- ## Monetary policy :

Monetary policy is the process by which monetary authority of a country generally a central bank controls the supply of money in the economy by its control over interest rates in order to maintain price stability & achieve high economic growth .

  - In INDIA,RBI controls the monetary policy. It is announced twice a year.
  - In INDIA there are two monetary season policy .
    - First is SLACK season policy . It’s time duration is April to September.
    - Second is BUSY season policy . it’s time duration is October to March .
    - In busy season policy some difficult decision is taken by RBI .

The Monetary Policy of RBI is not merely one of credit restriction, but it has also the duty to see that legitimate credit requirements are met and at the same time credit is not used for unproductive and speculative purposes RBI has various weapons of monetary control and by using them, it hopes to achieve its monetary policy.

- ## Making of Monetary policy :

What is it that monetary policy-makers do and how do they do it? The simple answer is that a central banker moves interest rates in order to maintain steady real growth and stable prices. In this essay, I examine the issues that arise in framing the problem faced by monetary policy-makers. I begin with a discussion of how, over the past decade or so, central banks have been made more independent and more accountable. The result has been the virtual elimination of the inflation bias problem that is caused by political interference in the monetary policy process, and better overall macroeconomic performance. The essay proceeds with an example of a formal version of the policymakers' problem, describing their objectives and the information they need to formulate a policy rule. I conclude with a discussion of a simple versus complex policy rules, the impact of uncertainty on policy-making, and how central bankers use formal modelling in making their day-to-day decisions.

- ## Importance of monetary policy :

Gross National Product (GNP) = C + I + G + X

Where: C = Private Consumption expenditure
I = Private Investment Expenditure
G = Government Expenditure
X = Net Exports

C, I, X can be influenced by the monetary policy which can also influence the private consumption and investment spending and exports and imports.

- ## Types of Monetary Policy :

There are two types of monetary policy .

1. Expansionary monetary policy .
2. Contractionary monetary policy .

- ## Expansionary Monetary Policy :

Policy that increases the total supply of money in the economy more rapidly than usual and boost the economic activity.

- In the short run: expansionary monetary policy has a positive effect on output, demand and employment.Output and employment will be stimulated by this increase in demand that occurs.
- Advantage: The Feds can buy government bonds from banks and corporations to increase the money supply. More currency is put into the supply of money through buying bonds with currency held in the reserve.
- Effect of expansionary monetary policy over the long-term: Rise in inflation.

Arguments against Expansionary Monetary Policy

- Loosening the monetary policy will cause the bond prices to increase and interest rates to decrease. Demand for local bonds will fall and a demand for foreign bonds will rise, due to the lower interest rates. That will cause a fall in domestic currency and an increase in demand for foreign currency and in turn it will lead to a decline in the exchange rate.

- Effect of expansionary monetary policy over the long-term: Rise in inflation. The expansionary monetary policy will then fail to stimulate actual output and employment opportunities, as there will be an uncertainty due to higher inflation rates generated, also slowing economic activity down.

- ## Contractionary Monetray Policy :

Policy that reduces or contract the total supply of money in the economy to curb the inflation.

- This is done primarily through:
  1. Increasing interest rates
  2. Increasing reserve requirements
  3. Reducing the money supply, directly or indirectly

- This tool is used during high-growth periods of the business cycle, but does not have an immediate effect.
  1. Increasing the interest rate at which the Federal Reserve lends will also increase the rates at which banks lend. When rates are higher, it is more expensive for individuals to obtain loans; this reduces spending.
  2. Central banks can borrow money from institutions or individuals in the form of bonds. If the interest paid on these bonds is increased, more investors will buy them. This will take money out of circulation. Central banks can also reduce the amount of money they lend out or call in existing debts to reduce the money supply.

OBJECTIVES OF MONETARY POLICY

There are mainly 6 objectives of monetary policy .

1. Price stability.
2. High employment .
3. Economic growth .
4. Neutrality of money .
5. Interest rate stability .
6. Stability in foreign exchange market

- ## Price stability:

Price level stability is only a means to a higher goal. That goal is a rising standard of living, which depends upon sustainable growth in real GDP. Whether or not that growth is sustainable depends upon other factors such as technological advances, availability of natural resources, the willingness of people to work, the willingness of people to invest, and political stability. Monetary policy helps to create a stable environment which favors investment and saving.

