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Monetary Policy and its Function in the Economy

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Introduction:

Monetary policy is an economic policy that manages the size and growth rate of the money supply in an economy. It is a powerful tool to regulate macroeconomic variables such as inflation and unemployment. These policies are implemented through different tools, including the adjustment of interest rates, the purchase or sale of government securities, and changing the amount of cash circulating in the economy. The central bank or a similar regulatory organization is responsible for formulating these policies. According to Harry G. Johnson, "Monetary policy refers to the policy by which the central bank controls the supply of money in order to fulfil the objectives of general economic policy." According to P.D. Hajela, "Monetary policy refers to the rules by which the government and the central bank of a country carry out the general objectives of economic policies for that country." Broadly speaking, monetary policy objectives include short-run stabilization goals and long-term economic growth and development goals.

Different Views on Monetary Policy:

- The classical economist Adam Smith, Say and others believed that there was always full employment in the economy and the existence of unemployment in the event of downward rigidity of money wages. Such a situation could be corrected by an expansionary monetary policy.
- The Keynesian view dominated during the 1950s and 1960s. Keynesians argued that the money supply did not matter much. Keynesian economists have focused on Government Fiscal Policy.
- Monetary Economist Milton Friedman challenged the Keynesian view during the 1960s and 1970s and argued that changes in the money supply caused both inflation and economic instability
- Robert Lucas modern Keynesians and monetarists agree that monetary policy exerts an essential impact on the economy.

- A long tradition in macroeconomics (including both Keynesian and monetarist perspectives) emphasizes that monetary policy affects employment and production in the short run because prices respond sluggishly to changes in the money supply.
- According to A. J. Shapiro, “Monetary Policy is the exercise of the central bank’s control over the money supply as an instrument for achieving the objectives of economic policy.”
- Phelps’s model (Noble Prize winner) shows how monetary policy can create a short-run trade-off between inflation and unemployment (a downward-sloping Phillips curve), but in the long run, the Phillips curve is essentially vertical at the natural rate of unemployment.

The following are the specific objectives of monetary policy:

1. High level of output (or national income) - Most economists would agree that in the long run, output—usually measured by gross domestic product (GDP)—is fixed, so any changes in the money supply only cause prices to change. But in the short run, because prices and wages usually do not adjust immediately, changes in the money supply can affect the actual production of goods and services.

2. High rate of economic growth- An important objective of monetary policy is to provide the necessary supply of money and credit for the country’s economic development. Those sectors which are very important for economic development are provided adequate credit availability.

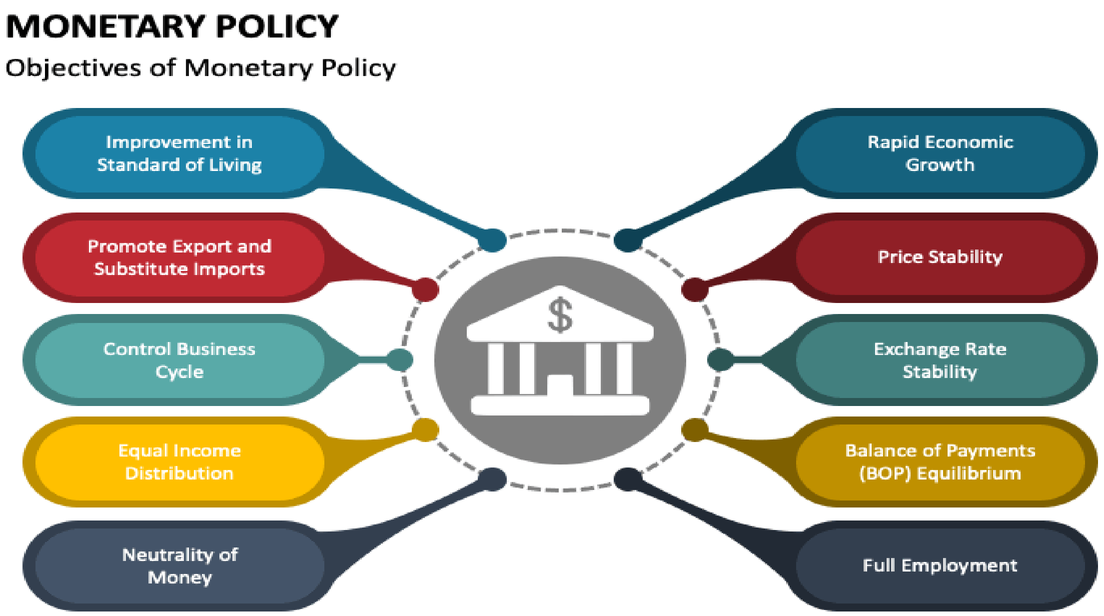
3. High employment - The monetary policy promotes employment by providing concessional credit to productive sectors, small and medium entrepreneurs, and special loan schemes for unemployed youth.

4. Price stability (or optimal rate of inflation – inflation rate is a nominal anchor for monetary policy) Simply objective of monetary policy is to maintain price stability while keeping in mind the objective of growth as price stability is a necessary precondition for sustainable economic growth. In India, the RBI plays an important role in controlling inflation through the consultation process regarding inflation targeting. The current inflation-targeting framework in India is flexible.

5. External stability or healthy balance of payment position (stability of the external value of domestic currency). Traditionally, the RBI has determined the exchange rate and also controlled the foreign exchange market now RBI only has indirect control over external stability through managed flexibility. Through this mechanism, the RBI influences the exchange rate by purchasing and sale of foreign currencies in the open market.

