After going through the chapter student shall be able to understand

- Credit Policy of RBI
- Fed Policy
- Inflation Index, CPI, WPI, etc.

1. CREDIT POLICY OF THE RESERVE BANK OF INDIA (RBI)

1.1 Meaning of Credit Policy

The credit policy is basically a plan of action executed by the Reserve Bank of India (RBI) on behalf of the Government of India to control and regulate the demand for and supply of money with the public and the flow of credit i.e. money into the economy. It refers to the use of credit policy instruments which are at the disposal of central bank to regulate the availability, cost and use of money and credit to promote economic growth, price stability, optimum levels of output and employment, balance of payments equilibrium, stable currency or any other goal of government’s economic policy.

1.2 Objectives of Credit Policy

The various objectives of Credit Policy are as follows:

(i) Maintenance of Price Stability – One of the foremost responsibilities of RBI is to control inflation and maintain the stability of prices.
(ii) Achieving Economic Growth – It is also one of the most important objectives of Credit Policy of RBI. The purpose is to achieve economic growth through various means which will be discussed later. Infact, the primary objective is to maintain a judicious balance between maintenance of price stability and achieving economic growth. So, achieving economic growth is not a direct objective. GDP growth and job creation is primarily the government function. Credit policy is primarily targeted to keep inflation in check and maintain sufficient liquidity in the system which will spur demand. This will lead to economic growth.

(iii) Exchange Rate Stability – The aim is to maintain exchange rate stability so the import is cheaper and exporters increase their export and earn precious foreign exchange.

(iv) External Balance of payment equilibrium – The balance of payment is basically economic transactions of the residents of a country with the rest of the world during a given period of time. When we add up all the demand for foreign currency and all the sources from which it comes, these two amounts are necessarily equal and thus the overall account of the balance of payments necessarily balance or must always be in equilibrium.

(v) Adequate flow of credit to productive sectors – It is the responsibility of the Central Bank to ensure that regular, easy and smooth availability of money to the needy sector of the economy is rendered on a continuous basis. This will help the industry to pump in the required money to boost up their production. This will automatically increase employment as the companies will hire more people to enhance their capacity. This in turn will lead to higher standard of living for the people.

(vi) Maintaining a moderate structure of interest rates to enhance investments – The RBI plays an important role in management of rate of interest. And, the fate of many industries depends upon the interest rate policy pursued by the Central Bank. They expect that interest rates be reduced so that loans can be available at cheaper rate. On the other hand, in case of inflation, general perception is to increase the rate of interest. Therefore, the RBI evaluates the pros and cons of its every prospective decision and decides interest rate policy to be pursued.

Hence, the role of RBI is to tread on a cautious path. People expect that inflation shall be contained and stay within a reasonable limit so that goods and services are available to them in a cheap manner. At the same time, people expect that unemployment should be reduced and more and more jobs should be available. So, tradeoff is required between controlling inflation and rising unemployment.

1.3 Analytics of Credit Policy

There are basically four different mechanisms through which monetary policy influences the price level and the national income. These are:

(i) Interest Rate Channel – Interest rates increases the cost of capital and real cost of borrowing for firms with the result that they cut back on their investment expenditures. Similarly, general public facing the heat of high interest rate cut back on their purchase of homes, cars, air-
conditioners and other goods. So, a decline in aggregate demand results in the decline in aggregate output and goods.

On the other hand, decrease in interest rates has the opposite effect of decrease in cost of capital of firms and cost of borrowing for households.

(ii) **Exchange Rate Channel** – Appreciation of the domestic currency makes domestically produced goods more expensive compared to foreign-produced goods. The reason is that import from countries outside India will become cheaper and it will make the goods produced in India dearer in comparison. This will cause the net export to fall (because expensive good produced in India will have to be sold at a higher price and it will find few takers outside India). Consequently, domestic output and employment will also fall.

(iii) **Quantum Channel (relating to money supply and credit)** – Two things are worth mentioning in this regard – the bank lending (credit) channel and the balance sheet channel. Credit channel operates by altering the access of firms and households to bank credit. Most of the business organizations depend on bank loans for their borrowing needs. To restrict the flow of credit in times of inflation, the RBI sells government securities to commercial banks and the public and squeeze money from them. This makes the firms which are dependent on bank loans to cut back on their spending on investment. This will diminish aggregate output and employment following a reduction in money supply.

Now, we shall look at how the balance sheet channel works. The direct effect of monetary policy on balance sheet is that it will show the interest cost and increase in payments through loan repayments. An indirect effect is that the same increase in interest rate works to reduce the capitalized value of the firm’s fixed assets. This will also raise the company’s cost of capital and consequently, precipitate reduction in production and output.

