month, to $75 billion. After a series of reductions throughout 2014, the program concluded following the Fed's October 29-30 meeting.

What is Fed Tapering: "Tapering" is a term that exploded into the financial lexicon on May 22, when U.S. Federal Reserve Chairman Ben Bernanke stated in testimony before Congress that that Fed may taper - or reduce - the size of the bond-buying program known as quantitative easing (QE).

The program, which is designed to stimulate the economy, has served the secondary purpose of supporting financial market performance in recent years. This tapering is called as "Fed Tapering" as is being implanted by Federal Reserve.

Taper Tantrum: A taper tantrum is a knee-jerk reaction by investors after the Federal Reserve announces scaling back its asset purchases.

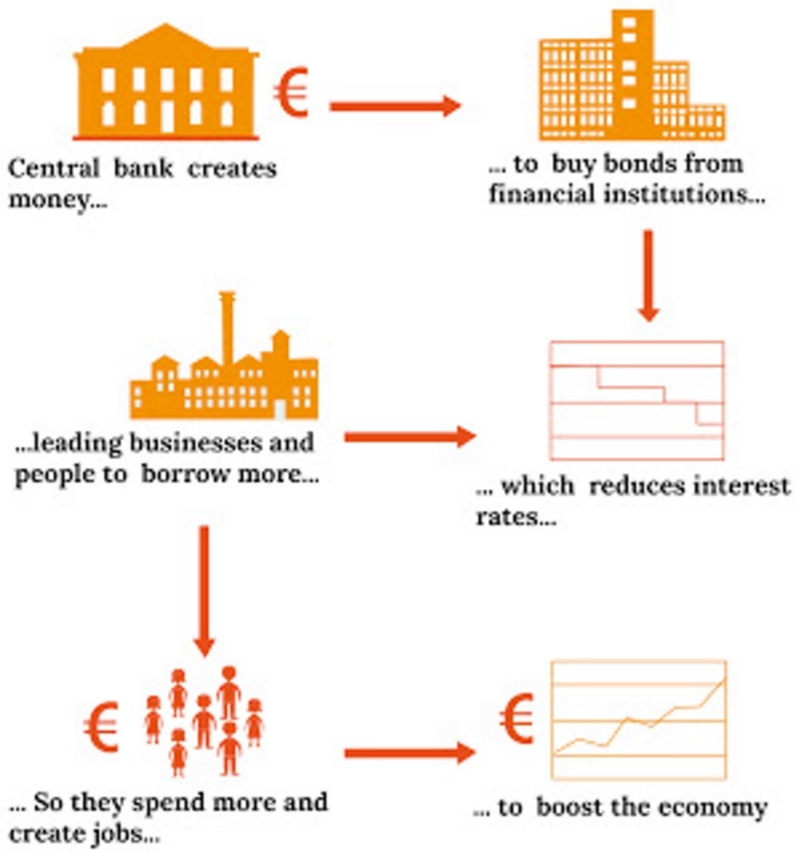
A taper tantrum refers to the movement in bond yields caused by investor reactions to a central bank announcing future tapering of bond-buying programs. Even if the central bank does not stop purchasing bonds immediately, investors may sell off their bonds, which forces yields to rise. These sales are said to be a "tantrum" in reaction to the news of a tapering.

Quantitative Easing in Europe:

The asset purchase program, a monetary experiment known as quantitative easing (QE), was launched in March 2015 to prevent sub-zero inflation from further hitting an economy still reeling from the euro zone debt crisis. The ECB has spent 2.6 trillion euros ($3 trillion) over almost four years, buying up mostly government but also corporate debt, asset-backed securities and covered bonds— at a pace of 1.3 million euros a minute.

That equates to roughly 7,600 euros for every person in the currency bloc. As intended, QE has lifted economic growth while wages and lending have risen but inflation remains subdued, complicating the QE exit and ensuring interest rates will stay at record lows for some time.

The ECB has also been criticized because the bond buying has depressed interest rates and hurt European banks' profitability. The ECB will also plow money from maturing bonds it holds back into the market for years to anchor borrowing costs.



Liquidity Trap:

