Monetary policy measures in times of global recession

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Abstract

This paper gives a holistic view of monetary policy measures taken in India in view of the global recession. Monetary policies are measures taken by the central bank of a country. As in case of all countries, RBI has taken several measures to inject liquidity in the Indian economy. It has made use of several instruments as CRR, Repo and reverse rates. The latest step was the cut in repo and reverse repo rates which was taken on 21 April, 09. This paper discusses the monetary policy measures taken to revive the economy in times of recession. It also shows the results arising due to monetary policy measures taken in times of recession. The aim of the paper is to highlight a. The monetary policy in times of global recession in India.
b. Effect of monetary policy

Key Words: Monetary policy, liquidity, RBI

Introduction

The global recession has impacted major economies of the world. All major economies, especially the developed countries have been impacted by the crisis. India is not facing a recession but a slowdown. India was a buoyant healthy economy with a GDP growth rate of 7.2 % (Economic Survey 2010). In 2006, CRR and interbank rates were raised and interest rates in the Indian economy increased by 2-4% of existing rates. Govt. eased restrictions on ECBs. Private borrowing increased in 07, 08 while Inflow of forex pushed up rupee. India was an attractive investment destination. Foreign institutional investors (FII) increased rapidly and stock markets kept rising and crossed the 20,000 mark. However things changed with the Subprime crash in dec07. Outflow of resources had started from jan 08. September 2008 witnessed the global meltdown. FII's started pulling out of the country. India's forex fell a billion$ a day and rupee depreciated rapidly pulling down the exchange rate to more than Rs 50 a dollar which initially ranged between 43-46 Rs.

Thus the impact of global recession in India was mainly on exit of foreign equity. Capital flow reversals took place and pressure on exchange rate. There was Drying up of overseas credit for both Indian corporate and Indian banks. This led to shift of credit demand from external to domestic sources. Exports were mainly hit due to deceleration or meltdown of global economy. The main problem before policy makers has been to infuse confidence and liquidity in the financial system. SME's were badly hit by the global

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recession. Policy makers have to ensure bank lending to SMEs at prime lending rate and channelise liquidity to productive channels.

Fiscal and monetary Policy measures are broadly the corrective measures taken to revive the economy in times of crisis (RBI 2009). Both short term and long term measures are required to revive the economy. In the long term, there is a need to enhance public investment in infrastructure eg roads, ports, power. Early completion of ongoing projects is to be ensured. Focus should be on education quality and skill development across sectors. There is need to pursue reforms in agriculture. Reforms are required in public expenditure. It should be ensured that public money is used in areas which provide maximum return.

There is a need to reduce burden on manufacturing through cost / price reduction. The role of policy becomes crucial. Fiscal policy reforms may be used to reduce tax burden on manufacturing sector. There is a need to augment external demand by enhancing export competitiveness. In the short run, cost of credit has to be made cheaper.

However, India is facing a high fiscal deficit. Currently India's fiscal deficit is projected at 5.5% in the interim budget. Revised budget estimate of 2008-09 show a deficit of 6%. This is the centre's fiscal deficit. Adding to it the state deficit, fiscal deficit can be as high as 10 -11%. This is an alarming figure which was prevailing before the 1991 reforms. Hence, there is not much scope for fiscal policy in India. Hence, role of monetary policy increases in a country like India.

Currently, the Indian economy is projected to grow 6 per cent during the current financial year and inflation expected to stay around 4 per cent. Reserve Bank of India has a prominent role in reviving growth by increasing the flow of credit through reduction in policy rates so as to reduce the cost of funds. Initially, the rate of inflation was very high reaching 11-12%. This prevented the RBI from taking drastic steps as monetary measures would fuel inflation further. The RBI had to move cautiously as it had to take into account both growth of the economy as well as inflation. The IIP growth rate had decelerated in the third quarter. This forced the RBI to rethink its measures. With inflation fairly in control, RBI had to rethink its measures. It also had the task of raising resources for the government to finance its ever increasing fiscal deficit. Also recessionary measures required massive resources which were mainly financed by government borrowings.