Achieving Price Level Stability

- The Federal Reserve can quickly affect short-term interest rates, such as three-month T-bills and rates on savings deposits. However, the impact of monetary policy on longer term interest rates is more moderate and more difficult to predict. Longer-term interest rates are more influenced by the supply and demand for investment funds, as opposed to monetary factors. Secondly, the impact of inflation must be taken into account. For example, suppose an expansionary monetary policy is perceived to be inflationary. The impact of that policy on longer-term interest rates, such as real estate mortgages, will be to raise them.

    - Fluctuations bring Uncertainty and Instability to the economy .
    - Ensures equitable distribution of income and wealth .
    - Discourages exports and encourages imports .

- ## High employment:

  Unemployment leads to

  - Wastage of potential output .

  - Loss of social standing & self respect .

- ## Economic growth:

The central bank tries to maintain price stability through controlling the level of money supply. Thus, monetary policy plays a stabilizing role in influencing economic growth through a number of channels. However, the scope of such a role may be limited by the concurrent pursuit of other primary objectives of monetary policy, the nature of monetary policy transmission mechanism, including the uncertainty facing policy makers and the stance of economic policies.

The contribution that monetary policy makes to sustainable growth is the maintenance of price stability. Since sustained increase in price levels is adjudged substantially to be a monetary phenomenon, monetary policy uses its tools to effectively check money supply with a view to maintaining price stability in the medium to long term. In other words, high inflation is damaging to long-run economic performance and welfare. Monetary policy has far reaching impact on financing conditions in the economy, not just the costs, but also the availability of credit, banks' willingness to assume specific risks, etc. It also influences expectations about the future direction of economic activity and inflation, thus affecting the prices of goods, asset prices, exchange rates as well as consumption and investment. ○ A monetary policy decision that cuts interest rate, for example, lowers the cost of borrowing, resulting in higher investment activity and the purchase of consumer durables. The combination of these factors raises output and employment as well as investment and consumer spending.

- Economic growth means increase in per capita income of the country .
- Promote economic growth through ensuring adequate availability of credit and lower cost of credit .

- **Neutrality of money:**

They are of the confirmed view that if somehow neutral monetary policy is followed, there will be no cyclical fluctuations, no trade cycle, no inflation and no deflation in the economy. Under this system, money is kept stable by the monetary authority.

- **Interest rate stability:**

A rate increase will push prices down, or at least rein in rising prices. A rate cut will make prices go up faster. An increased interest rate means that it will cost more to borrow money, and people will have less money left to spend. As a result, the economy will slow down and so will price increases.

- **Stability in foreign exchange market:**

It was popularly known, "Expand Currency and Credit when gold is coming in; contract currency and credit when gold is going out." This system will correct the disequilibrium in the balance of payments and exchange stability will be maintained.

- Fluctuations in exchange rates bring repercussions in the internal price level .

INSTRUMENTS AND TOOLS OF MONETARY POLICY

Instruments of Monetary Policy involve monetary techniques which operate on monetary magnitudes such as money supply, interest rates and availability of credit aimed to maintain :

- price stability,
- Stable exchange rate,
- Healthy Balance of payment,
- Financial stability,
- Economic growth.

These techniques have been broadly classified into two categories:

- Quantitative or General credit control techniques
- Qualitative or selective credit control techniques

• QUANTITATIVE OR GENERAL CREDIT CONTROL TECHNIQUES

These tools are related to quantity or volume of credit. They are employed to regulate the overall level of credit in the economy. These methods are designed to effect the lendable resources of commercial banks either directly affecting their reserve base or by making the cost of funds cheaper or dearer to them.

QUANTITATIVE TECHNIQUES:

- Bank rate
- Repo and reverse repo rate
- Open market operations
- Cash reserve ratio
- Statutory liquidity ratio

• BANK RATE :

It is the rate at which commercial banks borrows from the reserve bank. It is also known as “discount rate”. It is the rate of interest charged by RBI for providing funds or loans to the banking system.

The Reserve Bank makes changes in Bank Rate often depending upon liquidity position of banks, short-term interest level, and inflation.

BANK RATE AS A TOOL DURING INFLATION:

At the time of inflation , when the supply of money is more in the economy RBI adopts **"dear money policy"** .

It increases the bank rate.

⇓

Credit becomes costlier for the commercial banks.

⇓

Commercial banks increase their lending rates.

⇓

Higher rate of interest for loans from commercial banks

⇓

Demand for credit among the public decreases

⇓

Lower demand and price level is lowered.

