

Evolution of the Reserve Bank of India

The origins of the Reserve Bank of India (RBI) can be traced to 1926, when the Royal Commission on Indian Currency and Finance – also known as the Hilton- Young Commission – recommended the creation of a central bank for India to separate the control of currency and credit from the Government and to augment banking facilities throughout the country. The Reserve Bank of India Act of 1934 established the Reserve Bank and set in motion a series of actions culminating in the start of operations in 1935. Since then, the Reserve Bank's role and functions have evolved, as the nature of the Indian economy and financial sector changed. Though started as a private shareholders' bank, the Reserve Bank was nationalised in 1949.

The Preamble to the Reserve Bank of India Act, 1934, under which it was constituted, specifies its objective as “to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage”. The primary role of the RBI, as the Act suggests, is monetary stability, that is, to sustain confidence in the value of the country's money or preserve the purchasing power of the currency. Ultimately, this means low and stable expectations of inflation, whether that inflation stems from domestic sources or from changes in the value of the currency, from supply constraints or demand pressures. In addition, the RBI has two other important mandates; inclusive growth and development, as well as financial stability.

India's financial system is dominated by banks. Their regulation and supervision is therefore important both from the viewpoint of protecting the depositors' interest and preserving financial stability. The RBI, deriving powers from the Banking Regulation Act, 1949, designs and implements the regulatory policy framework for banks operating in India. Over the years, the purview of regulation and supervision has been expanded to include non-banking entities also.

Central banks are at the heart of a country's payment and settlement system. “One of the principal functions of central banks is to be the guardian of public confidence in money, and this confidence depends crucially on the ability of economic agents to transmit money and financial instruments smoothly and securely through payment and settlement systems”¹. The RBI has, over the years, taken several initiatives in building a robust and state-of-the-art payment

Functions of the Reserve Bank

The functions of the Reserve Bank today can be categorised as follows:

- (i) Monetary policy
- (ii) Regulation and supervision of the banking and non-banking financial institutions, including credit information companies

- (iii) Regulation of money, forex and government securities markets as also certain financial derivatives
- (iv) Debt and cash management for Central and State Governments
- (v) Management of foreign exchange reserves
- (vi) Foreign exchange management—current and capital account management
- (vii) Banker to banks
- (viii) Banker to the Central and State Governments
- (ix) Oversight of the payment and settlement systems
- (x) Currency management
- (xi) Developmental role
- (xii) Research and *statistics*

Aims and Objectives

- i) to regulate the issue of banknotes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage; and
- ii) that it is essential to have a modern monetary policy framework to meet the challenge of an increasingly complex economy and the primary objective of the monetary policy is to maintain price stability while keeping in mind the objective of growth.

Monetary Policy Making in India

Central banks derive their objectives from their respective mandates. Monetary Policy could have either a single objective of price stability or multiple objectives of the policy. In the literature and in practice, price stability is considered as the dominant objective of monetary policy. For countries, which have adopted inflation targeting framework, price stability is the core objective. Monetary Policy refers to the use of monetary instruments under the control of the central bank to influence variables, such as interest rates, money supply and availability of credit, with a view to achieving the objectives of the policy.

After the amendment to RBI Act, 1934, in May 2016, the primary objective of monetary policy is to maintaining price stability while keeping in mind the objective of growth.

There are various direct and indirect instruments used for implementing monetary policy including Repo Rate, Reverse Repo Rate, Liquidity Adjustment Facility (LAF), Marginal Standing Facility (MSF), Corridor, Bank Rate, Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), Open

Market Operations (OMOs) and Market Stabilisation Scheme (MSS). They are briefly explained below

Repo Rate : The (fixed) interest rate at which the Reserve Bank provides overnight liquidity to banks against the collateral of government and other approved securities under the Liquidity Adjustment Facility (LAF).

Reverse Repo Rate : The (fixed) interest rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF.

