7 Monetary Policy Tools in hands of RBI

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One of the major functions of RBI (Reserve bank of India) is to control inflation and liquidity in the economy. Today I am going to discuss various tools with RBI that directly impacts the money supply in the economy.

Cash Reserve Ratio

CRR is the minimum percentage of deposits with commercial banks that they need to deposit with the central bank of RBI.

Impact of increased CRR

Positive impact - It is a quick fix to control inflation. By increasing CRR, commercial banks need to deposit more money with RBI. Thus commercial banks left with less money. Now loans become dearer, so people have less money. As

Less money with Commercial banks → Less money with people → Lower demand for goods and services → Lower prices

Higher CRR simply sucks money from the economy.

Impact of decreased CRR

More money with Commercial banks → More money with people → Higher demand for good sand services → Higher prices

CRR should be aligned with supply and production levels. If people are producing more then they deserve to spend more. Decreased CRR provides a short term fix as it increases demand for short term.

Statutory liquidity ratio

This is the percentage of liabilities and time deposits that commercial banks need to keep with them in form of cash, gold or government approved securities.

Impact of increase in SLR

Commercial banks need to keep more liquid funds → Provides less loans to people → Lower demand for good sand services → Lower prices

Impact on decrease in SLR

Commercial banks need to keep less liquid funds → Provides more loans to people → Higher demand for good sand services → Higher prices

Repo and Reverse Repo rates

Repo rate

It is the rate at which RBI lends money to commercial banks against securities in case commercial banks fall short of funds.

Reverse Repo Rate

Rate at which RBI borrows money from commercial banks.

Impact

If commercial banks get more money they will lend more money to people which will lead more demand in economy. Thus prices will increase.

Bank rate

It is a rate at which RBI lends money to commercial banks **without any security**.

Impact

When bank rate is increased interest rate also increases which have negative impact on demand thus prices increases.

Marginal Standing Funding

By this mechanism commercial banks can get loans from RBI for their emergency needs. Commercial banks can take loan only upto 1% of their liabilities and time deposits.

Open market operations

Buying and selling government securities and bonds in order to manage liquidity in the economy.

Impact of purchasing securities

More money in economy → More demand → Higher growth rate

Impact of selling

Less money in economy → Less demand → Lower prices

Conclusion

Many economist says effect of "More demand" is higher growth rate while some says higher prices. While it is actually state of economy. Money supply should be aligned with production rate.