- **<u>REPO RATE :</u>**

Repo rate is the rate at which RBI lends money to commercial banks in the event of shortfall of funds against government securities. It is a kind of "repurchase agreement".

- **<u>REVERSE REPO RATE :</u>**

It is the interest rate paid to the bank by RBI which parks its excess liquidity with RBI i.e. it is the rate at which RBI borrows money from commercial banks.

- Increase in Repo rate discourages the commercial banks to get money as the rate increases and becomes expensive.
- As the rates are high the availability of credit and demand decreases resulting to decrease in inflation.

- **<u>OPEN MARKET OPERATIONS:</u>**

Open market operations refer to sale and purchase of securities in the money market by the central bank.

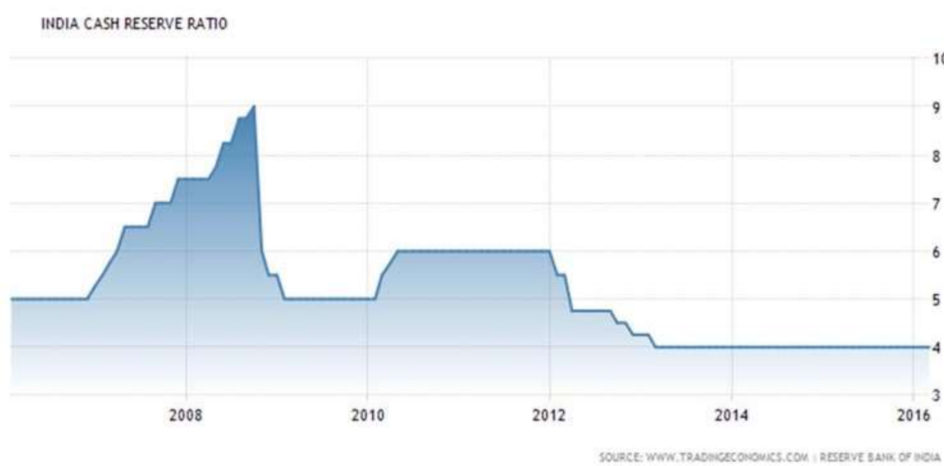
It influences the reserves of the banks. RBI sells government securities to control the flow of credit and buys to increase the flow of credit.

- During **inflation ,** RBI sells securities in open market ,commercial banks and private individuals buy them which reduces existing money supply as money gets transferred to RBI

- **<u>CASH RESERVE RATIOS(CRR):</u>**

Every commercial bank has to keep a certain percentage of its total deposits in the form of cash with the RBI.

- When RBI lowers CRR , it allows banks to have surplus money that they can lend to or invest



During financial crisis , there was a drop in foreign investment ,external commercial borrowing, decline in foreign exchange reserves,Policy rates decreased to increase rupee liquidity in banking system.

- **<u>STATUTORY LIQUIDITY RATIO(SLR):</u>**

It is the ratio of cash deposits that banks have to maintain in the form of gold , cash and other securities.

$$\textbf{SLR} = \frac{\text{Liquid assets (gold, securities)}}{\text{demand + time liabilities}} \times 100$$

- Time liabilities are liabilities which the banks are liable to pay after a certain period of time.

- Demand liabilities are those which the banks are liable to pay on being demanded by customer.

The main objectives of SLR are:

- To create or support a market for government securities in the economy which do not have a developed capital market and to allocate resources to government for augmenting the resources of the Public Sector.

CRR controls liquidity in economy while **SLR** regulates credit growth in country. Banks themselves maintain SLR in liquid form while CRR is with RBI maintained as cash.

• QUALITATIVE OR SELECTIVE CREDIT CONTROL

These techniques are intended to ensure an adequate credit flow to desired sectors & prevent excessive credit for less essential economic activities. It aims at controlling specific rates of credit .

QUALITATIVE TECHNIQUES:

- Margin requirements
- Credit rationing
- Regulation of consumer credit
- Moral suasion
- Direct action

- **MARGIN REQUIREMENTS :**

It is the part of a loan which a consumer has to raise in order to get finance for his purpose.

Margin requirement as a tool:

RBI increases margin requirements when it wants to decrease the supply of money and vice-versa.

- **REGULTION OF CONSUMER CREDIT :**

Credit facilities provided by banks to consumers to purchase durables is known as **consumer credit** . consumer credit is regulated through hire-purchase and installment sale of consumer goods.

- If there is excess demand for certain consumer durables which lead to their high prices , RBI can reduce consumer credit by
  - Reducing number of installments of repayment of credit.
  - Increasing down payment.