(iv) **Asset Price Channel** – The standard asset price channel indicates that changes in credit policy effects output, employment and inflation. An increase in interest rates in debt securities makes them more attractive to investors than equity. This leads to a fall in the share prices which resulted in the consequent fall in the consumption, production and employment. These also affect the overall financial wealth of the investors.

1.4 **Operating Procedure and Instruments**

The operating framework of monetary policy refers to how the various aspects of monetary policy are implemented. These aspects are briefly explained as below:

*Choosing the operating target* – The operating target to the variable (for e.g. inflation) that monetary policy can influence with its actions.

*Choosing the intermediate target* - (e.g. economic stability) is a variable which central bank can hope to influence to a reasonable degree.
Choosing the policy instruments - The credit policy instruments are the various tools that a central bank can use to influence money market and credit conditions and pursue its monetary policy objectives.

The day to day implementation of monetary policy by central banks through various instruments is referred to as ‘operating procedures’.

1.5 The instruments of Credit Policy

The various credit policy instruments are explained in the following paragraphs:

(i) Cash Reserve Ratio (CRR): Cash reserve ratio is the amount which the commercial banks have to maintain as cash deposit with the Reserve Bank of India. RBI may increase the CRR if it thinks that there is large amount of money supply in the economy. Conversely, it will decrease the CRR if it is of the opinion that inflation is in control and the industry needs a monetary boost up. The reduction in CRR will provide more money in the hands of commercial banks which it will pass it on to the industry. More money in the hands of industry will boost up production, consumption and employment. The cash reserve ratio as on 22nd August, 2017 is 4%.

(ii) Statutory Liquidity Ratio (SLR): Statutory Liquidity Ratio is the amount which commercial banks have to keep it with itself. So, SLR is the amount of money which banks have to keep in its custody at all times. SLR is also a very powerful tool to control liquidity in the economy. To encourage industries to boost up their production, SLR may be decreased to put more money in the hands of commercial banks. An increase in SLR is used as an inflation control measure to control price rise.

Maintenance of CRR and SLR are a part of what is known as the ‘Fractional Reserve System’ in Central Banking. Fractional Reserves are a part of the wider Quantitative Monetary Policy.

(iii) Liquidity Adjustment Facility (LAF): Under this facility, the commercial banks can borrow from RBI through the discount window against the collateral of securities like commercial bills, treasury bills or other eligible papers. Currently, the RBI provides financial accommodation to the commercial banks through repos/reverse repos under the LAF.

Repo is defined as an instrument through which commercial banks borrow from RBI. So, for borrowing funds by selling securities with an agreement to repurchase the securities on a mutually agreed future date at an agreed price which includes interest for the funds borrowed. In other words, repo is a money market instrument, which enables collateralized short term borrowing and lending through sale/purchase operations in debt instruments.
Reverse Repo, on the other hand, is an instrument through which RBI borrows from commercial banks by giving them securities. So, reverse repo is defined as an instrument for lending funds by purchasing securities with an agreement to resell the securities on a mutually agreed future date at an agreed price which includes interest for the funds lent.

(iv) Margin Standing Facility (MSF): Margin Standing Facility announced by the Reserve Bank of India (RBI) in its Monetary Policy, 2011-12 refers to the facility under which scheduled commercial banks can borrow additional amount of overnight money from the central bank over and above what is available to them through the LAF facility up to a limit at a penal rate of interest. The minimum amount which can be assessed through MSF is ₹ 1 crore and more will be available in multiples of ₹ 1 crore. The MSF would be the last resort for banks once they exhaust all borrowing options including the liquidity adjustment facility on which the rates are lower compared to the MSF.

(v) Market Stabilization Scheme: Under the market stabilization scheme, the Government of India borrows from the RBI and issues treasury bills/dated securities for absorbing excess liquidity from the market arising from large capital inflows. Now, with the introduction of Liquidity Adjustment Facility (LAF) i.e. Repo and Reverse Repo mechanism, bank rate has become dormant as an instrument of monetary policy. The bank rate has been aligned to the Marginal Standing Facility (MSF) rate and therefore, as and when the MSF rate changes alongside policy repo rate changes, the bank rate also changes automatically. Now, bank rate is used only for calculating penalty on default in the maintenance of Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR).

