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MONETARY POLICY

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8.1 MONETARY POLICY : MEANING AND DEFINITION

Meaning

Monetary policy is concerned with the changes in the supply of money and credit. It refers to the policy measures undertaken by the central bank to influence the availability, cost and use of money and credit with the help of monetary techniques to achieve specific objectives. Monetary policy aims at influencing economic activity in the economy mainly through two major variables, i.e., (a) money or credit supply, and (b) the rate of interest.

Definition

RBI: Monetary policy refers to the use of instruments under the control of the central bank to regulate the availability, cost and use of money and credit.

A. J. Shapiro : "Monetary policy is the exercise of the central bank's control over the money supply as an instrument for achieving the objectives of economic policy."

N. G. Mankiw : "Monetary policy refers to the setting of the money supply in the economy by the central bank."

G. F. Stanlake : "It is any deliberate action by the monetary authorities which is designed to change the availability (money supply) or the cost of money (rate of interest)."

8.2 OBJECTIVES OF MONETARY POLICY

Monetary policy is not an end in itself, but a means to an end. It involves the management of money and credit for the betterment of the general economic policy of the government to achieve predetermined objectives. The objectives of monetary policy vary in different countries at different times and in different economic conditions.

The objectives often conflict with each other and there is a problem of selecting a right objective for the monetary policy of a country. The proper objective of monetary policy is selected by the monetary authority keeping in view the specific conditions and requirements of the economy.

Various objectives or goals of monetary policy are:

1. **Neutrality of Money:** The neutrality of money is based on the idea that changing the money supply will not change

the aggregate supply and demand of goods, technology or services. In other words, changes in the aggregate money supply only affect nominal variables, rather than real variables; therefore, an increase in the money supply would increase all prices and wages proportionately, but have no effect on real economic output (GDP), unemployment levels, or real prices (prices measured against a base index).

This theory is based on the approach of classical economists such as Wicksteed and Robertson who have considered money as a passive factor. According to them, money should play only the role of a medium of exchange. Thus monetary policy has to regulate the supply of money and neutralise the effect of money expansion. However this objective is always criticised on the ground that if money supply is kept constant then it would be difficult to attain price stability.

2. **Price Stability (low and stable rate of inflation):** Stable prices improve public confidence, promote business activity, and ensure equal distribution of income and wealth. It is a pre-requisite for development.

The stability objective includes maintaining the domestic as well as the external value of the currency, while the development objective requires promoting and supporting a high level of domestic production, employment and growth. In formulating its monetary policy, the central bank takes into consideration the prevailing and prospective domestic economic situation, fiscal operations and emerging external sector developments. In particular, credit and liquidity conditions are continuously monitored by the central bank.

The overriding importance of the price stability objective in monetary policy mirrors the broad consensus among economists that monetary policy only has a temporary

impact on real economic variables (such as e.g., economic growth and unemployment). In the long run, monetary policy only has an influence on monetary variables; this means that steering the increase of price levels (i.e., the inflation rate) naturally falls within the task of monetary policy makers.

3. **Economic Growth:** One of the most important objectives of monetary policy has been the rapid economic growth and development of a country. A suitable monetary policy would help with the proper utilisation of natural and human resources, more capital formation, more employment, increase in national and per capita income along with an increase in the standard of living.
4. **Balance of Payments (BOP) Equilibrium:** Many developing countries suffer from disequilibrium in the BOP. Disequilibrium in BOP can be 'BOP Surplus' or 'BOP Deficit'. The former reflects an excess money supply in the domestic economy, while the later stands for stringency of money. If the monetary policy succeeds in maintaining monetary equilibrium, then the BOP equilibrium can be attained.
5. **Exchange Stability (orderly foreign exchange market and an adequate level of foreign exchange reserves):** Exchange rate is the price of a home currency expressed in terms of any foreign currency. The traditional objective of monetary policy has been the achievement of stable exchange rates. If the exchange rate is very volatile (frequent ups and downs), it leads to the international community losing confidence in the economy. Monetary policy aims at maintaining relative stability in the exchange rate.
6. **Full Employment:** Full employment has been ranked among the foremost objectives of monetary policy. It is an important goal not only because unemployment leads to

wastage of potential output, but also because of the loss of social standing and self-respect. Monetary growth, it is believed will tend to stimulate employment; monetary contraction, to retard employment. The objective of monetary policy is thus to check rising unemployment during a depression.