- **MORAL SUASION :**

It implies pressure exerted by RBI without any strict action for compliance of rules. It is a means of strengthening mutual confidence and understanding between monetary authority and the banks .

Following are some of the guidelines given by RBI :

- in regard to lending to priority sectors. The nationalization of the leading banks has enhanced the scope of this weapon in credit control. To refrain from lending for speculative purposes.
- To reduce the level of advances against certain commodities without prejudice to their assistance to industry.
- To increase their investment in government securities.
- To maintain exchange rate stability, mostly to arrest falling rate of rupee

- **DIRECT ACTION :**

RBI is empowered to take certain penal actions against banks which do not follow line of policy . When the moral suasion proves ineffective , RBI uses direct action on banks. Default banks may have to suffer :

- Levying penal interest rates on the defaulting banks.
- Cancelling the licences of such banks (extreme step)
- Refusing to grant refinance facilities to such banks.
- Putting lending restrictions on the banks.
- Not permitting opening of new branches for the banks.
- Not allowing participation in money market, etc.

Trends in Monetary Policy of India

Pre-reform Period (1972-91)- Tight Monetary Policy

- A good part of fiscal deficit was monetised that is, financed by borrowing from Reserve Bank which created money against treasury bills issued by the Government. This resulted in a very large increase in Reserve Bank credit to the Government which caused rapid growth in money supply.
- Statutory Liquidity Ratio (SLR) had progressively raised to meet the borrowing needs of the Government and eventually it was increased to the maximum limit of 38.5 per cent.
- The banks were compelled to fund most of the large fiscal deficit at below the market rates of interest as they had to meet the high and rising SLR imposed on them by Reserve Bank of India.

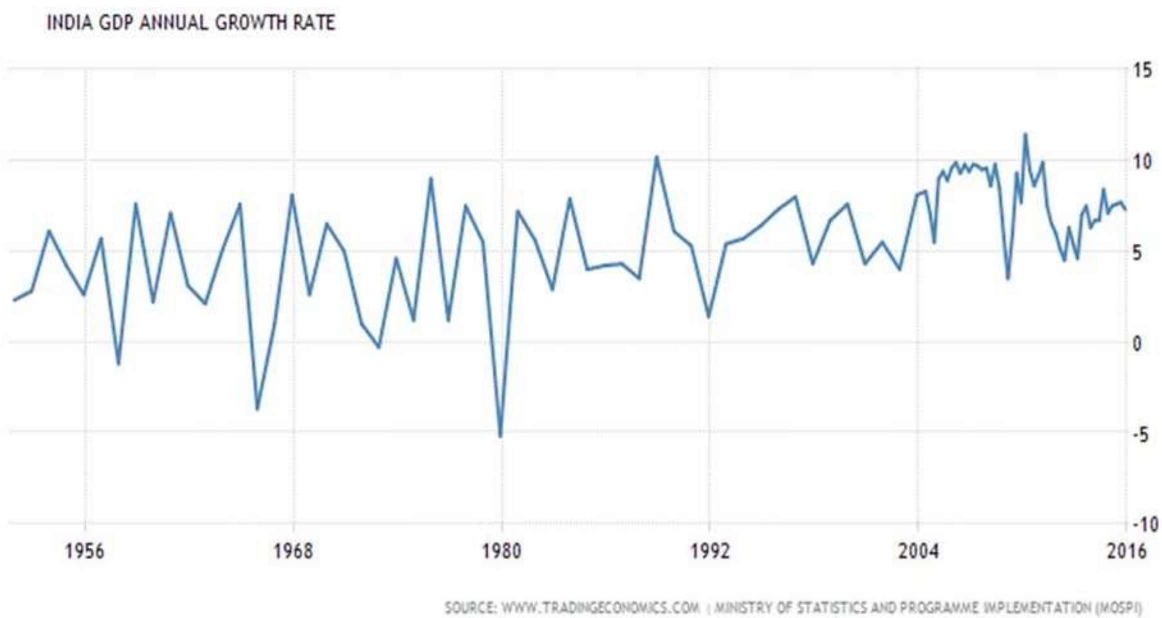
Post Reform Period (1991-96):

