UNIT - V

Monetary Policy: Meaning - Objectives - Limitations - Monetary Policy in India - Money Market: Indian Money Market - Structure and Composition - Importance - Defects.

MONEATRY POLICY

MEANING

Monetary policy, the demand side of economic policy, refers to the actions undertaken by a nation's central bank to control money supply and achieve macroeconomic goals that promote sustainable economic growth.

Understanding Monetary Policy

Monetary policy is the process of drafting, announcing, and implementing the plan of actions taken by the central bank, currency board, or other competent monetary authority of a country that controls the quantity of money in an economy and the channels by which new money is supplied.

Monetary policy consists of the management of money supply and interest rates, aimed at meeting macroeconomic objectives such as controlling inflation, consumption, growth, and liquidity. This is achieved by actions such as modifying the interest rate, buying or selling government bonds, regulating foreign exchange (forex) rates, and changing the amount of money banks are required to maintain as reserves.

Economists, analysts, investors, and financial experts across the globe eagerly await monetary policy reports and the outcome of meetings involving monetary policy decision-makers. Such developments have a long-lasting impact on the overall economy, as well as on specific industry sectors or markets.

Monetary policy is formulated based on inputs gathered from a variety of sources. For instance, the monetary authority may look at macroeconomic numbers such as gross domestic product (GDP) and inflation, industry/sector-specific growth rates and associated figures, as well as geopolitical developments in international markets—

including oil embargos or trade tariffs. These entities may also ponder concerns raised by groups representing industries and businesses, survey results from organizations of repute, and inputs from the government and other credible sources.

Monetary Policy Requirements

Monetary authorities are typically given policy mandates to achieve a stable rise in GDP, keep unemployment low, and maintain foreign exchange (forex) and inflation rates in a predictable range.

The Federal Reserve Bank is in charge of monetary policy in the United States. The Federal Reserve (Fed) has what is commonly referred to as a "dual mandate": to achieve maximum employment while keeping inflation in check.

Simply put, it is the Fed's responsibility to balance economic growth and inflation. In addition, it aims to keep long-term interest rates relatively low. Its core role is to be the lender of last resort, providing banks with liquidity and regulatory scrutiny in order to prevent them from failing and panic spreading in the financial services sector.

Types of Monetary Policies

Broadly speaking, monetary policies can be categorized as either:

Expansionary

If a country is facing a high unemployment rate during a slowdown or a recession, the monetary authority can opt for an expansionary policy aimed at increasing economic growth and expanding economic activity. As a part of expansionary monetary policy, the monetary authority often lowers the interest rates through various measures, serving to promote spending and make money-saving relatively unfavorable.

Increased money supply in the market aims to boost investment and consumer spending. Lower interest rates mean that businesses and individuals can secure loans on convenient terms to expand productive activities and spend more on big-ticket consumer goods. An example of this expansionary approach is the low to zero interest rates maintained by many leading economies across the globe since the 2008 financial crisis.

Contractionary

Increased money supply can lead to higher inflation, raising the cost of living and cost of doing business. Contractionary monetary policy, increasing interest rates, and slowing the growth of the money supply, aims to bring down inflation. This can slow economic growth and increase unemployment, but is often necessary to cool down the economy and keep it in check.

In the early 1980s when inflation hit record highs and was hovering in the double-digit range of around 15%, the Fed raised its benchmark interest rate to a record 20%. Though the high rates resulted in a recession, it managed to bring back inflation to the desired range of 3% to 4% over the next few years.

Tools to Implement Monetary Policy

Central banks use a number of tools to shape and implement monetary policy.

1. First is the buying and selling of short-term bonds on the open market using newly created bank reserves. This is known as open market operations. Open market operations traditionally target short-term interest rates such as the federal funds rate.

   The central bank adds money into the banking system by buying assets—or removes it by selling assets—and banks respond by loaning the money more easily at lower rates—or more dearly, at higher rates—until the central bank's interest rate target is met. Open market operations can also target specific increases in the money supply to get banks to loan funds more easily by purchasing a specified quantity of assets, in a process known as quantitative easing (QE) 2
2. The second option used by monetary authorities is to change the interest rates and/or the required collateral that the central bank demands for emergency direct loans to banks in its role as lender-of-last-resort. In the U.S., this rate is known as the discount rate.

Charging higher rates and requiring more collateral, an example of contractionary monetary policy, will mean that banks have to be more cautious with their own lending or risk failure. Conversely, lending to banks at lower rates and at looser collateral requirements will enable banks to make riskier loans at lower rates and run with lower reserves

3. Authorities also use a third option: the reserve requirements, which refer to the funds that banks must retain as a proportion of the deposits made by their customers in order to ensure that they are able to meet their liabilities.