7. **Reduction in Inequality of Income and Wealth:** Inequality in income and wealth due to right of private property and law of inheritance is a common feature of capitalist and mixed economies. As a result, society is divided into two classes, rich and poor. The objective of monetary policy is to reduce the inequalities of income and wealth.
8. **Creation and Expansion of Financial Institutions:** A major objective of monetary policy in a developing country is to speed up the process of economic development by providing credit facilities and mobilising savings for productive purposes. The monetary authority can help in establishment and expansion of banks and financial institutions in urban and rural areas.

8.3 INSTRUMENTS OF MONETARY POLICY

Since the supply of money consists predominantly of bank deposits, policies designed to control the money supply are concentrated on the activities of commercial banks.

Quantitative Techniques of Credit Control

The most commonly used quantitative techniques include the following:

- (1) Bank Rate
- (2) Open Market Operations

(3) Variable Reserve Requirements

1. Bank Rate (also known as the Discount Rate)

The bank rate is the interest rate charged for the loans that the central bank gives to commercial banks. It is the minimum rate at which the central bank of a country provides loans to the commercial banks of the country. Bank rate is also called discount rate because the central bank provides finance to the commercial bank by rediscounting the bills of exchange.

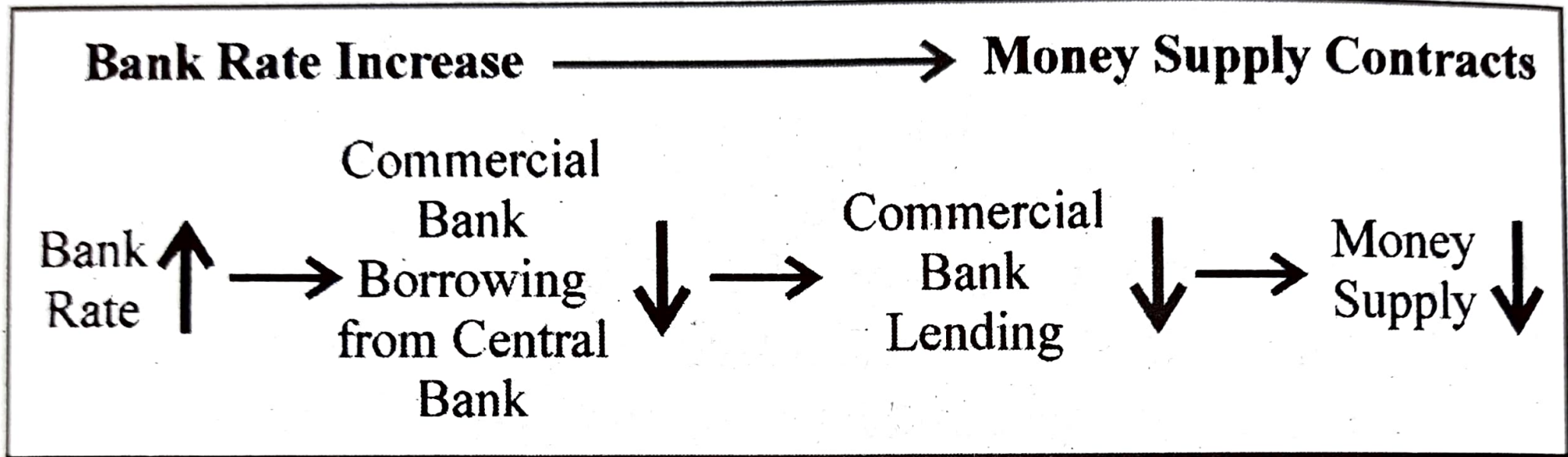
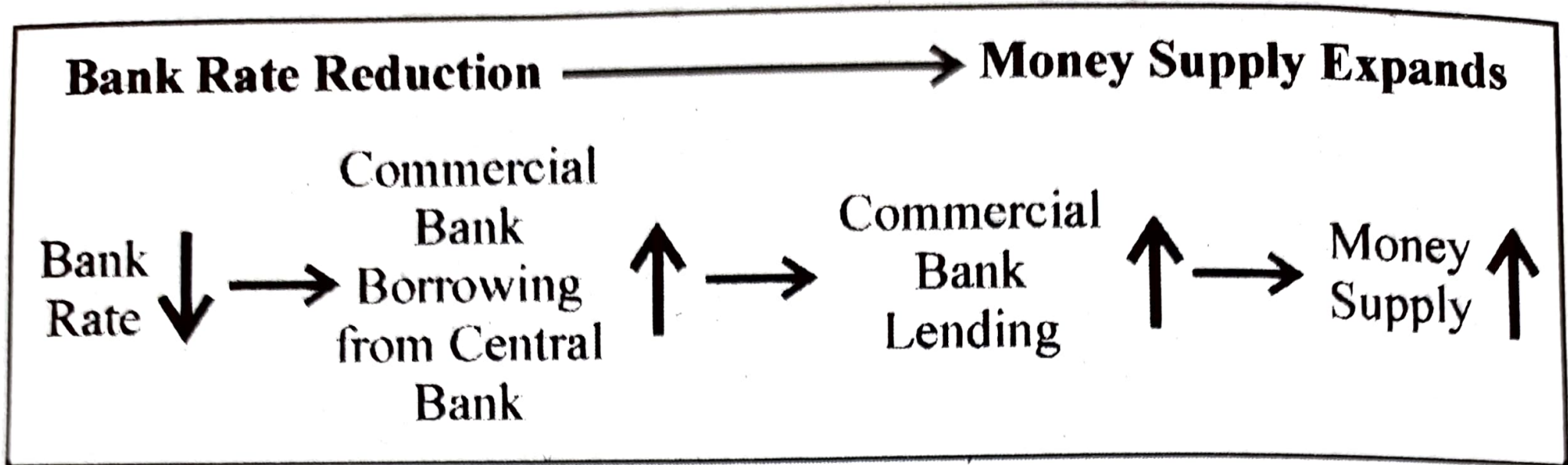
A bank borrows from the central bank when it has too few reserves to meet its reserve requirements. This might occur if it has made too many loans or it has experienced unexpectedly high withdrawals. When the central bank makes such a loan to a bank, the banking system has more reserves than it otherwise would, and these additional reserves allow the banking system to create more money.

