INSTRUMENTS OF MONETARY POLICY

Monetary policy is a way for the RBI to control the supply of money in the economy. So these credit policies help control the inflation and in turn help with the economic growth and development of the country. So now let us take a look at the various instruments of monetary policy that the RBI has at its disposal.

1. Open Market Operations:

Open market operations refer to sale and purchase of securities in the money market by the central bank. When prices are rising and there is need to control them, the central bank sells securities. The reserves of commercial banks are reduced and they are not in a position to lend more to the business community.

Further investment is discouraged and the rise in prices is checked. Contrariwise, when recessionary forces start in the economy, the central bank buys securities. The reserves of commercial banks are raised. They lend more. Investment, output, employment, income and demand rise and fall in price is checked.

2. Bank Rate

One of the most effective instruments of monetary policy is the bank rate. A bank rate is essentially the rate at which the RBI lends money to commercial banks without any security or collateral. It is also the standard rate at which the RBI will buy or discount bills of exchange and other such commercial instruments.

So now if the RBI were to increase the bank rate, the commercial banks would also have to increase their lending rates. And this will help control the supply of money in the market. And the reverse will obviously increase the supply of money in the market.

3. Variable Reserve Requirement

There are two components to this instrument of monetary policy, namely – The Cash Reserve Ratio (CLR) and the Statutory Liquidity Ratio (SLR). Let us understand them both.

Cash Reserve Ratio (CRR) is the portion of deposits with the commercial banks that it has to deposit to the RBI. So CRR is the percent of deposits the commercial banks have to keep with the RBI. The RBI will adjust the said percentage to control the supply of money available with the bank. And accordingly, the loans given by the bank will either become cheaper or more expensive. The CRR is a great tool to control inflation.

The Statutory Liquidity Ratio (SLR) is the percent of total deposits that the commercial banks have to keep with themselves in form of cash reserves or gold. So increasing the SLR will mean the banks have fewer funds to give as loans thus controlling the supply of money in the economy. And the opposite is true as well.

4. Liquidity Adjustment Facility

The liquidity adjustment facility (LAF) is a tool used in monetary policy, mainly by the Reserve Bank of India (RBI), which enables banks to borrow money through repurchase agreements (repo) or banks to lend to the RBI using reverse repo contracts. This arrangement manages liquidity pressures and ensures basic financial-market stability.

The repo rate is actually the rate at which commercial banks and other institutes obtain short-term loans from the Central Bank.

And the reverse repo rate is the rate at which the RBI parks its funds with the commercial banks for short time periods. So the RBI constantly changes these rates to control the flow of money in the market according to the economic situations.

5. Moral Suasion

This is an informal method of monetary control. The RBI is the Central Bank of the country and thus enjoys a supervisory position in the banking system. If there is a need it can urge the banks to exercise credit control at times to maintain the balance of funds in the market. This method is actually quite effective since banks tend to follow the policies set by the RBI.