Liquidity Adjustment Facility (LAF) : The LAF consists of overnight as well as term repo auctions. Progressively, the Reserve Bank has increased the proportion of liquidity injected under variable rate repo auctions across the range of tenors. The aim of term-repo is to help develop the inter-bank term-money market, which in turn can set market-based benchmarks for pricing of loans and deposits, and hence improve transmission of monetary policy. The RBI also conducts variable interest-rate reverse-repo auctions, as necessitated under market conditions.

Marginal Standing Facility (MSF) : A facility under which scheduled commercial banks can borrow additional amount of overnight money from the Reserve Bank by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a limit at a penal rate of interest. This provides a safety valve against unanticipated liquidity shocks to the banking system.

Corridor : The MSF rate and reverse repo rate determine the corridor for the daily movement in the weighted average call money rate.

Bank Rate : It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers. The Bank Rate is published under Section 49 of the Reserve Bank of India Act, 1934. This rate has been aligned to the MSF rate and, therefore, changes automatically as and when the MSF rate changes alongside policy repo rate changes.

Cash Reserve Ratio (CRR) : The average daily balance that a bank is required to maintain with the Reserve Bank as a share of such per cent of its Net demand and time liabilities (NDTL) that the Reserve Bank may notify from time to time in the Gazette of India.

Statutory Liquidity Ratio (SLR) : The share of NDTL that a bank is required to maintain in safe and liquid assets, such as, unencumbered government securities, cash and gold. Changes in SLR often influence the availability of resources in the banking system for lending to the private sector.

Open Market Operations (OMOs): These include both, outright purchase and sale of government securities, for injection and absorption of durable liquidity, respectively.

Market Stabilisation Scheme (MSS): This instrument for monetary management was introduced in 2004. Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-

dated government securities and treasury bills. The cash so mobilised is held in a separate government account with the Reserve Bank.

Evolution of Monetary Policy Framework in India

In order to attain the objectives of monetary policy, it is necessary to have a consistent policy framework.

Objectives are the aims of the monetary policy, which are goal variables or nominal anchors and long-term in scope but are not directly under the control of the central bank. As a result, central banks strive to achieve these objectives only indirectly by targeting intermediate and operating targets, which bear a stable relationship with the ultimate objectives, through instruments which are under its direct control. The choice of the operating target is crucial as this variable is at the beginning of the monetary transmission mechanism. Similarly, the selection of intermediate targets is conditional upon the channels of transmission – the process through which monetary policy actions impact the ultimate objectives.

Operating procedure essentially deals with how the central bank intends to influence the operating target and thereby the intermediate target with the use of monetary policy instruments at its disposal and attain the end- objectives of monetary policy. Therefore, the operating procedure is essentially the day-to-day management of monetary conditions consistent with the overall stance of the monetary policy. In other words, operating procedure is also called the nuts and bolts of monetary policy.

Governance arrangements primarily deal with the process of decision making and focus on responsibilities, powers and accountability of the monetary authority

Monetary Targeting Framework

Under this framework, broad money became the intermediate target while reserve money was one of the main operating instruments for achieving control on broad money growth. Accordingly, monetary (M3) projection was made consistent with the expected real GDP growth and a tolerable level of inflation. Technically, in a simple form, if expected real GDP growth was 6 per cent, the income elasticity of demand for money was 1.5 and a tolerable inflation was 5 per cent, the M3 expansion target was set at 14 per cent ($M3 \text{ growth} = 1.5(6) + 5 = 14$ percent). This framework was in operation during mid-1980s to 1997-98. Analysis of the money growth outcomes during the monetary targeting regime indicates that targets were rarely met. The biggest impediment to monetary targeting was lack of control over RBI's credit to the central government, which accounted for the bulk of reserve money creation.

