

Business Environment and Legal Framework

Monetary policy -objectives tools and types of monetary policies

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Meaning and Introduction of Monetary Policy

Monetary policy refers to the policy adopted by a country's central bank to regulate the supply of money, the availability of credit, and the rate of interest in the economy. Its main purpose is to maintain price stability, promote economic growth, control inflation, and support financial stability.

In India, the Reserve Bank of India (RBI) is responsible for formulating and implementing monetary policy. The RBI uses various instruments to influence liquidity, borrowing costs, and credit conditions in the economy.

Definition: Monetary policy is the process by which a central bank controls the supply of money and the cost and availability of credit to achieve the economic objectives of a country.

Example: When inflation is high, the RBI may increase the policy interest rate to make borrowing more expensive and reduce excessive demand in the economy.

Objectives of Monetary Policy

The major objectives of monetary policy are explained below.

1. Price Stability

- Price stability means controlling excessive increases or decreases in the general price level. The RBI attempts to keep inflation under control so that the purchasing power of money remains reasonably stable.

2. Control of Inflation

- Inflation refers to a sustained increase in the general price level. When inflation rises excessively, the central bank may adopt a contractionary monetary policy by increasing interest rates and tightening credit conditions.

3. Economic Growth

- Monetary policy supports economic growth by influencing the availability and cost of credit. Lower interest rates may encourage businesses to invest in factories, machinery, technology, and other productive activities.

4. Employment Generation

- An appropriate monetary policy can encourage investment, production, and business expansion. These activities may increase employment opportunities, although monetary policy alone cannot guarantee full employment.

5. Exchange Rate Stability

- Monetary policy can influence the demand for domestic currency and international capital flows. The central bank may take suitable measures to reduce excessive exchange-rate volatility, while considering other economic objectives.

6. Financial Stability

- The RBI seeks to support a stable financial system by managing liquidity conditions and using monetary and regulatory measures. Financial stability helps maintain confidence in banks and financial markets.

7. Regulation of Credit

- Monetary policy regulates the availability and cost of loans. It seeks to prevent excessive credit expansion while ensuring that productive sectors of the economy can obtain finance.

8. Balance of Payments Considerations

- Monetary policy may influence imports, exports, capital flows, and foreign exchange demand through its effects on interest rates, inflation, and economic activity. However, the balance of payments is also affected by fiscal policy, trade policy, and international conditions.

Tools or Instruments of Monetary Policy

The RBI uses quantitative and qualitative instruments to influence money supply, liquidity, interest rates, and credit.

A. Quantitative Instruments

- Quantitative instruments affect the overall volume or cost of credit in the economy.

1. Repo Rate

- The repo rate is the policy rate at which the RBI provides short-term funds to eligible banks against eligible securities under the applicable framework. Changes in the repo rate influence lending and deposit rates in the banking system.
- - Increase in repo rate: borrowing generally becomes more expensive.
- - Decrease in repo rate: borrowing may become cheaper.

2. Cash Reserve Ratio (CRR)

- CRR is the proportion of a bank's net demand and time liabilities (NDTL) that it must maintain as cash balances with the RBI.
- - Increase in CRR: reduces the funds available to banks for lending.
- - Decrease in CRR: releases more funds for lending, other things remaining equal.

3. Statutory Liquidity Ratio (SLR)

- SLR is the prescribed proportion of a bank's NDTL that must be maintained in specified liquid assets, such as cash, gold, and eligible unencumbered securities.
- It influences banks' liquidity management and the funds available for lending.

4. Open Market Operations (OMO)

- OMO refers to the purchase and sale of government securities by the RBI to manage liquidity in the banking system.
- - Purchase of securities: generally injects liquidity into the banking system.
- - Sale of securities: generally absorbs liquidity from the banking system.

5. Standing Deposit Facility (SDF)

- The SDF allows eligible banks to deposit funds with the RBI without providing collateral. It serves as the floor of the RBI's liquidity adjustment facility interest-rate corridor and helps absorb surplus liquidity.

