Monetary Policy

Introduction

- Monetary Policy is regarded as an important tool of the Macro Economic Policy.
- The Classical and Neo-Classical economists have assigned greater importance to the monetary policy.
- In 1930, fiscal policy became popular than monetary policy.
- After the year 1960, there arose the problem of inflation in countries like America, England etc then some monetary economists then advised to adopt some monetary measures.
- In this way the Monetary Policy became popular.

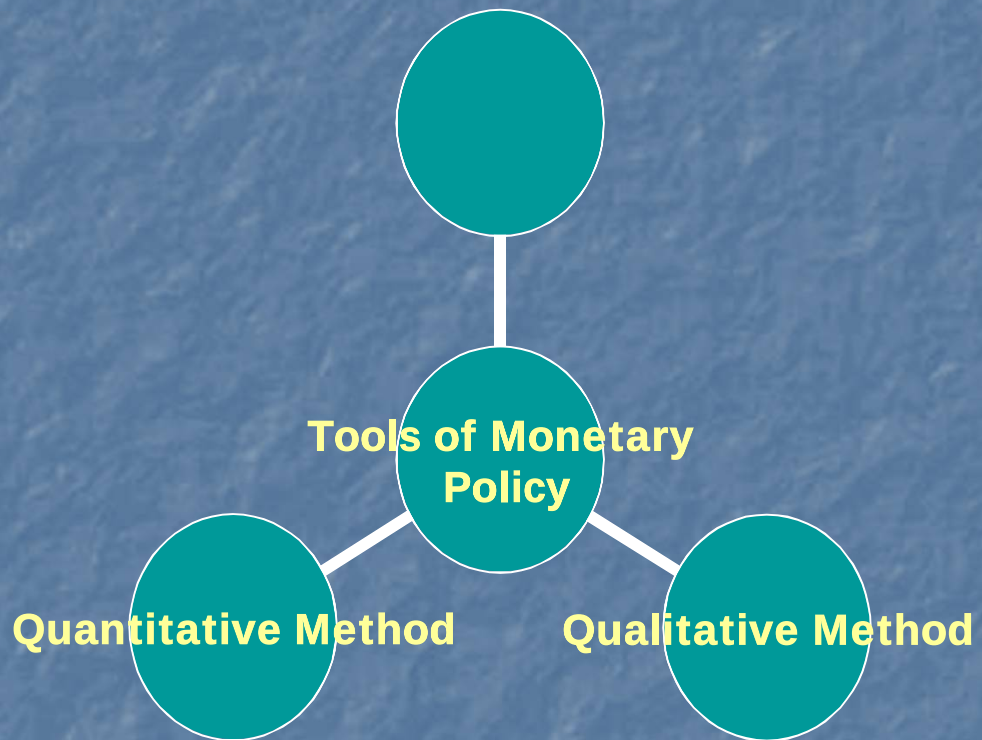
Meaning of Monetary Policy

- Monetary policy refers to the measures adopted by the central bank of a country to control the money supply to achieve the objectives of general economic policy.
- In the words of Prof.H.G.Johnson, “By monetary policy we mean any conscious action undertaken by the monetary authorities to change the quantity, availability or cost (interest rate) of money.

Objectives of Monetary Policy

- Price Stability
- Stability of Foreign Exchange Rate
- Full Employment
- High rate of Economic Growth
- Equitable Distribution of Income

Instruments/Tools of Monetary Policy



Quantitative Method

- Bank Rate Policy
- Open market Operations
- Variable Reserve Ratio

Bank Rate

- **Bank rate**, also referred to as the discount rate, is the rate of interest which a central bank charges on the loans and advances that it extends to commercial banks and other financial intermediaries. Changes in the bank rate are often used by central banks to control the money supply

Open Market Operations

- The **money market** is the global financial market for short-term borrowing and lending
- Open market operations refers to sale and purchase of securities in the money market by the central bank.

Changing the Reserve Ratio

- Every bank is required by law to keep a certain percentage of its total deposits in the form of a reserve fund & also a certain % with the central bank.

Qualitative or Selective Instruments

- Moral Persuation or Advice : The Central Bank gives advice to other banks on moral grounds, about the credit control. It is a measure used by central bank to put pressure upon the lending activities of commercial banks by urging them to voluntarily adopt certain restrictive practices.

Rationing of Credit

- The Central bank may issue directions to commercial banks to restrict (ration) credit to certain sectors or sections of the population. This method is particularly useful in controlling inflationary pressures.

Direct Action

- This method is used for those commercial banks which do not cooperate with central bank in controlling credit.
- The direct action refers to forceful measures adopted against those commercial banks which have committed errors.
- Sometimes central bank refuses to give loans to commercial banks, sometimes the central bank starts imposing some extra fines other than the bank rate on the commercial banks.

Variable Margin Requirements

- This measure is used to thwart hoarding activity by traders.
- For ex, if traders hoard necessary commodities like foodgrains in an attempt to create artificial scarcity and thereby push up prices, then the Central Bank can raise margin requirements with respect to such goods.
- If the margin requirement is 50%, then the trader can get a loan of Rs 10 Lakhs against a security of Rs 20 Lakhs.

Regulation of Consumer Credit

- This measure is resorted to only under several inflationary conditions in an effort to restrict demand for credit.
- For ex, credit given for the purchase of consumer durables may be charged very high rates of interest to discourage borrowing for this purpose by the consumer.
- This results in a fall in demand and thereby a fall in the prices of these goods.

Limitations of Monetary Policy

- Conflicting goals
- Limitations during deflation
- Limitations during inflation
- Lags in Monetary Policy
- Near Money assets
- Non Banking Financial Institutions
- Limitations in Under developed countries