Monetary Policy Mechanism

In India, the central bank of the country, the RBI responds to the evolving economic activity within an articulated monetary policy framework. There are three basic constituents of a framework, the objectives of monetary policy, the analytics, transmission mechanism and the operating procedure- targets and instruments. The aim of monetary policy is price stability and growth. It also has other objectives as exchange rate stability, credit avilability and financial stability while pursuing the basic objectives (Pailwar 2010).

The Monetary policy impulses are transmitted through various channels, affecting different variables and different markets, and at various speeds and intensities. Monetary policy affects output and prices through its influence on key financial variables such as: interest rates, exchange rates, asset prices, credit and monetary aggregates. Further, the financial variables may be divided into: financial prices (*e.g.*, interest rates, exchange rates, yields, asset prices, equity prices) and financial quantities (money supply, credit aggregates, supply of government bonds, foreign denominated assets). With the short-term interest rates emerging as the predominant instrument of monetary signals worldwide, the interest rate channel is the key channel of transmission.The main instruments of monetary policy are both quantitative and qualitative in nature.

Quantitative instruments are mainly Cash reserve Ratio (CRR), Statutory liquidity ratio (SLR), and Bank Rate. CRR is the amount of cash banks are required to keep with the RBI. The RBI increases of decreases this amount to decrease or decrease the liquidity according to the monetary situation of the country. There are various schemes to manage liquidity as LAF, OMO and MSS. LAF or Liquid Adjustment facility was introduced for injecting liquidity in the economy through use of Reps and reverse repos. This was introduced in 2000.

MSS or Market Stabilisation scheme was introduced in 2004 to sterilise impact of large capital inflows. This deals with T bills and securities from MSS account managed by RBI. A major instrument of monetary policy is Open market operation (OMO) where there is sale and purchase for government securities and treasury bills from RBI account.

Apart from quantitative instruments, RBI also uses Qualitative instruments as Priority sector lending, differential interest rates, Margin requirements, Rationing credit etc. It also resorts to moral suasion to keep interest rates in check.

Monetary policy in different countries

Policymakers in governments, central banks and in other regulating agencies of financial institutions around the world responded to the crisis with aggressive, radical and unconventional measures to restore calm and confidence in financial markets and bring them back to normalcy. Interest rates have been used to regulate money supply. Financial stability was the main aim of all countries.

In order to revive growth, many countries have slashed their policy interest rates aggressively to historically low since the beginning of the crisis against the backdrop of decreasing inflationary pressures . The US has lowered the Fed funds rate target to a near-zero range of 0.0-0.25 per cent, the UK has pruned its benchmark bank rate to 0.5 per cent (the lowest level since the creation of the bank in 1694). The policy rate in Euro area was cut to an unprecedented low of 1.25 per cent. Moreover, many nations have enacted heavy fiscal stimulus plans in response to the ongoing recession. These plans, which were a combination of government spending and tax cuts, were aimed at giving a boost to domestic demand. Table 1 shows the monetary measures taken worldwide , mainly interest rate cuts in nine different countries.

Table 1: Monetary measures taken worldwide

Country	Starting of Monetary measures	Previous interest rate (%)	Current interest rate
USA	Sept 2007	5.25	0 - .25
Eurozone	Oct 2008	4.25	1.25
Japan	Oct 2008	.5	.1
UK	Dec 2007	5.75	.5
Australia	Sept 2008	7.25	3.0
China	Sept 2008	7.47	5.3
India	Oct 2008	9	4.75
Malaysia	Nov 2008	3.5	2.0
South Korea	Oct 2008	5.3	2.0

Source: Crisil Research Analysis

Monetary policy in India

In India, the prime instruments of monetary policy were mainly referred to CRR, SLR and OMO. After liberalization and post 2000, with more liquidity in the economy, their role was reduced. Other measure as repo/reverse repos and qualitative measures used more. After the recession traditional measures were again resorted to. Since the global recession in September 2008, many measures have been taken. The main aim of RBI has been to provide ample rupee liquidity, ensuring comfortable dollar liquidity and maintaining a market environment conducive for the continued flow of credit to productive sectors. The RBI has made use of instruments as CRR, SLR, Repo and reverse repos. There has been a reduction in CRR, repo and reverse repo. CRR has been reduced from 9% to 5.5%. Rates for repo and reverse repo rates have been reduced by 325 basis points and 175 basis points since September 2008. The last round of cuts was implemented in April 21. The current repo and reverse repos are 4.75 and 3.25% respectively.