Objectives of the Indian Monetary Policy: The short title to the Reserve Bank of India Act, 1934 sets out the objectives of the Bank: "to regulate the issue of Bank notes and the keeping of reserves to secure monetary stability in India and generally to operate the currency and credit system of the country to its advantage". The objectives of monetary policy in India are widely regarded as

1- **To accelerate the process of economic growth with a stable price-**The central bank tries to maintain price stability by controlling the level of the money supply. Thus, monetary policy plays a stabilizing role in influencing economic growth through several channels.
2- Provision of adequate credit to productive sectors of the economy to support aggregate demand and ensure high and sustained growth.



3- Growth with Stability
4- Regulation, Supervision, and also Development of Financial Stability
5- Promoting Priority Sector
6- Generation of Employment
7- External Stability
8- Encouraging Savings as well as Investments
9- Redistribution of Income and Wealth
10- Regulation of NBFIs

Monetary Policy Framework in India:

The Reserve Bank of India was established following the Reserve Bank of India Act of 1934. Though privately owned initially, it was nationalised in 1949 and since then fully owned by the Ministry of Finance, Government of India. In May 2016, the RBI Act was amended to provide a legislative mandate to the central bank to operate the country's monetary policy framework. The framework aims at setting the policy (repo) rate based on an assessment of the current and evolving macroeconomic situation, and modulation of liquidity conditions to anchor money market rates at or around the repo rate. The amended RBI Act, of 1934 also provides for the inflation target (4% +-2%) to be set by the Government of India, in consultation with the Reserve Bank, once every five years.

Types of Monetary Policy

1- Contractionary Monetary Policy

A contractionary policy increases interest rates and limits the outstanding money supply to slow growth and decrease inflation, where the prices of goods and services in an economy rise and reduce the purchasing power of money.

2- Expansionary Monetary Policy

During times of slowdown or a recession, an expansionary policy grows economic activity. By lowering interest rates, saving becomes less attractive, and consumer spending and borrowing increase.

Measures of monetary policy

Some of the following instruments are used by RBI as a part of their monetary policies.

Open Market Operations: An open market operation is an instrument which involves buying/selling of securities like government bond from or to the public and banks. The RBI sells government securities to control the flow of credit and buys government securities to increase credit flow.

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 percentage of total deposits that 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. The CRR was reduced from 15% in 1990 to 5 % in 2002. As of 31st December 2019, the CRR is at 4%. Statutory Liquidity Ratio (SLR): All financial institutions have to maintain a certain quantity of liquid assets with themselves at any point in time of their total time and demand liabilities. This is known as the Statutory Liquidity Ratio. The assets are kept in non-cash forms such as precious metals, bonds, etc. As of December 2019, SLR stands at 18.25%.

Bank Rate Policy: Also known as the discount rate, bank rates are interest charged by the RBI for providing funds and loans to the banking system. An increase in bank rate increases the cost of borrowing by commercial banks which results in the reduction in credit volume to the banks and hence the supply of money declines. An increase in the bank rate is the symbol of the tightening of the RBI monetary policy. As of 31 December 2019, the bank rate is 5.40%.

Credit Ceiling: With this instrument, RBI issues prior information or direction that loans to the commercial bank will be given up to a certain limit. In this case, a commercial bank will be tight in advancing loans to the public. They will allocate loans to limited sectors. A few examples of credit ceiling are agriculture sector advances and priority sector lending.

S. No.	Types of Tools	Dear Money Policy	Cheap Money Policy
1	Cash Reserve Ratio	Increase CRR	Decrease CRR
2	Statutory Liquidity Ratio	Increase SLR	Decrease SLR
3	Open Market Operations	RBI sells securities and Bonds	RBI buys securities and Bonds
4	Bank Rate	Increase Bank Rate	Decrease Bank Rate
5	Repo Rate	Increase Repo Rate	Decrease Repo Rate
6	Reverse Repo Rate	Value is dependent on Repo Rate	
7	Marginal Standing Facility	Value is dependent on Repo Rate	

Conclusion:

RBIs policies during the pandemic have facilitated resource mobilisation for the central and state governments at low costs. 11 While the fiscal deficit in India is going to be higher in 2020 than was intended, it is important to note that this has primarily been driven by falling revenues. The later rounds of fiscal policies announced in the wake of the pandemic emphasised that government spending would be shifting towards boosting investment rather than consumption. Of course, this will depend on the speed of the recovery. Some studies suggest that debt sustainability depends on the interest rate and growth rate differential – if the interest rate paid by the government is less than the growth rate, then the intertemporal budget constraint facing the government is no longer binding (Blanchard (2019)).

Monetary Policy, as a concept has evolved with the increasingly complex economy of ours. For the recent development, it has been almost four and a half years since flexible inflation targeting framework was formally implemented along with amendment to RBI Act in 2016, pursuant to Monetary Policy Framework Agreement and the inflation target was notified to be4% with ± 2% tolerance band for the time period of August 5, 2016 to March 31, 2021. Further, provision for Monetary Policy Committee was made in the RBI Act, which replaced the Technical Advisory Committee. It can be concluded that the implementation of monetary policy plays a very prominent role in the development of a country. The monetary and credit policy has emphasised a multi-indicator approach, with movements not only in the money supply but also in the economic growth of the country.

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