With economic and financial sector reforms in the 1990s, there was a shift in financing government and the commercial sector with increasing reliance on market-determined interest rates and exchange rate. RBI was able to move away from direct instruments to indirect market-based instruments. The SLR and CRR were gradually brought down to 25 per cent and 9.5 per cent, respectively by 1997. Further, as the pace of trade and financial liberalisation gained momentum in the 1990s, the efficacy of broad money as an intermediate target was re-assessed. Financial innovations and external shocks emanating from swings in capital flows, volatility in the exchange rate and global business cycles imparted instability to the demand for money. There was also increasing evidence of changes in the underlying transmission mechanism of monetary policy with interest rate and the exchange rate gaining importance vis-à-vis quantity variables. Against this backdrop, in India, the search for an alternative monetary framework ended in switching over to Multiple Indicator Approach in 1998-99.

Monetary Policy Operations

The objective of monetary policy operations is to enable the transmission of monetary policy to the financial system. The MPC determines the policy interest rate, and the policy stance to achieve the inflation target. The operating target of the monetary policy is the weighted average call rate (WACR), which is the volume weighted rate of the overnight transactions undertaken in Call money market (uncollateralised) segment of the money market with banks and primary dealers as participants). By conducting the market operations as per the liquidity management framework designed by it, the RBI ensures that the operating target, i.e., the WACR is aligned to the policy rate on a daily basis.

The liquidity management framework of RBI comprises of the Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF) for management of transient liquidity, i.e., liquidity surplus or deficit of temporary nature. LAF includes various types of repos and reverse repos conducted by the RBI. MSF is an additional facility in which banks can borrow rupee funds from RBI by using the collateral from dipping into SLR securities up to a specified limit at penal rate. For managing liquidity of enduring nature, i.e., liquidity surplus or deficit, which is persisting due to various factors, Open Market Operations (OMO) by outright purchase and sale of government securities, changes in CRR and Market Stabilisation Scheme (MSS) are used.

The Cash Reserve Ratio (CRR) is a direct instrument which immediately impacts the system liquidity. If CRR is increased, banks have to maintain higher balances in their current account with RBI, thereby creating liquidity

deficit in the banking system. Similarly decrease in CRR has the immediate impact of creating liquidity surplus in the banking system.

Monetary Policy Framework Agreement (MPFA)

With the signing of the MPFA between the Government of India and the Reserve Bank on February 20, 2015, flexible inflation targeting (FIT) has been formally adopted in India. Under the MPFA, the objective of monetary policy is to primarily maintain price stability while keeping in view the objective of growth. The Reserve Bank was to bring CPI inflation below 6 per cent by January 2016. The target for 2016-17 and all subsequent years was set at 4 per cent with a band of +/- 2 per cent. The MPFA also requires the Reserve Bank to establish an operating target and an operating procedure for monetary policy through which the operating target is to be achieved. The Reserve Bank shall be seen to have failed to meet the target if inflation remains above 6 per cent or below 2 per cent for three consecutive quarters. In such circumstances, the Reserve Bank is required to provide the reasons for the failure, and propose remedial measures and the expected time to return inflation to the target. The Reserve Bank shall publish a document explaining the sources of inflation as well as forecasts of inflation for the next six to eighteen months.

The Reserve Bank has been publishing a bi-annual Monetary Policy Report (MPR) since September 2014, which provides forecasts of inflation and growth as well as an assessment of the overall macroeconomic conditions.

The MPR also sets out the operating target and gives details of the operating procedure of monetary policy and any changes thereto.

With the amendment to the RBI Act on May 14, 2016, several provisions of MPFA were subsumed in the amended Act. The Central Government, in consultation with the Reserve Bank, has notified the inflation target of 4.0 per cent (with 6.0 per cent and 2.0 per cent as the upper and lower tolerance levels, respectively) in the Official Gazette on August 5, 2016. This inflation target is applicable for the period from August 5, 2016 to March 31, 2021. Moreover, factors that constitute a failure to achieve the inflation target – i.e., if the average inflation is more/less than the upper/lower tolerance level for three consecutive quarters – have also been defined and notified in the Official Gazette on June 27, 2016.