(vi) Open Market Operations: Open Market Operation is basically a tactic employed by the RBI to control the liquidity in the economic system. When the RBI feels there is excess liquidity in the market, it resorts to sale of securities thereby reducing excess rupee flowing in the Indian economy. Similarly, when there is tight liquidity situation in the economy, the RBI will buy securities from the market, thereby releasing money (rupee) into the system.
2. FED POLICY

2.1 About the Federal Reserve System

The Federal Reserve System is the Central Bank of the United States. It performs five general functions to promote the effective operation of the U.S. economy and, more generally, the public interest. The Federal Reserve:

- **conducts the nation's monetary policy** to promote maximum employment, stable prices, and moderate long-term interest rates in the U.S. economy;
- **promotes the stability of the financial system** and seeks to minimize and contain systematic risks through active monitoring and engagement in the U.S. and abroad;
- **promotes the safety and soundness of individual financial institutions** and monitors their impact on the financial system as a whole;
- **fosters payment and settlement system safety and efficiency** through services to the banking industry and the U.S. government that facilitate U.S. dollar transactions and payments; and
- **promotes consumer protection and community development** through consumer-focused supervision and examination, research and analysis of emerging consumer issues and trends, community economic development activities, and the administration of consumer laws and regulations.

2.2 Fed Policy Tools

The techniques or tools employed by the US Federal Reserve as a part of Fed Policy have been discussed in brief in the following paragraphs. The purpose of the Fed Policy tools is more or less the same as employed by the Reserve Bank of India which has been discussed in detail in the preceding paragraphs.

(i) **Open Market Operations:** Open market operations (OMOs)--the purchase and sale of securities in the open market by a central bank--are a key tool used by the Federal Reserve in the implementation of monetary policy.

(ii) **The Discount Rate:** The discount rate is the interest rate charged to commercial banks and other depository institutions on loans they receive from their regional Federal Reserve Bank's lending facility--the discount window. The Federal Reserve Banks offer three discount window programs to depository institutions: primary credit, secondary credit, and seasonal credit, each with its own interest rate. All discount window loans are fully secured.

Under the primary credit program, loans are extended for a very short term (usually overnight) to depository institutions in generally sound financial condition. Depository institutions that are not eligible for primary credit may apply for secondary credit to meet short-term liquidity needs or to
resolve severe financial difficulties. Seasonal credit is extended to relatively small depository institutions that have recurring intra-year fluctuations in funding needs, such as banks in agricultural or seasonal resort communities.

(iii) Reserve Requirements: Reserve requirements are the amount of funds that a depository institution must hold in reserve against specified deposit liabilities. Within limits specified by law, the Board of Governors has sole authority over changes in reserve requirements. Depository institutions must hold reserves in the form of vault cash or deposits with Federal Reserve Banks.

(iv) Interest on Required Reserve Balances and Excess Balances: The Federal Reserve Banks pay interest on required reserve balances and on excess reserve balances. The interest rate on required reserves (IORR rate) is determined by the Board and is intended to eliminate effectively the implicit tax that reserve requirements used to impose on depository institutions.

(v) Overnight Reverse Repurchase Agreement Facility: When the Federal Reserve conducts an overnight RRP, it sells a security to an eligible counterparty and simultaneously agrees to buy the security back the next day.

(vi) Term Deposit Facility: Funds placed in term deposits are removed from the reserve accounts of participating institutions for the life of the term deposit and thereby drain reserve balances from the banking system.

(Source: www.federalreserve.gov)

2.3 Fed Funds Rate and its impact on Global Financial Market

The Fed Funds Rate is the interest rate at which the top US banks borrow overnight money from common reserves. All American banks are required to park a portion of their deposits with the Federal Reserve in cash, as a statutory requirement.

Actually, fed fund rate gives the direction in which US interest rates should be heading at any given point of time. If the Fed is increasing the interest rates, lending rates for companies and retail borrowers will go up and vice versa. In India, hike in repo rate may not impact the countries outside India. On the other hand, US interest rates matter a lot to global capital flows. Some of the world’s richest institutions and investors have their base in USA. They constantly compare Fed rates with interest rates across the world to make their allocation decisions.

Any changes in the Fed Fund Rates impact the domestic borrowing market to a large extent. For instance, if the Fed rates go up, it will make the RBI hesitant in cutting rates at that time. The reason is that if RBI cut rates it will lead to heavy pullout of foreign investors from the Indian bond market.

Further, US interest rates matter to foreign stock investors in India also. The reason is zero or near zero returns on safe investments in the US. But, if the Fed rates go up, it may lead to mass exodus of foreign investors from the Indian Stock Market because higher returns in the form of interest is available there.
3. COST INFLATION INDEX (CII)

Cost Inflation Index is a measure of inflation that is used for computing long-term capital gains on sale of capital assets. It is prescribed by the central government every year and useful in the calculation of the indexed value of the capital assets. It helps a tax payer in computing the actual long term gain or loss on selling of capital assets and also allows the tax payer to factor the impact of inflation on the cost of their asset.