The central bank can alter the money supply by changing the discount rate. A higher discount rate discourages banks from borrowing reserves from the central bank. Commercial banks raise their lending rates which results in less borrowings and consequently reduces money supply in the economy. Conversely, a lower discount rate encourages banks to borrow from the central bank, lend at a lower rate of interest and increase the money supply.

A central bank uses discount rate lending not only to control money supply but also to help financial institutions when they are in trouble.

In India the bank rate is the rate at which the RBI is ready to buy or rediscount bills of exchange or other commercial papers. This rate has been aligned to the MSF (Marginal Standing Facility) rate and, therefore, changes automatically as and when the MSF rate changes alongside policy **repo rate changes**.

Box 8.1 : Bank Rate



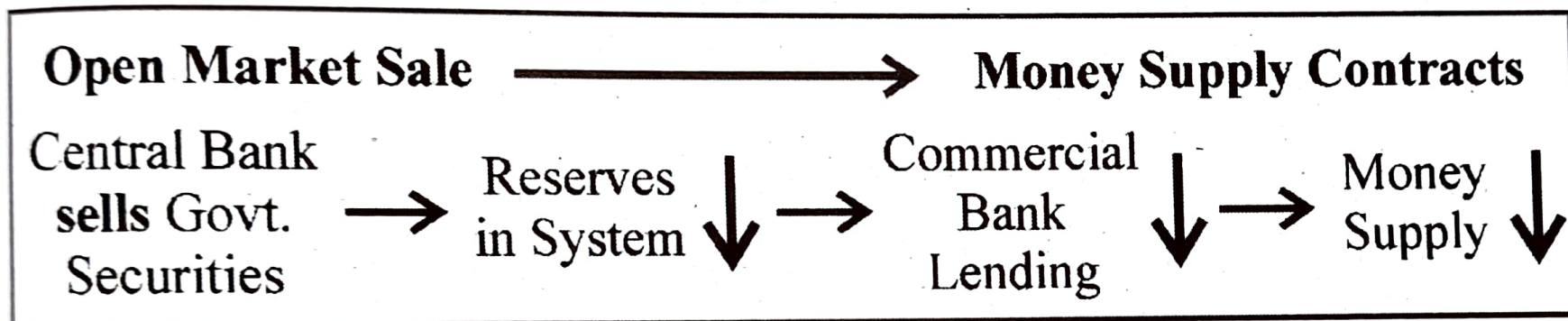
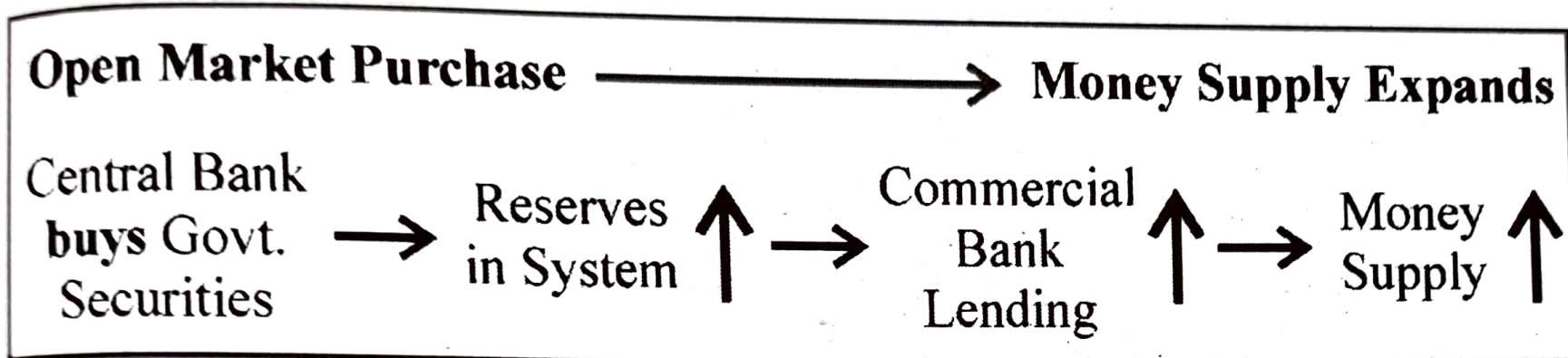
2. Open Market Operations

