

MONETARY POLICY OF INDIA

What is RBI's Monetary Policy: Objectives & Instruments

Monetary Policy of India is formulated and executed by Reserve Bank of India to achieve specific objectives. It refers to that policy by which central bank of the country controls (i) the supply of money, and (ii) cost of money or the rate of interest, with a view to achieve particular objectives.

In the words of D.C. Rowan, "The monetary policy is defined as discretionary act undertaken by the authorities designed to influence (a) the supply of money,

(b) cost of money or rate of interest, and

(c) the availability of money for achieving specific objective."

Thus, monetary policy of India refers to that policy which is concerned with the measures taken to regulate the volume of credit created by the banks. The main objectives of monetary policy are to achieve price stability, financial stability and adequate availability of credit for growth.

Following are the main elements of the monetary policy of India:

- i. It regulates the stocks and the growth rate of money supply.
- ii. It regulates the entire banking system of the economy.
- iii. It determines the allocation of loans among different sectors.
- iv. It provides incentives to promote savings and to raise the savings-income ratio.
- v. It ensures adequate availability of credit for growth and tries to achieve price stability.

Objectives of Monetary Policy:

According to RBI Governor Dr. D. Subba Rao, "The objectives of monetary policy in India are price stability and growth. These are pursued through ensuring credit availability with stability in the external value of rupee and overall financial stability."

Following are the main objectives of monetary policy:

i. To Regulate Money Supply in the Economy:

Money supply includes both money in circulation and credit creation by banks. Monetary policy is framed to regulate the money supply in the economy by credit expansion or credit contraction. By credit expansion (giving more loans), the money supply can be expanded. By credit contraction (giving less loans) money supply can be decreased.

The main aim of the monetary policy of the Reserve Bank was to control the money supply in such a manner as to expand it to meet the needs of economic growth and at the same time contract it to curb inflation. In other words monetary policy aimed at expanding and contracting money supply according to the needs of the economy.

ii. To Attain Price Stability:

Another major objective of monetary policy in India is to maintain price stability in the country. It implies Control over inflation. Price level, is affected by money supply. Monetary policy regulates money supply to maintain price stability.

iii. To promote Economic Growth:

An important objective of monetary policy is to make available necessary supply of money and credit for the economic growth of the country. Those sectors which are quite significant for the economic growth are provided with adequate availability of credit.

iv. To Promote saving and Investment:

By regulating the rate of interest and checking inflation, monetary policy promotes saving and investment. Higher rates of interest promote saving and investment.

v. To Control Business Cycles:

Boom and depression are the main phases of business cycle. Monetary policy puts a check on boom and depression. In period of boom, credit is contracted, so as to reduce money supply and thus check inflation. In period of depression, credit is expanded, so as to increase money supply and thus promote aggregate demand in the economy.

vi. To Promote Exports and Substitute Imports:

By providing concessional loans to export oriented and import substitution units, monetary policy encourages such industries and thus help to improve the position of balance of payments.

vii. To Manage Aggregate Demand:

Monetary authority tries to keep the aggregate demand in balance with aggregate supply of goods and services. If aggregate demand is to be increased than credit is expanded and the interest rate is lowered down. Because of low interest rate, more people take loan to buy goods and services and hence aggregate demand increases and vice-verse.

viii. To Ensure more Credit for Priority Sector:

Monetary policy aims at providing more funds to priority sector by lowering interest rates for these sectors. Priority sector includes agriculture, small- scale industry, weaker sections of society, etc.

ix. To Promote Employment:

By providing concessional loans to productive sectors, small and medium entrepreneurs, special loan schemes for unemployed youth, monetary policy promotes employment.

x. To Develop Infrastructure:

Monetary policy aims at developing infrastructure. It provides concessional funds for developing infrastructure.

xi. To Regulate and Expand Banking:

RBI regulates the banking system of the economy. RBI has expanded banking to all parts of the country. Through monetary policy, RBI issues directives to different banks for setting up rural

branches for promoting agricultural credit. Besides it, government has also set up cooperative banks and regional rural banks.

Instruments of Monetary Policy

The instruments of monetary policy are of two types:

- 1. Quantitative, general or indirect (CRR, SLR, Open Market Operations, Bank Rate, Repo Rate, Reverse Repo Rate)**
- 2. Qualitative, selective or direct (change in the margin money, direct action, moral suasion)**

These both methods affect the level of aggregate demand through the supply of money, cost of money and availability of credit. Of the two types of instruments, the first category includes bank rate variations, open market operations and changing reserve requirements (cash reserve ratio, statutory reserve ratio).

Policy instruments 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.

We discuss them as under:

a. 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 inflation has been increasing continuously, it raises the bank rate so borrowing from the central bank becomes costly and commercial banks borrow less money from it (RBI).

The commercial banks, in reaction, raise their lending rates to the business community and borrowers who further borrow less from the commercial banks. 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. Businessmen are encouraged to borrow more. Investment is encouraged and followed by rise in Output, employment, income and demand and the downward movement of prices is checked.

List of Public Sector Banks in India and their Headquarters

b. Open Market Operations:

Open market operations refer to sale and purchase of securities in the money market by the central bank of the country. When prices start 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 or general public.

Further investment is discouraged and the rise in prices is checked. Contrariwise, when recessionary forces start in the economy, the central bank buys securities. The reserves of commercial banks are raised so they lend more to business community and general public. It further raises Investment, output, employment, income and demand in the economy hence the fall in price is checked.

c. Changes in Reserve Ratios:

Under this method, CRR and SLR are two main deposit ratios, which reduce or increases the idle cash balance of the commercial banks. Every bank is required by law to keep a certain percentage of its total deposits in the form of a reserve fund in its vaults and also a certain percentage with the central bank.

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.

2. 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.

Structure of Banking Sector in India

a. Change in Margin Money:

The result is that the borrowers are given less money in loans against specified securities. For instance, raising the margin requirement to 70% means that the pledger of securities of the value of Rs 10,000 will be given 30% of their value, i.e. Rs 3,000 as loan. In case of recession in a particular sector, the central bank encourages borrowing by lowering margin requirements.

b. Moral Suasion: Under this method RBI urges to commercial banks to help in controlling the supply of money in the economy.

Conclusion:

So it can be conclude that the implementation of the monetary policy plays a very prominent role in the development of a country. It's a kind of double edge sword, if money is not available in the market as the requirement of the economy, the investors will suffer (investment will decline in the economy) and on the other hand if the money is supplied more than its requirement then the poor section of the country will suffer.

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