FACULTY OF JURIDICAL SCIENCES

Lecture-13

MONETARY POLICY

- Monetary policy is a set of actions that can be undertaken by a nation's central bank to control the overall money supply and achieve sustainable economic growth.
- Monetary policy can be broadly classified as either expansionary or contractionary.
- Some of the available tools include revising interest rates up or down, directly lending cash to banks, and changing bank reserve requirements.

Monetary Policy is the process by which the monetary authority of a country, generally the central bank, controls the supply of money in the economy by 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).

It is designed to maintain the price stability in the economy. Other objectives of the monetary policy of India, as stated by RBI, are:

Price stability

Price stability implies promoting economic development with considerable emphasis on price stability. The centre of focus is to facilitate the environment which is favorable to the architecture that enables the developmental projects to run swiftly while also maintaining reasonable price stability.

Controlled expansion of bank credit

One of the important functions of RBI is the controlled expansion of bank credit and money supply with special attention to seasonal requirement for credit without affecting the output.

Promotion of fixed investment

The aim here is to increase the productivity of investment by restraining non essential fixed investment.

Restriction of inventories and stocks

Overfilling of stocks and products becoming outdated due to excess of stock often results in sickness of the unit. To avoid this problem, the central monetary authority carries out this essential function of restricting the inventories. The main objective of this policy is to avoid over-stocking and idle money in the organization.

Promoting efficiency

It tries to increase the efficiency in the financial system and tries to incorporate structural changes such as deregulating interest rates, easing operational constraints in the credit delivery system, introducing new money market instruments, etc.

Reducing rigidity

RBI tries to bring about flexibilities in operations which provide a considerable autonomy. It encourages more competitive environment and diversification. It maintains its control over financial system whenever and wherever necessary to maintain the discipline and prudence in operations of the financial system

INSTRUMENTS OF MONETARY POLICY

Open market operations

An open market operation is an instrument of monetary policy which involves buying or selling of government securities like government bonds 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 control 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.

Cash reserve ratio (CRR)

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. The higher the CRR with the RBI, the lower will be the liquidity in the system, and vice versa. RBI is empowered to vary CRR between 15 percent and 3 percent. Per the suggestion by the Narasimham Committee report, the CRR was reduced from 15% in 1990 to 5 percent in 2002. As of 21st may 2022, the CRR is 4.50 percent.

Statutory liquidity ratio (SLR)

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 have to be kept in non cash form such as G-secs precious metals, approved securities like bonds. The ratio of the liquid assets to time and demand liabilities is termed as the statutory liquidity ratio.

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 institutions. Funds are provided either through lending directly or discounting or buying money market instruments like commercial bills and treasury bills. 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. Increase in the bank rate is the symbol of tightening of RBI monetary policy.

Repo rate and reverse repo rate

Repo rate is the rate at which RBI lends to its clients generally against government securities. Reduction in repo rate helps the commercial banks to get money at a cheaper rate and increase in repo rate discourages the commercial banks to get money as the rate increases and becomes expensive. The reverse repo rate is the rate at which RBI borrows money from the commercial banks. The increase in the repo rate will increase the cost of borrowing and lending of the banks which will discourage the public to borrow money and will encourage them to deposit. As the rates are high the availability of credit and demand decreases resulting to decrease in inflation. This increase in repo rate and reverse repo rate is a symbol of tightening of the policy. As of May 2022, the repo rate is 4.40% and the reverse repo rate is 3.35%.