A central bank conducts open market operations when it buys or sells government securities/bonds. These include both, outright purchase/sale of government securities (for injection/absorption of liquidity). Individuals and institutions are eligible to participate in purchase and sale of securities. Hence it is called 'open market operation'.

To increase money supply or expand credit it buys bonds/securities and to decrease money supply or contract credit, it sells securities/bonds. The rupees paid by the central bank (i.e., the Reserve Bank of India) for the securities/bonds increases the number of rupees in the economy. Some of these rupees may be held as cash and some are deposited in banks. Each rupee held as currency increases money supply by exactly one rupee. Each rupee deposited in a bank increases the money supply to an even greater extent because it creates reserves and therefore the amount of money that the banking system can create.

To reduce the money supply the central bank does the opposite - it sells securities/bonds.

Box : 8.2



Open market operations are easy to conduct and can be used to change the money supply by a large or small amount on any day without major changes in the banking laws or regulations. Therefore, open market operations are the tool of monetary policy that central banks use often.

securities can be encouraged by a rate of discount.

- (iii) **Stable Security Prices** : Wide fluctuations in security prices will render OMO difficult. The security market becomes speculative. Fear of capital loss prevents people from participation in OMO.
- (iv) **Demand for and Supply of Securities** : The Central Bank must possess sufficient stock of securities to sell them whenever needed. There must be enough demand for the securities from the public. If the public do not possess enough securities the central bank will not be successful in its purchasing operations. For the OMO to be successful both the central bank and the public must have sufficient stock of securities.
- (v) **Stable Cash Reserves** : The OMO aims at controlling money supply through the changes in bank reserves. If the banks possess additional reserves or if they opt to work with less than minimum necessary reserves then the OMO would fail in achieving the desired result.

The success of the OMO depends on the existence of the above conditions. Such conditions need not necessarily exist, more so in the developing countries. Therefore, in developing countries the open market operations have limited success. In these countries OMO has been considered more of a public debt management method rather than the monetary control instrument.

3. Variable Reserve Requirements

Reserve requirements are the minimum amount of reserves that banks must hold with the Central Bank of the country (RBI)