- The year 1991 -92 saw a fundamental change in the institutional framework for the adoption of the proper monetary policy to achieve the twin objectives of price stability and economic growth. The crucial economic reforms were undertaken to tackle the economic crisis that overtook the Indian economy in the early nineties. All the structural changes in the institutional framework required changes in the conduct of monetary policy by the Reserve Bank of India in terms of objectives and the use of various instruments of monetary control.
- Rapid growth of money supply is an important factor responsible for causing high rate of inflation in the Indian economy. With automatic monetisation of the budget deficit, the task of RBI was merely to neutralise the inflationary impact of the Government deficit. For this, cash reserve ratio (CRR) was gradually raised to its statutory maximum limit of 25% and Statutory Liquidity Ratio (SLR) to the maximum ceiling of 38.5%.
- To control inflationary pressures in the Indian economy Reserve Bank raised bank rate from 10 per cent to 11 per cent in July 1991 and further to 12 per cent in October 1991. Raising of lending rates of interest on the advances to the businessmen was intended to discourage demand for credit.

Effect of Monetary Policy of India

1. **Economic Growth:**

The era of 1991-96 and 2008-10 reflects the effect of monetary policy of the country.It is the monetary policy of the country which even after the great depression of 2008 in USA marks the highest economic growth in India. At that time, India adopted expansionary policy allowing investors to invest in Indian market and loosening strict regulations. Similar is the effect at the time of 1991-96 when even after huge fiscal deficit reforms in the monetary policy marked the highest growth of the decade.



2. **Assurance of Financial Stability:**

Monetary Policy of India always make efforts to maintain the financial stability in the country. It ensures that not only rich gain from such policies but benefits are reached to poor people also.

Poverty headcount ratio at national poverty lines (% of population)

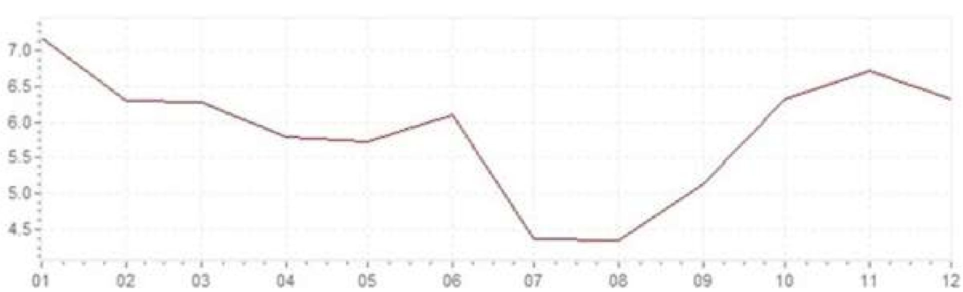
%of Population	Year
21.9%	2011
29.8%	2009
37.2%	2004
45.3%	1993

Source : data.worldbank.org

3. **Balance between Inflation and Deflation:**

As from the graphs, it is clear that balance among inflation, deflation and economic growth is maintained. Rates are cut down or increased when needed accordingly.

Chart – current CPI inflation India
(yearly basis) – last 12 months



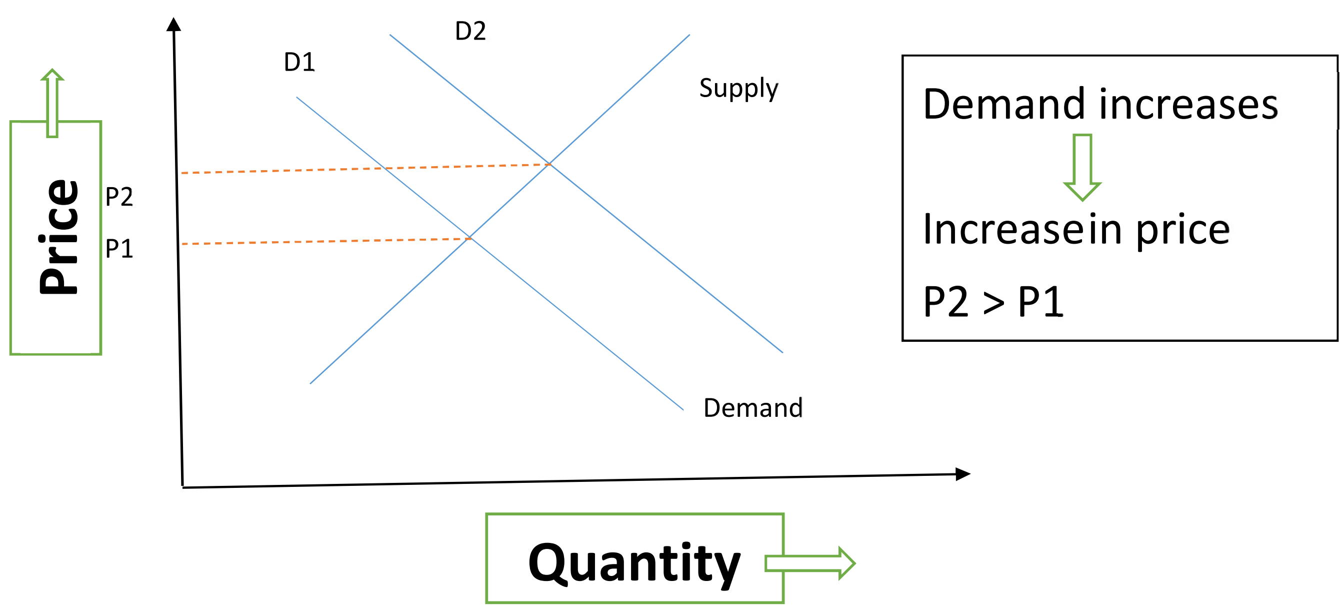
Source – www.inflation.eu | Ministry of Labour & Employment , Govt. of India