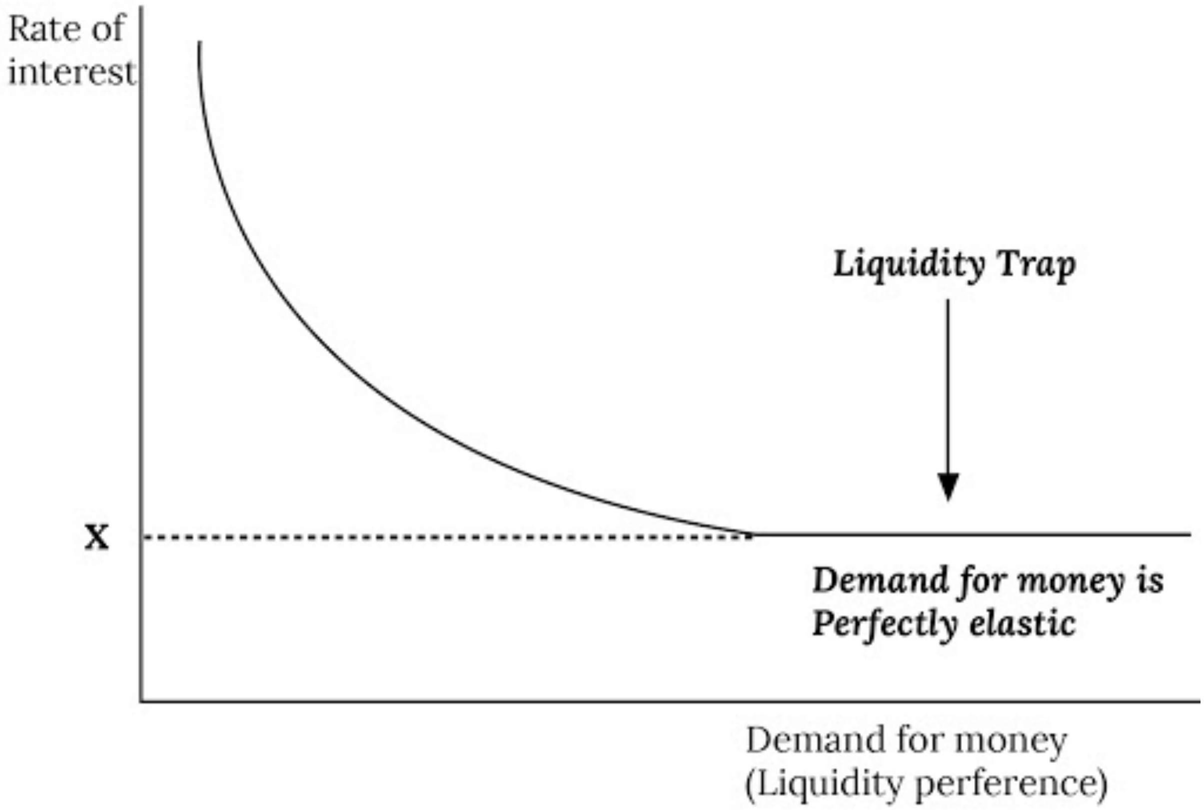
Liquidity trap is a situation when expansionary monetary policy (increase in money supply) does not increase the interest rate, income and hence does not stimulate economic growth.

When does it occur: A liquidity trap usually happens after a severe recession. Families and businesses are afraid to spend, no matter how much credit is available.

Power of monetary policy in countering liquidity trap: Liquidity trap is the extreme effect of monetary policy. It is a situation in which the general public is prepared to hold on to whatever amount of money is supplied, at a given rate of interest.

They do so because of the fear of adverse events like deflation, war. In that case, a monetary policy carried out through open market operations has no effect on either the interest rate, or the level of income. In a liquidity trap, the monetary policy is powerless to affect the interest rate.

There is a liquidity trap at short term zero percent interest rate. When interest rate is zero, public would not want to hold any bond, since money, which also pays zero percent interest, has the advantage of being usable in transactions. Hence, if the interest is zero, an increase in quantity of money cannot not induce anyone to buy bonds and thereby reduce the interest on bonds below zero.



Consequences of prolonged Loose Money Policy: A loose monetary policy is, in other words, lowering interest rates below the market rate. Lower interest rates will make credit cheaper. If this policy continues for long it will lead to inflation in the economy.
The reason for this is because of the law of marginal utility. Prolonged situation of inflation will lead to hyper-inflation.

Liquidity Crunch: It is a phenomenon, when cash resources are in short supply and demand is high. During a liquidity crunch, businesses and consumers are charged high interest rates on loans which are more difficult to obtain. It is also known as liquidity crisis or credit crunch.

When does it occur?

- When lenders have limited funds available to lend (or are unwilling to lend additional funds), or have increased the cost of borrowing to a rate that is unaffordable to most borrowers.
- When lending institutions have suffered losses from previous loans, they are generally unwilling or unable to lend. This occurs when borrowers default and the properties underlying a defaulted loan decline in value.

- When regulatory bodies increase capital requirements for financial institutions. Banks and other lenders are required to maintain a set amount of capital liquidity based on their risk-weighted level of assets.
- If banks perceive a greater risk in the market, they will often raise their lending rates to offset this risk. This increases the cost of borrowing and makes it more difficult for borrowers to access financing.

Consequences of prolonged Tight Money Policy: Tight monetary policies can reduce the amount of credit, because banks do not generate enough income from the interest rates on loans. The interest rate on loans is directly affected by the prime rate set by the RBI.