To calculate the indexed cost of acquisition we have to divide the Cost Inflation Index or CII for year in which asset is sold by the Cost Inflation Index or CII for a year in which asset is bought, then multiplied with the purchase price of the asset to arrive at the indexed cost of acquisition which is the actual or true cost used at the time of tax computation.

Since the government levies a tax on such transactions, the owner would be required to pay a large amount as tax. In order to avoid paying a large sum towards tax, the purchase price of the asset can be indexed to show the asset’s value as per its current value, taking into account inflation by increasing its value. In this manner, the profit derived from the sale would be lower, thus reducing the capital gains payable.

Thus, indexation helps the actual value of the asset to reflect at its present market rates, taking into account the reduction in its value due to inflation.

When selling an asset, the purchase price is referred to as the indexed cost of acquisition. The cost inflation index (CII), therefore, is the indexed price that the asset is purchased at. The CII for a particular year is fixed by the government and released before the accounting year ends, for the purpose of tax computation.

**Computation of Cost Inflation Index**

Cost Inflation Index (CII) = CII for the year the asset was transferred or sold / CII for the year the asset was acquired or bought.

The above formula for the computation of CII has been explained with the help of an example:

**Example**

Suppose, you purchased a house for Rs.25 lakhs in Jan 2005 and sold it for Rs.70 lakhs in Jan 2015. Your profit or capital gain is Rs.45 lakhs.

The CII for the year the apartment was bought in is 406. The CII for the year the apartment was sold is 1081.

Now, the cost inflation index = CII for the year the asset was transferred or sold / CII for the year the asset was acquired or bought = 1081/406 = 2.66

While computing tax, CII is multiplied with the purchase price to arrive at the indexed cost of acquisition. This is the actual cost of the asset.
Therefore, the indexed cost of acquisition = 25,00,000 X 2.66 = Rs.66,50,000

And, the long term capital gain = sale value of the asset - indexed cost of acquisition
= 70,00,000 – 66,50,000 = Rs.3,50,000

The tax liability if you use the indexation method is charged at 20 percent. The tax liability will be 20% X 3,50,000 = Rs.70000.

If you do not use the indexation method, the tax is payable at 10% on the capital gain. The capital gain in this case is sale price of the apartment – cost of acquisition = 70,00,000 – 25,00,000 = Rs. 45,00,000. The capital gains tax is 10% x 45,00,000 = Rs. 4,50,000.

Therefore, when indexation benefit is taken, it helps you in saving taxes. It helps you adjust the purchase price of the house with the current market prices.

4. CONSUMER PRICE INDEX (CPI)

A Consumer Price Index (CPI) is designed to measure the changes over time in general level of retail prices of selected goods and services that households purchase for the purpose of consumption. Such changes affect the real purchasing power of consumers’ income and their welfare. The CPI measures price changes by comparing, through time, the cost of a fixed basket of commodities. The basket is based on the expenditures of a target population in a certain reference period. Since the basket contains commodities of unchanging or equivalent quantity and quality, the index reflects only pure price. Traditionally, CPI numbers were originally introduced to provide a measure of changes in the living costs of workers, so that their wages could be compensated to the changing level of prices. However, over the years, CPIs have been widely used as a macroeconomic indicator of inflation, and also as a tool by Government and Central Bank for targeting inflation and monitoring price stability. CPI is also used as deflators in the National Accounts. Therefore, CPI is considered as one of the most important economic indicators.

Given the many uses of CPIs, it is unlikely that one index can perform equally satisfactory in all applications. Therefore, there is a practice of compiling several CPI variants for specific purpose. Each index should be properly defined and named to avoid confusion. The purpose of CPI should influence all aspects of its construction.

4.1 Classification of Items

Classification is the first step in compiling the CPI because its sub-aggregates must be defined in such a way that expenditure weights and prices will relate precisely to the coverage of the sub-aggregates. It establishes a hierarchical framework from whose boundaries the representative items for inclusion in the index (and sometimes the outlets) will be defined and drawn. In broad sense, a classification is a procedure in which items are organized into categories based on information on one or more characteristics inherent to the items. In years past, countries used their own distinct systems for classifying the range of products covered by their CPI. Most countries
have now, however, moved to the international standard classification COICOP (Classification of Individual Consumption according to Purpose).

In order to ensure better comparability with CPIs of other countries, it is desirable to have the classification of items synchronized with COICOP. At the same time, it is also important to make it relevant to the Indian context by making it comparable to groups and sub-groups being followed in the CPI series compiled in the country. Accordingly, all consumption items have been classified under various Groups, Categories, Sub-groups and Sections.

