

Monetary Policy

Definition: 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.

Description: In India, monetary policy of the Reserve Bank of India is aimed at managing the quantity of money in order to meet the requirements of different sectors of the economy and to increase the pace of economic growth.

The RBI implements the monetary policy through open market operations, bank rate policy, reserve system, credit control policy, moral persuasion and through many other instruments. Using any of these instruments will lead to changes in the interest rate, or the money supply in the economy. Monetary policy can be expansionary and contractionary in nature. Increasing money supply and reducing interest rates indicate an expansionary policy. The reverse of this is a contractionary monetary policy.

For instance, liquidity is important for an economy to spur growth. To maintain liquidity, the RBI is dependent on the monetary policy. By purchasing bonds through open market operations, the RBI introduces money in the system and reduces the interest rate.

Objectives of Monetary Policy

i. 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.

ii. To Attain Price Stability:

Another major objective of monetary policy in India is to maintain price stability in the country. Stable prices improve public confidence, promote business activity & ensure equal distribution of income & wealth. Price level, is affected by money supply. Monetary policy regulates money supply to maintain price stability

iii. 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.

iv. 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.

v. 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.

vi. To Promote Exports and Substitute Imports:

By providing concessional loans to export oriented and import substitution units, monetary policy encourages such industries and thus help to improve the position of balance of payments.

vii. 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.

viii. 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.

ix. Employment Generation

The monetary policy of a country can influence the rate of investment and its allocation among the different economic activities of the country with varying labor intensities. Therefore, it helps in employment generation.

x. To Develop Infrastructure:

Monetary policy aims at developing infrastructure. It provides concessional funds for developing infrastructure.