Monetary Policy

Introduction

- It includes the measures undertaken to regulate the supply of money, the cost and availability of credit in the economy.
- Instruments of monetary policy are, changes in supply of currency, variations in bank rates and interest rates, open market operations, selective credit controls, and variations in reserve requirements.

Objectives

- Price stability or control of inflation
- Economic growth – through availability of credit
- Exchange rate stability – changes in interest rates can help to control demand for or supply of foreign currency in the foreign exchange market.

Role of Monetary Policy in Economic Growth

- Increase in aggregate savings in the economy – through higher rates of interest
- Mobilisation of these savings so that they are made available for the purpose of investment and production
- Increase in rate of investment – increase in public investments through changes in Statutory Liquidity Ratio (the portion of the deposits that banks are required to keep in the form of specified liquid assets by investing in government and other securities); increase in private investments through provision of term loans to the private sector.
- Allocation of investment funds for productive purposes and priority sectors of the economy – through selective credit controls.

Functions of Central Bank

- Acts as a note issuing agency – has the monopoly in issuing notes or paper currency to the public
- Banker to the government – all balances of the government are kept with the central bank; on these balances central bank pays no interest; central bank receives and makes payments on behalf of the government, and provides loans to the government.
- Banker to the bank – central banks act as (1) custodian of the cash reserves of the commercial banks; (2) lender of the last resort.
- Control of credit
- To promote economic development
- Exchange rate stability

Methods of Credit Control

Quantitative Methods

- Bank rate policy – Bank rate is the minimum rate at which central bank of a country provides loans to the commercial bank of the country. Rise in bank rate will discourage borrowings by the commercial banks from the central bank.
- Open market operations – purchase and sale of securities by the central bank of a country. Sale of securities to the commercial banks results in fall in cash balances of the commercial banks and hence their lending abilities.
- Changes in cash reserve ratio – amount of cash to be held as reserves by the commercial banks, against the deposits received.

Methods of Credit Control cont.

Qualitative Methods

- Selective credit control – regulate the flow of credit for particular or specific purposes

Functions of Commercial Banks

- Accepting deposits – demand deposits (current account deposits), fixed deposits (time deposits), savings bank deposits
- Advancing loans
- Discounting bills of exchange
- Transfer of money
- Miscellaneous functions – provision of locker facilities, collects interest on behalf of customers, pays dividends on behalf of joint stock companies etc.

Credit Creation by Commercial Banks

Balance Sheet of Bank A			
Assets		Liabilities	
Cash	20,000	Deposits	1,00,000
Loan	80,000		

Balance Sheet of Bank B			
Assets		Liabilities	
Cash	16,000	Deposits	80,000
Loan	64,000		

Balance Sheet of Bank C			
Assets		Liabilities	
Cash	12,800	Deposits	64,000
Loan	51,200		

Credit Creation by Commercial Banks cont.

Total Deposit creation by all banks:

1,00,000+80,000+64,000+51,200+…….

$= 1{,}00{,}000+1{,}00{,}000(1\text{-}cr)+1{,}00{,}000(1\text{-}cr)^2+\ldots\ldots.$

$=1{,}00{,}000[1+(1\text{-}cr)+(1\text{-}cr)^2+\ldots\ldots..$

$=1{,}00{,}000/(1\text{-}1+cr)$

=1,00,000/0.20

=5,00,000