

INSTRUMENT TO CONTROL SUPPLY OF MONEY: MONETARY POLICY

Dr. Anju Agarwal¹ M.A. (Economics)¹, Ph.D.

Abstract

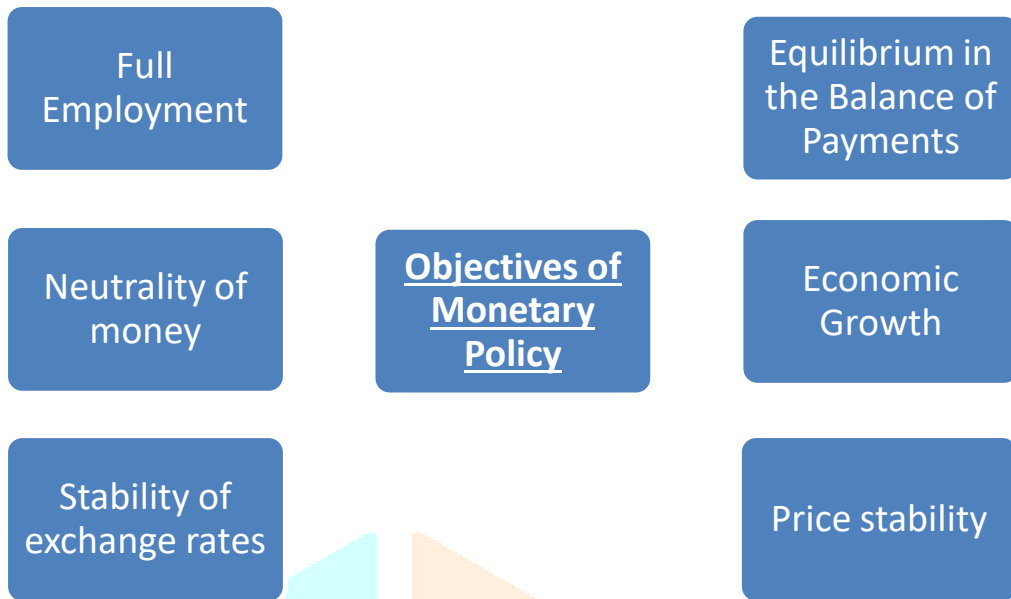
In this Paper, Monetary policy is the process by which the monetary authority of a country, like the central bank (in case of India, Reserve Bank of India), controls the supply of money, often targeting an inflation rate or interest rate to ensure price stability and general trust in the currency. Monetary 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. Cash Reserve Ratio (CRR) – Banks are required to set aside this portion in cash with the RBI. The bank can neither lend it to anyone nor can it earn any interest rate or profit on CRR. • Statutory Liquidity Ratio (SLR) – Banks are required to set aside this portion in liquid assets such as gold or RBI approved securities such as government securities. Banks are allowed to earn interest on these securities, however it is very low.

Keywords: - Monetary policy, Economic growth, Currency, RBI

Introduction

Monetary policy is the policy by which the monetary authority of a country like the central bank, controls the supply of money, to ensure price stability and economic growth. In other words, Monetary policy is how central banks manage liquidity to create economic growth. Liquidity is how much there is in the money supply. That includes credit, cash, checks and money market mutual funds. The most important of these is credit. It includes loans, bonds and mortgages. Monetary policy is the process by which monetary authority of a country, generally 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 so designed as to maintain the price stability in the economy. The Government of India, in consultation with RBI, notified the 'Inflation Target' in the Gazette of India Extraordinary dated 5th August 2016 for the period beginning from the date of publication of this notification and ending on the March 31, 2021 as 4%. At the same time lower and upper tolerance levels were notified to be 2% and 6% respectively.

Objectives of Monetary Policy



➤ **Neutrality of Money:**

Economists like Wicksteed, Hayek and Robertson are the chief exponents of neutral money.

