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CREDIT REQUIREMENT IN INDIA: A STUDY ABOUT MONETARY POLICY

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Credit Requirement in India: A Study about Monetary Policy

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Abstract – Money markets facilitate the conduct of monetary policy in a country. The development of money market in India in the last few years has been facilitated by some major factors. It permitted a gradual de-emphasis on cash reserve ratio as a monetary policy instrument and the development of an array of instruments of indirect monetary control, such as, the Bank Rate and the Liquidity Adjustment Facility (LAF). The monetary policy is often, shaped by developments in the money and the foreign exchange markets.

Keywords: Monetary Policy, Credit Requirement, Financial

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INTRODUCTION

Banks in the process of financial intermediation are confronted with various kinds of financial and non-financial risks viz., credit, interest rate, foreign exchange rate, liquidity, equity price, commodity price, legal, regulatory, reputational, operational, etc. These risks are highly interdependent and events that affect one area of risk can have ramifications for a range of other risk categories. Thus, top management of banks should attach considerable importance to improve the ability to identify measure, monitor and control the overall level of risks undertaken.

The broad parameters of risk management function should encompass:

i) Organizational structure;

ii) Comprehensive risk measurement approach;

iii) Risk management policies approved by the Board which should be consistent with the broader business strategies, capital strength, management expertise and overall willingness to assume risk;

iv) Guidelines and other parameters used to govern risk taking including detailed structure of prudential limits;

v) Strong MIS for reporting, monitoring and controlling risks;

vi) Well laid out procedures, effective control and comprehensive risk reporting framework;

vii) Separate risk management framework independent of operational Departments and with clear delineation of levels of responsibility for management of risk; and

viii) Periodical review and evaluation.

The market crisis scenario analyses cases of extreme tightening of liquidity conditions arising out of monetary policy stance of Reserve Bank, general perception about risk profile of the banking system, severe market disruptions, failure of one or more of major players in the market, financial crisis, contagion, etc. Under this scenario, the rollover of high value customer deposits and purchased funds could extremely be difficult besides flight of volatile deposits / liabilities. The banks could also sell their investment with huge discounts, entailing severe capital loss. Undertake rapid portfolio reviews, stress tests and scenario analysis when external environment undergoes rapid changes (e.g. volatility in the forex market, economic sanctions, changes in the fiscal/monetary policies, general slowdown of the economy, market risk events, extreme liquidity conditions, etc.). The stress tests would reveal undetected areas of potential credit risk exposure and linkages between different categories of risk. In adverse circumstances, there may be substantial correlation of various risks, especially credit and market risks. Stress testing can range from relatively simple alterations in assumptions about one or more financial, structural or economic variables to the use of highly sophisticated models. The output of such portfolio-wide stress tests should be reviewed by the Board and suitable changes may be made in prudential risk limits for protecting the quality. Stress tests could also include contingency plans, detailing management responses to stressful situations.

MARKET RISK MANAGEMENT:

Management of market risk should be the major concern of top management of banks. The Boards should clearly articulate market risk management policies, procedures, prudential risk limits, review mechanisms and reporting and auditing systems. The policies should address the bank's exposure on a consolidated basis and clearly articulate the risk measurement systems that capture all material sources of market risk and assess the effects on the bank. The operating prudential limits and the accountability of the line management should also be clearly defined.

The Asset-Liability Management Committee (ALCO) should function as the top operational unit for managing the balance sheet within the performance/risk parameters laid down by the Board.

The banks should also set up an independent Middle Office to track the magnitude of market risk on a real time basis. The Middle Office should comprise of experts in market risk management, economists, statisticians and general bankers and may be functionally placed directly under the ALCO. The Middle Office should also be separated from Treasury Department and should not be involved in the day to day management of Treasury. The Middle Office should apprise the top management / ALCO / Treasury about adherence to prudential / risk parameters and also aggregate the total market risk exposures assumed by the bank at any point of time.

LIQUIDITY RISK:

Liquidity Planning is an important facet of risk management framework in banks. Liquidity is the ability to efficiently accommodate deposit and other liability decreases, as well as, fund loan portfolio growth and the possible funding of off-balance sheet claims. A bank has adequate liquidity when sufficient funds can be raised, either by increasing liabilities or converting assets, promptly and at a reasonable cost. It encompasses the potential sale of liquid assets and borrowings from money, capital and forex markets. Thus, liquidity should be considered as a defense mechanism from losses on fire sale of assets.

REVIEW OF LITERATURE:

- **Traditional Monetary theory**

The notion that there is a simple and direct relation between the quantity of money and the general level of commodity prices has intrigued thoughtful men for centuries. But the precise nature of the relation has yet to be established [1].

There appears to be no middle ground between brute empiricism and full scale theoretical specification of dynamic interrelations between monetary magnitudes and other aspects of economic activity. What Senior had to say on the subject more than a century ago is nearly as penetrating as anything that has been written since. Indeed, the difficulty of asserting anything that is both interesting and non-obvious runs like a red thread through the whole of the literature on the quantity theory of money, becoming especially prominent in those writings that attempt to assign money an independent role as a casual factor in economic fluctuations. The essay of Professor Friedman is particularly instructive in the latter respect [2]. Marshall speaks with a firmer voice only because he carefully omits all but incidental reference to dynamic complications [3]. As matters presently stand, the quantity theory of money is interesting more for doctrinal than for substantive reasons.

CONTEMPORARY MONETARY THEORY:

- ***Patinkin's Monetary Model***

Don Patinkin in his monumental work Money, Interest and Prices criticizes the Cambridge economists for the homogeneity postulate and the dichotomization of goods and money markets and then reconciles the two markets through the real balance effect [4].

The homogeneity postulate states that the demand and supply of goods are affected only by relative prices. It means that a doubling of money prices will have no effect on the demand and supply of goods. Patinkin criticizes this postulate for its failure to have any determinate theory of money and prices.

- ***Monetary Theory of R. W. Clower***

R.W. Clower in his article, a reconsideration of the micro foundations of monetary theory, 'shows that the conception of a money economy implicit in the work is empirically and analytically vacuous, and he proposes an alternative micro foundation for the pure theory of a money economy.

- ***Keynesian Monetary Theory***

Keynes General theory of Employment, Interest and Money'is a theory of the actual working of a money economy [5]. Unfortunately, Keynes expressed his ideas in language and relations that too easily lend themselves to interpretation within the formal framework of neo-classical equilibrium analysis. Partly for this reason, partly because the actual working of a monetary economy is inherently difficult to portray analytically, economic theorists are still arguing about the precise nature of the so- called Keynesian revolution, or the precise difference between money and a barter economy.

CONCLUSION:

India's monetary policy since the first plan period was one of 'controlled expansion'- that is, a policy of adequate financing of economic growth ensuring reasonable price stability. Thus, RBI helped the economy to expand via expansion of money and credit and attempted to check rise in prices through monetary and other control measures.

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