"Monetary Policy"

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Monetary Policy:

What it is?

An economic policy that manages the size and growth rate of money supply. It involves managing interest rates and credit conditions which influences the levels of economic activity.

Who controls monetary policy?

Most Governments have a central bank that controls monetary policy. In India, The R.B.I. (Reserve Bank of India) used to control the financial instruments to achieve the ultimate objective of economic policy mentioned in the Reserve Bank of India Act, 1934.

Objective of Monetary Policy of R.B.I.

The three objectives of monetary policy of R.B.I. are:
1) Price stability or control of inflation.
2) Economic growth and
3) Exchange rate stability.

Tools of Monetary Policy: -

The instrument of monetary policy are of two types: First, quantitative, general or indirect, and Second, qualitative, selective or direct. The first category includes bank rate variations, open market operations and changing reserve requirements. They are meant to regulate the overall level of credit in the economy through commercial banks. The selective credit controls aim at controlling specific types of credit. They include changing margin requirements and regulation of consumer credit.

Quantitative Tools: -

1. **Bank Rate (Discount rate) Policy:** - Bank rate refers to the rate at which the Central bank lends money to Commercial banks as the lender of the last resort. The bank rate is announced by the Central bank at regular intervals in response to the needs of money market. The Central bank advances loans against approved securities or eligible bills of exchange.

   When the Central Bank finds that inflationary pressures have started emerging within the economy, it raises the bank rate. Borrowings from the Central bank becomes costly and commercial banks borrow less from it. It forces the Commercial banks to increase their lending rates, which discourages borrowers from taking loans. There is contraction of credit and prices are checked from rising further. On the contrary, when prices are depressed, the Central bank lowers the bank rate. It is cheap to borrow from the Central bank on the part of commercial banks. The latter also lower their lending rates. Business men are encouraged to borrow more. Investment is geared up. Output, employment, income and demand start rising and the downward movement of prices is checked.

2. **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. On the contrary, when recessionary forces start in the economy, the Central Bank buys securities. The reserves of Commercial Banks are raised. They lend more. Automatically Investment, output, employment, income and demand rise and fall in price is checked.

3. **Legal Reserve Requirements: -** This weapon was suggested by Keynes_in his Treatise on Money and the USA was the first to adopt it as a monetary device. According to Legal reserve requirements, Commercial banks are obliged to maintain reserves. Commercial Banks required to maintain reserves on two accounts:
    a) **Cash Reserve Ratio (CRR)**:- It refers to the minimum percentage of net demand and time Liabilities, to be kept by Commercial Banks with the Central Bank. A change in CRR affects the ability of Commercial Banks to create the credit. For example, an increase in CRR reduces the excess reserves of Commercial Banks and limits their credit creating power.
    b) **Statutory Liquidity Ratio (SLR)**: - It refers to minimum percentage of net demand and time liabilities which Commercial Banks are required to maintain with themselves. SLR is maintained in the form of designated liquid assets such as excess reserves, Govt. and other approved securities or current account balances with other banks change in SLR affects the freedom of banks to sell Govt. securities or borrow against them from the Central Bank. An increase in SLR reduces the ability of banks to give credit and vice versa.

    When prices are rising, the Central Bank raises the reserve ratio. Banks are required to keep more with the Central bank. Their reserves are reduced and they lend less. The volume of investment, output and employment are adversely affected. In the opposite case, when the reserve ratio is lowered, the reserves of Commercial Banks are raised. They lend more and the economic activity is favourably affected.

Qualitative Tools: - The important Qualitative instruments are:

1. **Margin Requirements**: - Margin is the difference between the amount of loan and market value of the security offered by the borrower against the loan. By changing the margin requirements the R.B.I. can alter the amount of loans made against securities by the banks. An increase in margin reduces the borrowing capacity and money supply. Whereas a fall in margin encourages the people to borrow more.

2. **Moral Suasion**: - This is a combination of persuasion, and pressure that Central Bank applies on other banks in order to get them act, in a manner, in line with its policy. Moral suasion is exercised through discussions, letters, speeches and hints to banks. The Reserve Bank frequently announces its policy position and urges the banks to co-operate with in implementing its credit policies.

3. **Selective Credit Controls**: - Under selective credit controls, the RBI gives directions to other banks to give or not to give credit for certain purposes to particular sectors.

For an effective anticyclical monetary policy, Quantitative and Qualitative tools are required to be adopted simultaneously. But it has been accepted by all monetary theorists that –

i) The success of monetary policy is nil in a depression when business confidence is at its lowest ebb and
ii) It is successful against inflation. The Monetarists opine that as against fiscal policy, monetary policy possesses greater flexibility and can be implemented very quickly.