Under this system, money is kept stable by the monetary authority. Thus the main aim of the monetary authority is not to deviate from the neutrality of money. It means that quantity of money should be perfectly stable. It is not expected to influence or discourage consumption and production in the economy.

➤ **Exchange Stability:**

Exchange stability was the traditional objective of monetary authority. This was the main objective under Gold Standard among different countries. *“Expand Currency and Credit when gold is coming in; contract currency and credit when gold is going out.”*

Thus, the main objective of monetary policy is to maintain stability in the external equilibrium of the country. In other words, they should try to eliminate those adverse forces which tend to bring instability in exchange rates.

➤ **Price Stability:**

Economists like Crustar Cassels and Keynes suggested price stabilization as a main objective of monetary policy. Price stability is considered the most genuine objective of monetary policy.

It promotes business activity and ensures equitable distribution of income and wealth.

➤ **Full Employment:**

With the publication of Keynes 'General Theory of Employment, Interest and Money' in 1936, the chief objective of monetary policy is Full employment. Prof. Crowther is of the view that the main objective of monetary policy of a country is to bring about equilibrium between saving and investment at full employment level.

➤ **Economic Growth:**

Monetary policy promotes sustained and continuous economic growth by maintaining equilibrium between the total demand for money and total production capacity and further creating favourable conditions for saving and investment. For bringing equality between demand and supply, flexible monetary policy is the best course.

➤ **Equilibrium in the Balance of Payments:**

Equilibrium in the balance of payments is another objective of monetary policy which emerged significant in the post war years. This is simply due to the problem of international liquidity on account of the growth of world trade at a more faster speed than the world liquidity.

❖ **Instruments of Monetary Policy:**

The instruments of monetary policy are of two types:

I. Quantitative, general or indirect

- Bank Rate
- Open Market Operations
- Changes in reserve ratios

II. Qualitative, selective or direct.

I. **General Credit Controls:**

• **Bank Rate Policy:**

The bank rate is the minimum lending rate of the central bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. When the central bank finds that inflationary pressures have started

emerging within the economy, it raises the bank rate. On the contrary, when prices are depressed, the central bank lowers the bank rate.

- **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. But, when recessionary forces start in the economy, the central bank buys securities.

- **Changes in Reserve Ratios:**

This weapon was suggested by Keynes in his '*Treatise on Money*' and the USA was the first to adopt it as a monetary device. Every bank is required by law to keep a certain percentage of its total deposits in the form of a reserve fund with the central bank. When prices are rising, the central bank raises the reserve ratio. In the opposite case, when the reserve ratio is lowered, the reserves of commercial banks are raised.

II. Selective Credit Controls:

Selective credit controls are used to influence specific types of credit for particular purposes. They usually take the form of changing margin requirements to control speculative activities within the economy. When there is brisk speculative activity in the economy or in particular sectors in certain commodities and prices start rising, the central bank raises the margin requirement on them. The result is that the borrowers are given less money in loans against specified securities.

- ❖ **Importance of Monetary Policy**

Monetary policy is an effective instrument with which objectives of macroeconomic policy can be achieved. It is the Central Bank (The Reserve Bank of India) which formulates and implements the monetary policy in a country on behalf of the Government.

- ❖ **Conclusion**

Thus, Monetary policy is concerned with changing the supply of money stock and rate of interest for the purpose of stabilising the economy at full-employment or potential output level by influencing the level of aggregate demand. RBI has been following a neutral policy stance for some time now. This means that with inflation being at an all time low of 4.0%, and the growth projections of the Indian economy being at a constant 7.30%, the RBI will try not to destabilize the delicate balance, by either infusing or removing too much funds from the markets. the RBI can impose an action against a bank. If certain banks are not adhering to the RBI's directives, the RBI may refuse to rediscount their bills and securities. Secondly, RBI may refuse credit supply to those banks whose borrowings are in excess to their capital. The

Central bank can penalize a bank by changing some rates. At last, it can even put a ban on a particular bank if it does not follow its directives and work against the objectives of the monetary policy.

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