(Source: Ministry of Statistics and Programme Implementation)

4.2 Issues relating to Consumer Price Index (CPI)

Some of the issues relating to Consumer Price Index (CPI) which have been in vogue for quite some time have been discussed in the following points in order to have a good glimpse of the actual impact of CPI to the consumers in India.

(1) 90-95% of the index (CPI) is not affected by interest rates as the amount spent on household is not affected by the rate changes. This includes food products (covering 48% in index), housing or fuel expenses. These are fixed cost and had to be spent irrespective of the rate of inflation.

(2) Concept of CPI does not make sense to the household. A 2% CPI does not seem convincing to a housewife who believes that prices of most of the commodities are on the higher side than that reflected by CPI. So, it is frustrating for the consumer who after every fall in rate of inflation finds that actual prices are on the much higher side.

For example, prices of tomatoes suddenly increase from ₹ 30 per kg. to ₹ 80 per kg. Similarly, the prices of Tur Dal increases from ₹ 40 per kg. to ₹ 200 per kg in a very short span of time. However, prices came down slowly and now it is ₹ 80-90 per kg. So, prices increases at a very fast rate but came down after taking a lot of time and that too, the reduced price is generally at a much higher level than the previous one, as explained in the previous sentence with the help of an example.

(3) Lastly, a general view is that HRA allowance paid to Central Government employees would tend to raise inflation. However, if the government employee is residing in a government accommodation, HRA is automatically deducted form the pay slip of an employee. On the other hand, if employee is not staying in a government accommodation the amount in the pay slip will goes up. Therefore, increase in HRA may not translate into higher cost of living or higher retail demand.

5. WHOLESALE PRICE INDEX (WPI)

Wholesale Price Index (WPI) measures the average change in the prices of commodities for bulk sale at the level of early stage of transactions. The index basket of the WPI covers commodities
falling under the three major groups namely Primary Articles, Fuel and Power and Manufactured products. (The index basket of the present 2011-12 series has a total of 697 items including 117 items for Primary Articles, 16 items for Fuel & Power and 564 items for Manufactured Products.) The prices tracked are ex-factory price for manufactured products, mandi price for agricultural commodities and ex-mines prices for minerals. Weights given to each commodity covered in the WPI basket is based on the value of production adjusted for net imports. WPI basket does not cover services.

In India WPI is also known as the headline inflation rate.

The base year of all India WPI has been revised from 2004-05 to 2011-12 by the Office of the Economic Advisor, Department of Industrial Policy and Promotion, Ministry of Commerce and Industry.

In India, Office of Economic Advisor (OEA), Department of Industrial Policy and Promotion, Ministry of Commerce and Industry calculates the WPI.

The main uses of WPI are the following:

1. To provide estimates of inflation at the wholesale transaction level for the economy as a whole. This helps in timely intervention by the Government to check inflation in particular, in essential commodities, before the price increase spill over to retail prices.

2. WPI is used as deflator for many sectors of the economy including for estimating GDP by Central Statistical Organisation (CSO).

3. WPI is also used for indexation by users in business contracts.

4. Global investors also track WPI as one of the key macro indicators for their investment decisions.

**Difference between Wholesale Price Index (WPI) and Consumer Price Index (CPI)**

WPI reflects the change in average prices for bulk sale of commodities at the first stage of transaction while CPI reflects the average change in prices at retail level paid by the consumer.

The prices used for compilation of WPI are collected at ex-factory level for manufactured products, at ex-mine level for mineral products and mandi level for agricultural products. In contrast, retail prices applicable to consumers and collected from various markets are used to compile CPI.

The reasons for the divergence between the two indices can also be partly attributed to the difference in the weight of food group in the two baskets. CPI Food group has a weight of 39.1 per cent as compared to the combined weight of 24.4 per cent (Food articles and Manufactured Food products) in WPI basket.

The CPI basket consists of services like housing, education, medical care, recreation etc. which are not part of WPI basket. A significant proportion of WPI item basket represents manufacturing inputs and intermediate goods like minerals, basic metals, machinery etc. whose prices are
influenced by global factors but these are not directly consumed by the households and are not part of the CPI item basket.

Thus even significant price movements in items included in WPI basket need not necessarily translate into movements in CPI in the short run. The rise or fall in prices at wholesale level spill over to the retail level after a lag.

Similarly, the movement in prices of non-tradable items included in the CPI basket widens the gap between WPI and CPI movements. The relative price trends of tradable vis a vis non-tradable is an important explanatory factor for divergence in the two indices in the short term.

(Source: Arthapedia)