6. Marginal Standing Facility (MSF)

- MSF enables eligible scheduled commercial banks to obtain overnight funds from the RBI under specified conditions and against eligible securities. It helps banks manage short-term liquidity shortages and forms the upper end of the policy-rate corridor.

Qualitative Instruments

Qualitative instruments influence the direction and purpose of credit rather than only its total volume.

1. **Margin Requirements:** The RBI may use regulatory measures relating to lending against securities and collateral to influence credit availability.
2. **Credit Rationing:** Credit limits or other restrictions may be used to regulate lending to particular sectors or activities.
3. **Moral Suasion:** The central bank communicates with banks and encourages them to follow appropriate lending and credit policies.
4. **Selective Credit Control:** Measures may be used to restrict excessive credit for particular commodities, sectors, or activities.
5. **Directives and Regulatory Measures:** The RBI may issue directions within its legal authority to guide or restrict lending practices and maintain financial stability.

Types of Monetary Policy

There are two principal types of monetary policy.

A. Expansionary Monetary Policy

- Expansionary monetary policy is adopted when the central bank seeks to stimulate economic activity, support investment, and ease financial conditions.
- Main features:
 - - Reduction in policy interest rates.
 - - Reduction in reserve requirements, where appropriate.
 - - Purchase of government securities to inject liquidity.
 - - Easier credit conditions.
- Objectives:
 - - Encourage investment and consumption.
 - - Support production and employment.
 - - Improve access to credit.
 - - Help revive economic activity during a slowdown.
- Example: During an economic slowdown, the RBI may reduce the repo rate. Banks may then lower some lending rates, encouraging firms and households to borrow and spend.
- Limitation: If demand becomes excessive, expansionary policy can contribute to inflation or financial imbalances.

B. Contractionary Monetary Policy

Contractionary monetary policy is adopted when the central bank seeks to reduce excessive demand and contain inflation by tightening monetary and credit conditions.

- Main features:
 - - Increase in policy interest rates.
 - - Increase in reserve requirements, where appropriate.
 - - Sale of government securities to absorb liquidity.
 - - Tighter credit conditions.
- Objectives:
 - - Control inflationary pressure.
 - - Reduce excessive borrowing and spending.
 - - Prevent an unsustainable expansion of credit.
 - - Support price and financial stability.
- Example: When inflation remains persistently high, the RBI may increase the repo rate. Higher borrowing costs can moderate consumption and investment, helping to reduce demand-side inflation.
- Limitation: Higher interest rates may also reduce investment, slow economic growth, and increase the cost of borrowing.

Importance of Monetary Policy in India

Monetary policy is important for the Indian economy for the following reasons:

1. It helps maintain price stability and protect purchasing power.
2. It influences the cost and availability of loans for businesses and households.
3. It supports orderly economic growth.
4. It helps manage liquidity in the banking system.
5. It influences saving, consumption, and investment decisions.
6. It contributes to financial stability and confidence in the banking system.
7. It helps anchor inflation expectations and improve the predictability of economic conditions.

Limitations of Monetary Policy

Despite its importance, monetary policy has certain limitations:

- - Time lag: Its effects on inflation, output, and employment may take time to appear.
- - Limited control over supply-side inflation: Higher interest rates cannot directly increase the supply of food, fuel, or other scarce goods.
- - Weak credit demand: Lower interest rates may not stimulate borrowing if businesses lack confidence.
- - Conflicting objectives: Controlling inflation may sometimes slow economic growth in the short run.
- - External factors: International oil prices, global financial conditions, and exchange-rate movements can affect domestic inflation.
- - Uneven effects: Changes in interest rates may affect borrowers, savers, businesses, and households differently.

Conclusion

Monetary policy is an important instrument of economic management. In India, the RBI uses interest rates, reserve requirements, open market operations, and other measures to influence liquidity and credit conditions. Expansionary monetary policy seeks to support economic activity, while contractionary monetary policy aims to contain excessive demand and inflation. An effective monetary policy must balance price stability with the need to support sustainable economic growth and financial stability.