Monetary Policy of India:

A tug-of war between inflation control and growth

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Inflation

Inflation occurs due to an imbalance between demand and supply of money, changes in production and distribution cost or increase in taxes on products. When economy experiences inflation, i.e. when the price level of goods and services rises, the value of currency reduces. This means now each unit of currency buys fewer goods and services.

Economic Growth

Economic growth is an increase in the capacity of an **economy** to produce goods and services, compared from one period of time to another. It can be measured in nominal or real terms, the latter of which is adjusted for inflation.

Monetary Policies

Monetary policy is the macroeconomic policy laid down by the central bank. It involves management of money supply and interest rate and is the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity.

- It is concerned with the changing the supply of money stock and rate of interest for the purpose of stabilizing the economy by influencing the level of aggregate demand.
- At times of recession monetary policy involves the adoption of some monetary tools which tends to increase the money supply and lower interest rate so as to stimulate aggregate demand in the economy.
- At the time of inflation monetary policy seeks to contract aggregate spending by tightening the money supply or raising the rate of return.

- To ensure the economic stability at full employment or potential level of output.
- To achieve price stability by controlling inflation and deflation.
- To promote and encourage economic growth in the economy

- Cheap money policy : Followed in periods of slums & depression

- Dear money policy: Followed in periods of boom & inflation.

Open Market Operations

Bank rate

Cash Reserve Ratio

Statutory Liquidity Ratio

Repo rate

Reverse Repo rate

How are the three correlated?

When the RBI buys bonds from the market and infuses liquidity, the consequences are:

It tends to soften the interest rates

It enables corporate to borrow at favorable interest rates

It may tend to increase inflation

Consequently… If the RBI were to sell bonds instead and suck in liquidity, the effect would exactly be the opposite!!

- Any increase in Bank rate results in an increase in interest rate charged by Commercial banks which in turn leads to low level of investment and low inflation

- An increase in CRR reduces the cash with commercial banks which results in low supply of currency in the market, higher interest rate and low inflation

- If the RBI wants to make it more expensive for the banks to borrow money, it increases the repo rate; similarly, if it wants to make it cheaper for banks to borrow money, it reduces the repo rate.

- If the reverse repo rate is increased, it means the RBI will borrow money from the bank and offer them a lucrative rate of interest. As a result, banks would prefer to keep their money with the RBI (which is absolutely risk free) instead of lending it out (this option comes with a certain amount of risk)

Example I

Example II

Thank You!