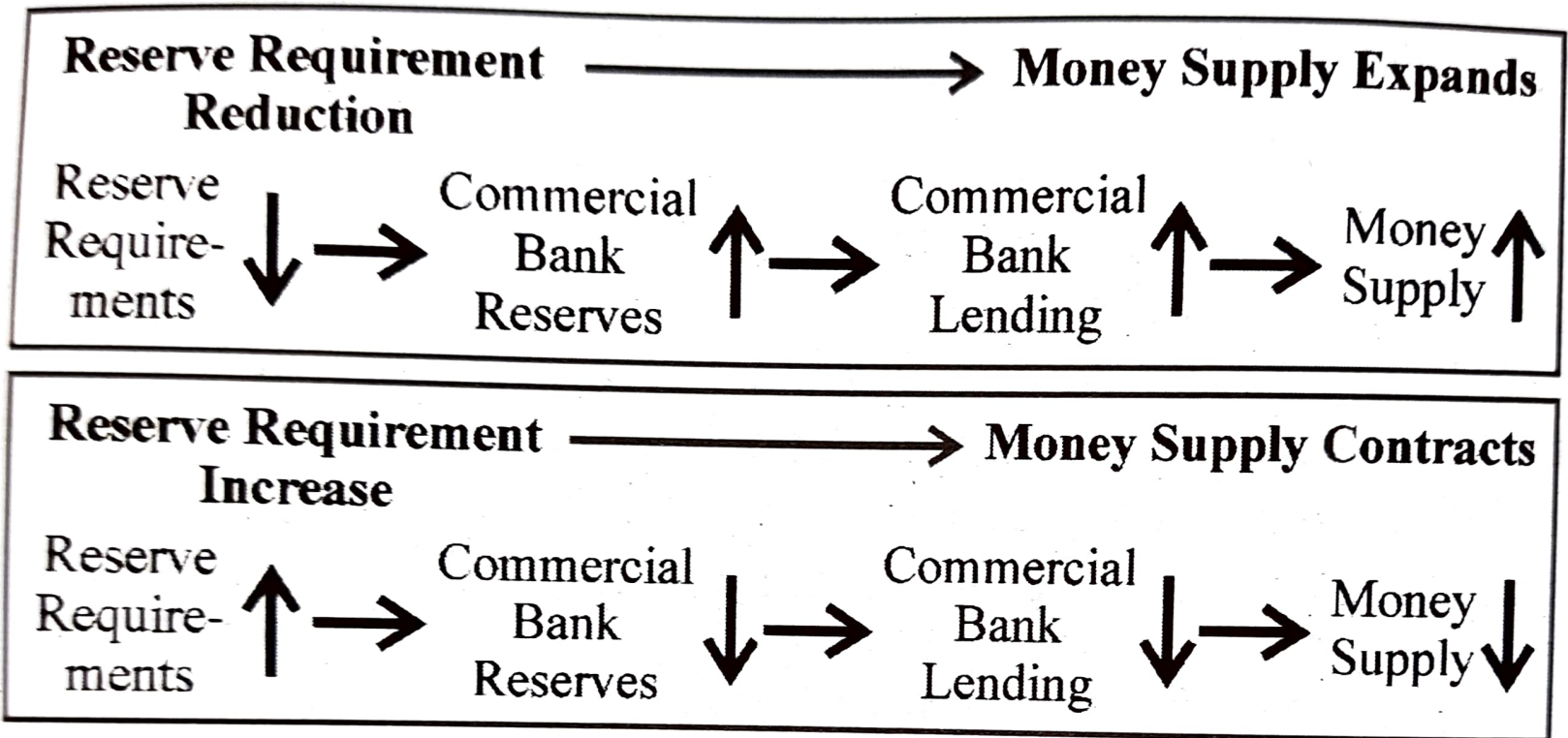
themselves as reserves against deposits. Reserve requirements influence how much money the banking system can create with each rupee of reserves.

An increase in reserve requirements means that banks must hold more reserves and, therefore, can loan less of each rupee that is deposited. Thus, an increase in the reserve requirements raises the reserve ratio, lowers the money multiplier and decreases the money supply. Conversely, a decrease in reserve requirements lowers the reserve ratio, raises the money multiplier and increases the money supply.

In India, there are two components of reserve requirements:

- (1) The Cash Reserve Ratio (CRR)
 - (2) The Statutory Liquidity ratio (SLR)
1. **CRR:** It is the share of net demand and time liabilities (deposits) that banks must maintain as cash balance with the Reserve Bank. This serves two purposes. It ensures that a portion of bank deposits is totally risk-free, and secondly it enables the central bank control liquidity in the system, and thereby, inflation. An increase in the CRR leads to the contraction of credit and a decrease in the CRR leads to an expansion of credit.
 2. **SLR:** The share of net demand and time liabilities (deposits) that banks must 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. The government securities (also known as gilt-edged securities or gilts) are bonds issued by the central government to meet its revenue requirements. Although the bonds are long-term in nature, they are liquid as they can be traded in the secondary market. Note that the SLR is not changed very frequently as compared with the CRR.

Box 8.3 : Reserve Requirement Ratio Operations



The central banks use changes in the reserve requirements occasionally, because frequent changes in the reserve requirements would disrupt the business of banking. When the central bank increases the reserve requirements some banks find themselves short of reserves even though they have had no change in deposits and have to curtail their lending till their reserves are built up to the new level.