The government has set up a Special purpose vehicle, SPV for NBFC. The statutory liquidity ratio (SLR) was reduced from 25.0 per cent of NDTL to 24.0 per cent. The export credit refinance limit for commercial banks was enhanced to 50.0 per cent from 15.0 per cent of outstanding export credit. A special 14-day term repo facility was instituted for commercial banks up to 1.5 per cent of NDTL. A special refinance facility was instituted for scheduled commercial banks (excluding RRBs) up to 1.0 per cent of each bank's NDTL as on October 24, 2008. Special refinance facilities were instituted for financial institutions (SIDBI, NHB and Exim Bank).

Several measures were taken to introduce Foreign exchange Liquidity. The Reserve Bank sold foreign exchange (US dollars) and made available a forex swap facility to banks. The dollar swap facility was an Unconventional Dollar swap facility where there was provision of buying or selling of a fixed amount of a foreign currency on the spot market, and the selling or buying of the same amount of the same currency on the forward market.

Other steps were also taken to promote forex liquidity was change in interest rate ceilings non-resident Indian (NRI) deposits. The all-in-cost ceiling for the external commercial borrowings (ECBs) was raised. The all-in-cost ceiling for ECBs through the approval route has been dispensed with up to June 30, 2009. The systemically important non-deposit taking non-banking financial companies (NBFCs-ND-SI) were permitted to raise short-term foreign currency borrowings.

Effect of RBI measures

The RBI has used all its tools to infuse liquidity in the economy. RBI has tried to inject nearly Rs 4,63,000 crore liquidity into the system and has heralded a low interest rate regime. These monetary policy measures are expected to bring in substantial liquidity in the economy, upto an amount of Rs 388,045 crores. Reduction in SLR rates is expected to induce additional liquidity of Rs. 40,000 crores.

Table 2:Actual/Potential Release of primary liquidity since mid sept 2008

	Measures/facility	**Amount (Rs.crores)**
1	Cash Reserve Ratio	1,60,000
2	MSS unwinding	63,045
3	Term repo facility	60,000
4	Increase in export credit refinance	25,500
5	Special refinance facility for SCBs	38,500
6	Refinance Facility for SIDBI/NHB/EXIM Bank	16,000
7	Liquidity Facility for NBFCs through SPV	25,000
	Total (1 to 7)	**3,88,045**
	Memo: Statutory Liquidity Ratio (SLR) Reduction	40,000

Source: RBI

The liquidity situation has improved significantly following the measures taken by the Reserve Bank. The overnight money market rates, which generally high, above the repo rate during September-October 2008, have reduced considerably. As shown in table 3, interest rates on call money market reached 9.9% in October. However, this reduced to 3.47%. Other money market rates such as discount rates of CDs, CPs and CBLO have also reduced with the overnight money market rates. For collateralized borrowing and lending obligations CBLO, the interest rates also dropped significantly from 7.73% to 2.6%. The LAF window has been in a net absorption mode since mid-November 2008. The liquidity problem faced by mutual funds has eased considerably. Most commercial banks have reduced their benchmark prime lending rates. The total utilisation under the recent refinance/liquidity facilities introduced by the Reserve Bank has been low as the overall liquidity conditions remain comfortable. However, their availability has provided comfort to the banks/FIs, which can fall back on them in case of need.

