MONETARY POLICY & CREDIT CONTROL INSTRUMENTS

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What is the Monetary Policy?

- The Monetary and Credit Policy is the policy statement, traditionally announced twice a year, through which the Reserve Bank of India seeks to ensure price stability for the economy.

  These factors include - money supply, interest rates and the inflation. In banking and economic terms money supply is referred to as M3 - which indicates the level (stock) of legal currency in the economy.

  Besides, the RBI also announces norms for the banking and financial sector and the institutions which are governed by it.

How is the Monetary Policy different from the Fiscal Policy?

- The Monetary Policy regulates the supply of money and the cost and availability of credit in the economy. It deals with both the lending and borrowing rates of interest for commercial banks.
- The Monetary Policy aims to maintain price stability, full employment and economic growth.
- The Monetary Policy is different from Fiscal Policy as the former brings about a change in the economy by changing money supply and interest rate, whereas fiscal policy is a broader tool with the government.
- The Fiscal Policy can be used to overcome recession and control inflation. It may be defined as a deliberate change in government revenue and expenditure to influence the level of national output and prices.

What are the objectives of the Monetary Policy?

- The objectives are to maintain price stability and ensure adequate flow of credit to the productive sectors of the economy.

  Stability for the national currency (after looking at prevailing economic conditions), growth in employment and income are also looked into. The monetary policy affects the real sector through long and variable periods while the financial markets are also impacted through short-term implications.

INSTRUMENTS OF MONETARY POLICY

- 1. Bank Rate of Interest
- 2. Cash Reserve Ratio
- 3. Statutory Liquidity Ratio
- 4. Open market Operations
- 5. Margin Requirements
- 6. Deficit Financing
- 7. Issue of New Currency
- 8. Credit Control

Bank Rate of Interest

It is the interest rate which is fixed by the RBI to control the lending capacity of Commercial banks . During Inflation , RBI increases the bank rate of interest due to which borrowing power of commercial banks reduces which thereby reduces the supply of money or credit in the economy .When Money supply Reduces it reduces the purchasing power and thereby curtailing Consumption and lowering Prices.

Cash Reserve Ratio

CRR, or cash reserve ratio, refers to a portion of deposits (as cash) which banks have to keep/maintain with the RBI. During Inflation RBI increases the CRR due to which commercial banks have to keep a greater portion of their deposits with the RBI . This serves two purposes. It ensures that a portion of bank deposits is totally risk-free and secondly it enables that RBI control liquidity in the system, and thereby, inflation.

Statutory Liquidity Ratio

Banks are required to invest a portion of their deposits in government securities as a part of their statutory liquidity ratio (SLR) requirements . If SLR increases the lending capacity of commercial banks decreases thereby regulating the supply of money in the economy.

Open market Operations

It refers to the buying and selling of Govt. securities in the open market . During inflation RBI sells securities in the open market which leads to transfer of money to RBI.Thus money supply is controlled in the economy.

Margin Requirements

- During Inflation RBI fixes a high rate of margin on the securities kept by the public for loans .If the margin increases the commercial banks will give less amount of credit on the securities kept by the public thereby controlling inflation.

Deficit Financing

- It means printing of new currency notes by Reserve Bank of India .If more new notes are printed it will increase the supply of money thereby increasing demand and prices.
- Thus during Inflation, RBI will stop printing new currency notes thereby controlling inflation.

Issue of New Currency

- During Inflation the RBI will issue new currency notes replacing many old notes.

  This will reduce the supply of money in the economy.

Fiscal Policy

- It refers to the Revenue and Expenditure policy of the Govt. which is generally used to cure recession and maintain economic stability in the country.

Instruments of Fiscal Policy

- 1. Reduction of Govt. Expenditure
- 2. Increase in Taxation
- 3. Imposition of new Taxes
- 4. Wage Control
- 5.Rationing
- 6. Public Debt
- 7. Increase in savings
- 8. Maintaining Surplus Budget

Other Measures

- 1. Increase in Imports of Raw materials
- 2. Decrease in Exports
- 3. Increase in Productivity
- 4. Provision of Subsidies
- 5. Use of Latest Technology
- 6. Rational Industrial Policy