Individuals and businesses with insufficient capital balances may also be unable to repay personal or business loans. Banks are usually unwilling to loan money when individuals or businesses cannot repay the balance.

There will be credit crunch in the system. It will ultimately lead to deflation in the economy. Prolonged deflationary trend will take economy into recession.

Why growth and inflation can't go together:

- When inflation is high, interest rates are hiked. The idea behind this is that, a high interest rate will discourage additional borrowings. This will reduce the amount of money people have in their hands to spend.
- When economic activities falter, a cut in interest rates are required. This is because companies need to borrow to plan new projects. A fall in interest rates would mean costs decrease, and the profitability increases.
- A high interest rate is harmful for growth. Companies put off expansion or growth plans due to high interest rates. They cut costs to maintain profits.
- A low interest rate can lead to a rise in inflation. This is because there is more money in the system. This leads to an overall rise in prices as demand increases. This is why inflation surged after the government infused money into the system after the US financial crisis in 2008.
- A high interest rate ends up controlling inflation but remains bad for growth. On the contrary, a low interest rate regime is good for overall

economic growth. This is why the RBI can't target both growth and inflation together.

- In the past few years, the RBI has maintained a high interest rate regime. This has helped control inflation – both wholesale and retail prices – to sufficient levels. The RBI's comfort zone for whole price inflation is 4-5%.
- At the same time, cries for an interest rate cut are growing as industrial productivity stalled and companies' profitability reduced.

Monetary Transmission (MT)

Monetary transmission refers to the process by which a central bank's monetary policy signals (like repo rate) are passed on, through financial system to influence the businesses and households.

Actually, monetary policy transmission is the way in which a monetary policy signal from the RBI works through the financial market (especially through the banking system) to influence general economic activities like consumption and investment.

Why MT as an idea gained more prominence: Banks find it more difficult to cut lending rates immediately after a cut in the policy rate because the cost of deposits does not adjust commensurately and immediately. The reasons for this:

- The banking system continues to be under stress due to rising non-performing assets (NPAs), which along with restructured assets are estimated at about 10 per cent of total assets currently.
- While the banks are not that eager to lend, the demand for credit from corporate also remain low, due to many factors.
- Some commercial banks have argued that a cash reserve ratio (CRR) cut is required to make the monetary transmission effective.

Currently, commercial banks have to maintain four per cent CRR with RBI, on which they do not earn any interest.

What is the mechanism devised for effective MT: Marginal Cost of Funds based Lending Rate (MCLR) [for more on MCLR refer Money and Banking Chapter].

Financial Repression: financial repression means that savers are not adequately compensated for their savings. Financial repression on the asset side of the balance sheet is created by the statutory liquidity ratio (SLR) requirement that forces banks to hold government securities, and priority sector lending that forces resource deployment in less-than-fully efficient ways.

Financial repression on the liability side has arisen from high inflation since 2007, leading to negative real interest rates, and a sharp reduction in households' financial savings," noted the Economic Survey 2014-15. These two sides of repression are called "double financial repression" as pointed out by Economic Survey 2014 -15.

Financial repression on the asset side: In the present context, high SLR and priority sector norms and rising NPAs are chains on the hands of the banking system and they constitute financial repression on the asset side.

Financial repression on the liability side: Financial repression on the liability (deposit) side is due to high inflation. Often higher inflation discourages savings or deposits as the real rate of interest is low or negative (During high inflation, rate of interest by banks seems to be little as value of money falls greater and people may turn to physical assets like gold). According to the Survey, the liability side of repression is getting weaker. Hence the government has to settle the asset side which is created out of its own policies.

"Beyond monetary policy, fiscal policy has traditionally played an important role in dealing with severe economic downturns – Janet Yellen"

Urjit Patel Committee on Monetary Policy Reforms

The Expert Committee to Revise and Strengthen the Monetary Policy Framework, headed by RBI Deputy Governor Urjit R Patel submitted its report to RBI Governor Dr. Raghuram Rajan.

Recommendations of the Urjit R Patel committee:

- RBI should adopt the new Consumer Price Index (CPI) for anchoring the monetary policy.
- Set the inflation target at 4% with a band of +/- 2% around it.
- Monetary policy decision making should be vested in a Monetary Policy Committee (MPC) that should be headed by the Governor.
- The two schemes- Dependence on Market Stabilisation Scheme (MSS) and Cash Management Bills (CMBs) may be discontinued and the government debt and cash management must be taken over by the government's Debt Management Office.
- All fixed income financial products should be treated on par with the bank deposits for the purposes of taxation and TDS.
- Detachment of Open Market Operations (OMOs) from the fiscal operations and instead linked solely to the liquidity management. OMOs should not be used for managing yields on government on government securities.

Main objective of the committee was to recommend what needs to be done to revise and strengthen the current monetary policy framework with a view to making it transparent and predictable.