Table 3: Interest rates in India, monthly average (%)

	March 08	October08	January09	March09	April 17,09
Call Money	7.37	9.90	9.90	4.17	3.47
CBLO	6.37	7.73	7.73	3.60	2.60
Market Repo	6.72	8.40	8.40	3.90	2.86
Commercial Paper	10.38	14.17	14.17	9.79	7.00
Certificates of Deposit	10.00	10.00	10.00	6.73#	4.00
91-day Treasury Bills	7.33	7.44	7.44	4.77	4.09
10-year Government Security	7.69	7.80	7.80	6.57	6.41

Source: RBI

Interest rates have been influenced by government borrowings. To finance fiscal deficit, the government is resorting to borrowings and proposed to raise Rs 2410 million in the current fiscal year 2009-10. The RBI has intervened here to conduct borrowings such that the debt market is not disrupted. The RBI has committed to buyback government securities worth Rs 800 billion and unwind MSS worth Rs 420 million in the first half of 2010. It aims that the pressure on government securities remain relatively low and expect interest rates to stabilize at around 6%. The government has reduced the repo and reverse repo rates so that people resort less to buying and lending of government securities. As banks used reverse repo to put funds with RBI, the RBI reduced this amount so that banks put less money with RBI and there is more liquidity in the system.

Although the RBI has made use of all its tools, the full transmission of the measures already announced by it since September has not taken place. Some banks, mainly public sector banks have responded. Table 4 shows the reduction in deposit and lending rates due to change in interest rates.

Table 4: Reduction in Deposit and Lending Rates on basis points (Oct 2008 - April 2009)

Bank Group	Deposit Rates	Lending Rates (BPLR)
Public Sector Banks	125-250	125-225
Private Sector Banks	75-200	100-125
Five Major Foreign Banks	100-200	0-100

Source: RBI

It is seen that there has been a reduction in deposit and lending rates. The maximum reduction has been in case of public sector banks where they have reduced deposit rates by 125 to 250 basis points as compared to private sector banks where deposit rates have been reduced by 75-200 basis points only. The lending rates have reduced drastically in case of public sector banks. This has drastically affected the deposit growth rates of different banks. Public sector banks witnessed a growth rate of 24% in 2008-09 as compared to 23% in 2007-08. Foreign sector banks witnessed a growth rate of 7.8% in 2008-09 as compared to 29.1% in 2007-08

Table 5 : Monetary Aggregates (%)

	2007-08	2008-09
Reserve Money	31.0	6.4
Reserve Money (adjusted for CRR changes)	25.3	19.0
Currency in Circulation	17.2	17.0
Money Supply (M3)	21.2	18.4
M3 (Policy Projection)	17.0-17.5	19.0
Money Multiplier	4.33	4.82

Monetary policy has led to increase in liquidity in the economy. Money supply (M3) is expected to grow at 17.0 per cent in 2009-10. The aggregate deposits of scheduled commercial banks are projected to grow by 18.0 per cent. The growth in adjusted non-food credit, including investment in bonds/ debentures/shares of public sector undertakings and private corporate sector and CPs, is placed at 20.0 per cent.

Conclusion

Overall, monetary measures have been effective in the Indian economy. The RBI has infused liquidity in the economy. The growth rate of Indian economy is expected to be 6% in 2009-10. Agriculture is expected to grow at 3%, industry at 3.6 to 3.9% while Services will grow at 7.3 to 7.8%. When inflation was very high, RBI took stringent measures and gave priority to controlling inflation. Inflation is expected to be around 4%. Inflation is under control and is expected to be around 1 to 1.5%. The growth of the economy is buoyant. There has been increase in the liquidity status of the economy. There has been low demand for credit. RBI measures are expected to lead to interest rate stabilization. Interest rates are expected to be around 6 to 6.2%. RBI has taken several steps to promote foreign exchange liquidity. It is expected that there will be capital inflows. Exchange rates are expected to be around 47-48 Rs per dollar. Money supply is expected to grow at 17%.

The monetary policy has led to change in preferences of people. From a private sector preference, people are still going back to traditional public sector banks. In some ways, the economy is reverting to the preliberalised era where the public sector played an important role. The role of PSU banks had diminished and now after the recession they have again come back in the limelight. The role of monetary policy will increase further. As there is not much room for fiscal stimulus in the economy, monetary policy measures will have greater role to play in the economy. It is expected that RBI would go for further rate cuts in the economy. Internationally, rate cuts have been much lower. India can still go for further cuts in the economy.

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