Monetary Policy

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About 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 exercising its control over interest rates in order to maintain price stability and achieve high economic growth.

- In India, the central monetary authority is the Reserve Bank of India (RBI) is so designed as to maintain the price stability in the economy

- RBI controls the monetary policy.

Objectives of Monetary

1. Price Stability: It means this policy should be able to reduce inflation rates
2. Controlled Expansion Of Bank Credit
3. Promotion of Fixed Investment: The aim here is to increase the productivity of investment by restraining non essential fixed investment.
4. Restriction of Inventories: The main objective of this policy is to avoid over- stocking and idle money in the organization
5. Promotion of Exports: Monetary policy pays special attention in order to boost exports and facilitate the trade so that favourable balance of payment is maintained

6. Desired Distribution of Credit: Monetary authority has control over the decisions regarding the allocation of credit to priority sector and small borrowers.

7. Equitable Distribution of Credit: The policy of Reserve Bank aims equitable distribution to all sectors of the economy and all social and economic class of people

8. To Promote Efficiency: It tries to increase the efficiency in the financial system and tries to incorporate structural changes such as deregulating interest rates, ease operational constraints in the credit delivery system.

9. Reducing the Rigidity: RBI tries to bring flexibility in the operations

Tools of Monetary Policy

Monetary Policy Tools

Quantitative Measures

Qualitative measures

Tools of Monetary Policy/ Monetary Operations

- Monetary operations 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.
- RBI, the apex institute of India which monitors and regulates the monetary policy of the country stabilizes the price by controlling Inflation.
- RBI takes into account the following monetary policies.

Quantitative measures

1. Open Market Operations:

- An open market operation is an instrument of monetary policy which involves buying or selling of government securities from or to the public and banks.
- This mechanism influences the reserve position of the banks, yield on government securities and cost of bank credit.
- The RBI sells government securities to contract the flow of credit and buys government securities to increase credit flow.
- Open market operation makes bank rate policy effective and maintains stability in government securities market.

Repo

- The repo or repurchase rate is the interest charged by the RBI to banks when they approach it for short-term loans.
- The repo rate is linked to the interest rate borrowers pay when they take loans from banks because the latter always charges interest which is higher than the existing
- Hence, lower repo rates could induce lenders into lowering the interest rates they charge from individual borrowers too, thereby making credit more affordable
- When the repo rate is raised, banks are compelled to pay higher interest to the RBI which in turn prompts them to raise the interest rates on loans they offer to customers.

Tools of Monetary Policy

2. Bank Rate Policy:

- The bank rate, also known as the discount rate, is the rate of interest charged by the RBI for providing funds or loans to the banking system.
- This banking system involves commercial and co-operative banks, Industrial Development Bank of India, IFC, EXIM Bank, and other approved financial institutes.
- Funds are provided either through lending directly or rediscounting or buying money market instruments like commercial bills and treasury bills.

Tools of Monetary Policy

- Increase in Bank Rate increases the cost of borrowing by commercial banks which results into the reduction in credit volume to the banks and hence declines the supply of money.
- Increase in the bank rate is the symbol of tightening of RBI monetary policy.
- Current bank rate is 4.25%

Tools of Monetary Policy

3. Cash Reserve Ratio:

- Cash Reserve Ratio is a certain percentage of bank deposits which banks are required to keep with RBI in the form of reserves or balances .
- Higher the CRR with the RBI lower will be the liquidity in the system and vice-versa.
- RBI is empowered to vary CRR between 15 percent and 3 percent.
- the CRR is 4.00 percent.

4 . Statutory Liquidity Ratio:

- Every financial institution has to maintain a certain quantity of liquid assets with themselves at any point of time of their total time and demand liabilities.
- These assets can be cash, precious metals, approved securities like bonds etc.
- The ratio of the liquid assets to time and demand liabilities is termed as the Statutory liquidity ratio.
- There was a reduction of SLR from 38.5% to 25% because of the suggestion by Narshimam Committee.
- The current SLR is 18%

Qualitative measures

1. Credit Rationing:

- Under this method there is a maximum limit to loans and advances that can be made, which the commercial banks cannot exceed.
- RBI fixes quota for member banks.
- Such rationing is used for situations when credit flow is to be checked, particularly for speculative activities.
- If member banks need loan more than the quota, they will have to pay higher rate of interest

Tools of Monetary Policy

2. Marginal Requirement:

- Marginal Requirement of loan = current value of security offered for loan-value of loans granted.
- If you increase the marginal requirement the flow of credit will be restricted in the economy.
- In case the flow of credit has to be increased, the marginal requirement will be lowered.
- e.g.- a person mortgages his property worth Rs. 1,00,000 against loan.
- The bank will give loan of Rs. 80,000 only. Remaining 20000 is the margin

Tools of Monetary Policy

3. Moral Suasion:

- This method is also known as "Moral Persuasion" as the method that the Reserve Bank of India, being the apex bank uses here, is that of persuading the commercial banks to follow its directions/orders on the flow of credit.
- RBI puts a pressure on the commercial banks to put a ceiling on credit flow during inflation and be liberal in lending during deflation.

Tools of Monetary Policy

4 . Direct Action:

- Under the banking regulation Act, the central bank has the authority to take strict action against any of the commercial banks that refuses to obey the directions given by Reserve Bank of India.
- There can be a restriction on advancing of loans imposed by Reserve Bank of India on such banks. e.g. - RBI had put up certain restrictions on the working of the Metropolitan Co-operative Banks.

5. Credit Authorization schemes: under this scheme banks had to seek authorization from RBI before sanctioning any fresh limit of Rs. 1 crore or more to single party. This limit was raised to 6 crore

Impact OF The Monetary Policy

1. Impact of cut in CRR on interest rates
2. Impact of change in SLR and gilt products on interest rates
3. Impact on domestic industry and exporters
4. Impact on stock markets and money supply
5. Impact of money supply on jobs, wages, and output

Evaluation/Limitation of Monetary Policy

1. Time Gap:

- It involves time taken in formulating & implementing monetary policy in an economy.
- Time Lag increases, it would not only result in new types of economic problems

2. Difficulty in Forecasting:

- Implies that monetary policy can be effective if there is proper analysis of economic problems for which the policy to be implemented should be assessed properly.

Limitation of Monetary Policy

3. Non-Banking Financial Intermediaries:

- Refers to that the growth of financial market has decreased the scope of monetary policy.
- This new segment of the economy is responsible in grabbing the share of commercial banks.

4. Less Development of Money & Credit Market:

- Acts as one of the important factors for ineffectiveness of monetary policy.
- The effectiveness of monetary policy depends upon the efficiency of money & credit market
- Therefore monetary policy in these countries has proved ineffective.

Limitation of Monetary Policy

5. Excessive fiscal deficit and government borrowing: high investment needs of the country has lead to high deficit condition and further increasing the inflation.
6. Excessive increase in bank credit to commercial sector: excessive credit to commercial banks have led to failure of the monetary system.
7. Limited role in reducing the inflationary conditions