Paper: Indian Economy –II

Topic: Monetary Policy

Meaning: Monetary policy is the macroeconomic policy laid down by the central bank of an economy. The policy involves an operational framework which uses certain instruments and targeting mechanisms to achieve macroeconomic objectives like price stability, reviving consumption, growth and liquidity. The Reserve Bank of India (RBI) is vested with the responsibility of conducting monetary policy. This responsibility is explicitly mandated under the Reserve Bank of India Act, 1934.

Monetary policy refers to that policy which is concerned with the measures taken to regulate the volume of credit created by the banks. Monetary policy thus involves the use of monetary instruments under the control of the central bank to achieve price stability, financial stability and adequate availability of credit for growth.

OBJECTIVES

1. To **Regulate Money Supply** in the Economy: Money supply includes both money in circulation and credit creation by banks. Monetary policy is framed to regulate the money supply in the economy by credit expansion or credit contraction. By credit expansion (giving more loans), the money supply can be expanded. By credit contraction (giving less loans) money supply can be decreased. The main aim of the monetary policy of the Reserve Bank is to control the money supply in such a manner as to expand it to meet the needs of economic growth and at the same time contract it to curb inflation. In other words monetary policy aimed at expanding and contracting money supply according to the needs of the economy.

2. To **Attain Price Stability**: Another major objective of monetary policy in India is to maintain price stability in the country. It implies Control over inflation. Price level, is affected by money supply. Monetary policy regulates money supply to maintain price stability.

3. To **Promote Economic Growth**: An important objective of monetary policy is to make available necessary supply of money and credit for the economic growth of the country. Those sectors which are quite significant for the economic growth are provided with adequate availability of credit.

4. To **Promote saving and Investment**: By regulating the rate of interest and checking inflation, monetary policy promotes saving and investment. Higher rates of interest promote saving and investment.

5. To **Control Business Cycles**: Boom and depression are the main phases of business cycle. Monetary policy puts a check on boom and depression. In period of boom, credit is contracted, so as to reduce money supply and thus check inflation. In period of depression, credit is expanded, so as to increase money supply and thus promote aggregate demand in the economy.

6. To **Manage Aggregate Demand**: Monetary authority tries to keep the aggregate demand in balance with aggregate supply of goods and services. If aggregate demand is to be increased than credit is expanded and the interest rate is lowered down. Because of low interest rate, more people take loan to buy goods and services and hence aggregate demand increases and vice-verse.
7. To ensure more **Credit for Priority Sector**: Monetary policy aims at providing more funds to priority sector by lowering interest rates for these sectors. Priority sector includes agriculture, small- scale industry, weaker sections of society, etc.

8. To **Promote Employment**: By providing concessional loans to productive sectors, small and medium entrepreneurs, special loan schemes for unemployed youth, monetary policy promotes employment.
9. To **Promote Exports**: By providing concessional loans to export oriented units monetary policy encourages such industries and thus help to improve the position of balance of payments.

10. To **Develop Infrastructure**: Monetary policy aims at developing infrastructure. It provides concessional funds for developing infrastructure.
11. To **Regulate and Expand Banking**: RBI regulates the banking system of the economy. RBI has expanded banking to all parts of the country. Through monetary policy, RBI issues directives to different banks for setting up rural branches for promoting agricultural credit. Besides it, government has also set up cooperative banks and regional rural banks.

EXPANSIONARY MONETARY POLICY VERSUS CONTRACTIONARY MONETARY POLICY

The monetary policy may be categorized as: expansionary monetary policy or contractionary monetary policy.

a) **Expansionary Monetary Policy**: This is known as loose monetary policy. Expansionary policy increases the supply of money and credit to generate economic growth.
Key Actions implements:
►Decreasing the discount rate
►Purchasing government securities
►Reducing the reserve ratio
In recession period the central bank reduces the rate of interest.

b) **Contractionary policy:** This is known as tight monetary policy. It is a monetary measure referring to restrict the supply of money and credit by a central bank. It is exactly opposite to expansionary policy. It is implemented in extreme inflation case.
►Increasing the discount rate
►Selling of government securities
►Increasing the reserve ratio

INSTRUMENTS OF MONETARY POLICY

There are several direct and indirect instruments that are used for implementing monetary policy.

1. Quantitative, general or indirect (CRR, SLR, Open Market Operations, Bank Rate, Repo Rate, Reverse Repo Rate)

2. Qualitative, selective or direct (change in the margin money, direct action, moral suasion)

QUANTITATIVE TOOLS

1**. Bank Rate**: It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers. It is thus basically an interest rate at which RBI gives loans and advances to commercial banks.

2. **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).The Reserve Bank may notify CRR from time to time in the Gazette of India.

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

4. **Open Market Operations (OMOs):** Open market operations refer to sale and purchase of securities in the money market by the central bank of the country

5. **Repo Rate**: It is rate at which RBI lends money to the commercial banks for any shortfall in their funds. Thus it is a short term lending rate of RBI.

6. **Reverse Repo Rate:** It is the rate at which RBI borrows money from the commercial baks to wipe out / absorbs excess funds from their hand. It is the borrowing rate of the RBI.

QUALITATIVE TOOLS

Margin Requirement

The RBI follows the margin requirement strategy to avoid bank loss. Under this system, the RBI provides loans less than the requirement of the bank.

Moral Suasion

Sometimes it is not possible or required to control the flow of money directly. At such times, the RBI releases informal advisories to the customers and the banks.

Direct Action

When the banks fail to follow the rules and guidelines passed by the RBI, then it has to take some steps against such banks.

CHANGES IN THE MONETARY POLICY MECHANISM IN INDIA

1. **Liquidity Adjustment Facility (LAF):** The LAF was launched in 2000and was subsequently revised in 2004. It is a short term liquidity management technique. Under this, the RBI sells and purchase govt securities at repo rate and reverse repo rate respectively to absorb or inject money into the economy on short term basis.

2. **Market Stabilization Scheme (MSS):** This instrument for monetary management was introduced in 2004 to withdraw excess liquidity from the economy by selling govt. bonds. . Surplus liquidity arising from large capital inflows is absorbed through sale of government bonds.

3. **Marginal Standing Facility (MSF)**: It was launched in 2011 under LAF for lending funds to the commercial banks. It is a facility under which scheduled commercial banks can borrow additional amount of overnight money from the Reserve Bank.

4. **Demonetization:** Demonetization means that Reserve Bank of India has withdrawn the old ₹500 and ₹1000 notes as an official mode of payment. Demonetization is the act of stripping a

currency unit of its status as legal tender. . On November 2016 the government took the great initiative of demonetization to crack down on black money in the country.

5. **Financial Inclusion:** Financial Inclusion is described as the method of offering banking and financial solutions and services to every individual in the society without any form of discrimination. It primarily aims to include everybody in the society by giving them basic financial services. The main objective is to serve the basic banking services to the unreserved people in the country. Under this, the services should be available for disadvantaged people and low-income groups.