Course Name:-B.A.LLB-IVth Sem

Subject:-Economics-IV

Teacher:-Ms.Munesh

Topic:-Monetory Policy

Meaning of Monetary Policy

Monetary policy is concerned with the changes in the supply of money and credit. It refers to the policy measures undertaken by the government or the central bank to influence the availability, cost and use of money and credit with the help of monetary techniques to achieve specific objectives.

Definition of Monetary Policy

- According to A. J. Shapiro, “Monetary Policy is the exercise of the central bank’s control over the money supply as an instrument for achieving the objectives of economic policy.”
- D.C. Rowan, “The monetary policy is defined as discretionary action 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.”

Objectives of Monetary Policy

The goals of monetary policy refer to its objectives such as reasonable price stability, high employment and faster rate of economic growth. The targets of monetary policy refer to such variables as the supply of bank credit, interest rate and the supply of money.

These are to be changed by using the instruments of monetary policy for attaining the objectives (goals). The instruments of monetary policy are variation in the bank rate, the repo rate and other interest rates, open market operations (OMOs), selective credit controls and variations in reserve ratio (VRR).

Objectives of monetary policy are the following

Stabilising the Business Cycle:-

- Monetary policy has an important effect on both actual GDP and potential GDP. Industrially advanced countries rely on monetary policy to stabilise the economy by controlling business. But it becomes impotent in deep recessions.

Keynes pointed out that monetary policy loses its effectiveness during economic downturn for two reasons:

- (i) The existence of liquidity trap situation (i.e., infinite elasticity of demand for money) and
- (ii) Low interest elasticity of (autonomous) investment.

Reasonable Price Stability:

- Price stability is perhaps the most important goal which can be pursued most effectively by using monetary policy. In a developing country like India the acceleration of investment activity in the face of a fall in agricultural output creates excessive pressure on prices. The food inflation in India is a proof of this. In such a situation, monetary policy has much to contribute to short-run price stability.
- Due to various changes in the structure of the economy in a developing country like India some degree of inflation is inevitable. And mild inflation or a functional rise in prices is desirable to give necessary incentive to producers and investors. As P. A. Samuelson put it, mild inflation at the rate of 3% to 4% per annum lubricates the wheels of trade and industry and promotes faster economic growth.

Faster Economic Growth

- Monetary policy can promote faster economic growth by making credit cheaper and more readily available. Industry and agriculture require two types of credit—short-term credit to meet working capital needs and long-term credit to meet fixed capital needs.
- The need for these two types of credit can be met through commercial banks and development banks. Easy availability of credit at low rates of interest stimulates investment or expansion of society's production capacity. This in its turn, enables the economy to grow faster than before.

Exchange Rate Stability

In an ‘open economy’—that is, one whose borders are open to goods, services, and financial flows— the exchange-rate system is also a central part of monetary policy. In order to prevent large depreciation or appreciation of the rupee in terms of the US dollar and other foreign currencies under the present system of floating exchange rate the central bank has to adopt suitable monetary measures.

Conclusion

- In the long run there is no conflict between the first two objectives, viz., price stability and economic growth. In fact, price stability is a means to achieve faster economic growth. In the context of the Indian economy C. Rangarajan writes, **"It is price stability which provides the appropriate environment under which growth can occur and social justice can be ensured."**
- However, in the short run there is a trade-off between price stability and economic growth. Faster economic growth is achieved by increasing-the availability of credit at a lower rate of interest. This amounts to an increase in the money supply.
- But an increase in the money supply and the consequent rise in consumer demand tends to generate a high rate of inflation.