The Growth-Inflation Tug of War

"Too less sugar means a bitter coffee, and too much sugar has health consequences"

Bank of India (RBI) likes its coffee bitter. Central government likes it too sweet. The twist is that there is a recipe sufficient only for one cup!

The Finance Minister Arun Jaitley is stapping up pressure on RBI to cut rates while on the other hand the RBI Governor seems still wary of interest rate cuts as he fears inflation the most.



- The central government bends more in favour of high economic growth and likes to see interest rates cut so that cost of capital goes down and economic activity picks up helping growth of economy.

- For laymen, rate cut refers to reduction in interest rates charged by RBI on lending to commercial banks (Repo Rate). A high rate makes borrowings costly and reduces money supply to the markets. Reduced money supply in markets pins down demand in economy as a whole and helps prices come down. On the flip side, reduction in aggregate demand slows down economic activity and reduces growth in Gross Domestic Product (GDP) which is an indicator of economic growth.

- Thus there is always a tug of war between inflation and economic growth. On increasing economic growth, inflation also increases side by side which is a bad indicator in an economy.

- Thus, we should promote economic growth in such a way that inflation doesn't rise too much and prices are in reach of common man also and even poor get also benefited with the growth of economy.

Limitations of Monetary Policy of India

1. **Unfavourable Banking Habits**:

An important limitation of the monetary policy is unfavourable banking habits of Indian masses. People in India prefer to make use of cash rather than cheque. This means that a major portion of the cash generally continues to circulate in the economy without returning to the banks in the form of deposits. This reduces the credit creation capacity of the banks.

2. **Underdeveloped Money Market:**

The money market comprises of the parts, the organised money market and unorganised money market. The money policy works only in organised money market. It fails to achieve the desired results in unorganised money market.

3. **Existence of Black Money**:

The black money is not recorded since the borrowers and lenders keep their transactions secret. Consequently the supply and demand of money also not remain as desired by the monetary policy.

4. **Influence of Non-monetary factors**:

The monetary policy can never be the primary factor in controlling inflation originating in real factors, deficit financing and foreign exchange resources.

5. **Not Proper Implementation**:

The success of the monetary policy depends on the timely implementation of it. However, in many cases unnecessary delay is found in implementation of the monetary policy.

6. **Conflicting Objectives**:

To achieve the objective of economic development the monetary policy is to be expansionary but contrary to it to achieve the objective of price stability a curb on inflation can be realised by contracting the money supply. The monetary policy generally fails to achieve a proper coordination between these two objectives.

Conclusion

To conclude, monetary policy is helpful in attaining economic growth with stability. However, there are challenges in maintaining the momentum mainly because of the conflicting objectives of economic growth and inflation control.

- For this Govt. and RBI should work with accordingly to achieve the goal. In current budget of 2016-17 Monetary Policy Committee(MPC) has formed which will fix the benchmark interest rate of the central bank and set inflation targets.

The proposed committee will have six members, with three appointed by the Reserve Bank of India (RBI) and the remaining nominated by an external selection committee. The RBI governor will have the casting vote in case of a tie.

- According to the Finance Bill, the committee will consist of the RBI governor, the deputy governor in charge of monetary policy and one official nominated by the central bank.

Such steps taken in future will be helpful to control increasing inflation and enhancing economic growth.

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