   Lowering this reserve requirement releases more capital for the banks to offer loans or to buy other assets. Increasing the reserve requirement, meanwhile, has a reverse effect, curtailing bank lending and slowing growth of the money supply.

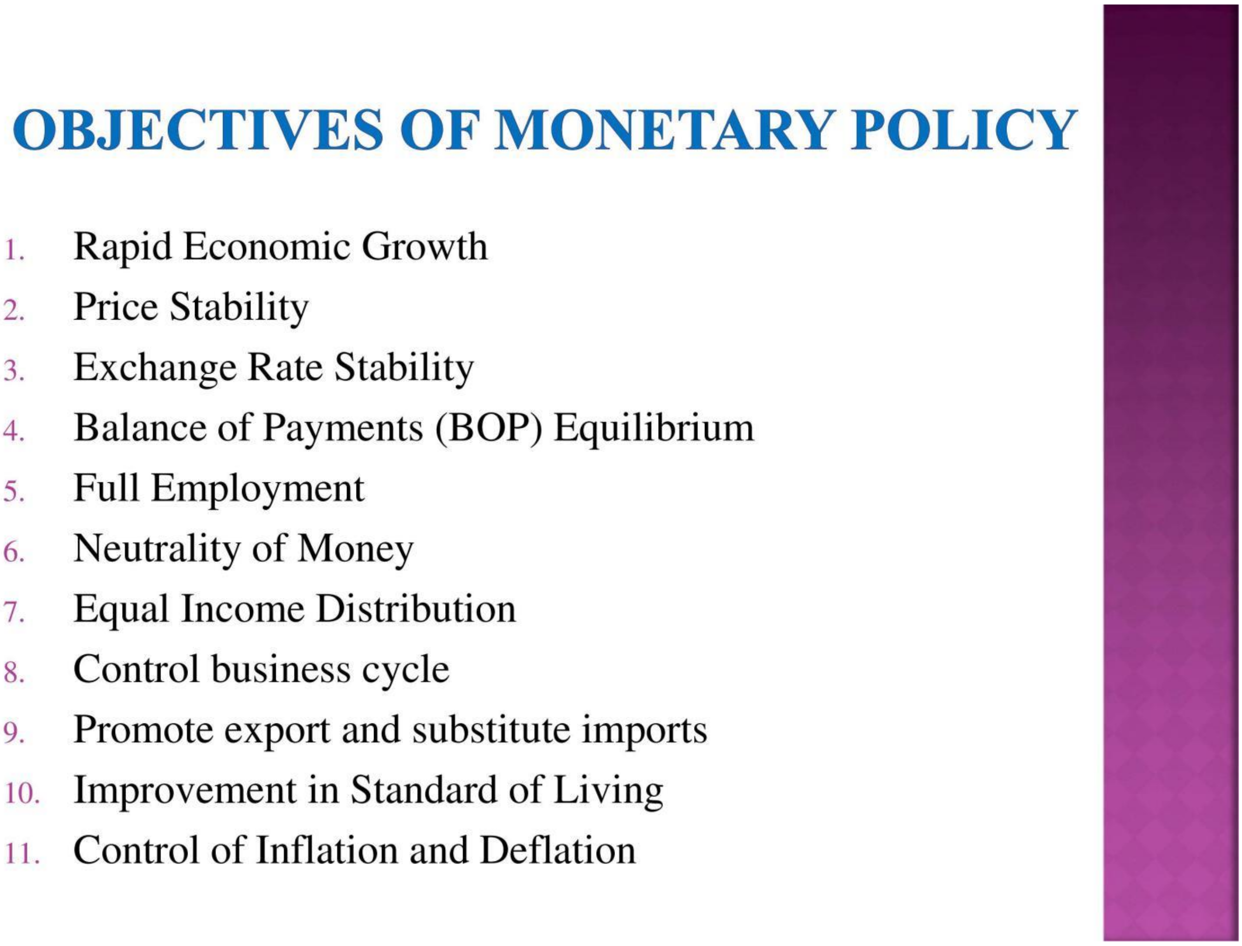
4. In addition to the standard expansionary and contractionary monetary policies, unconventional monetary policy has also gained tremendous popularity in recent times.

   During periods of extreme economic turmoil, such as the financial crisis of 2008, the U.S. Fed loaded its balance sheet with trillions of dollars in treasury notes and mortgage-backed securities (MBS), introducing new lending and asset-purchase programs that combined aspects of discount lending, open market operations, and QE. Monetary authorities of other leading economies across the globe followed suit, with the Bank of England (BoE), the European Central Bank (ECB), and the Bank of Japan (BoJ) pursuing similar policies.

5. Lastly, in addition to direct influence over the money supply and bank lending environment, central banks have a powerful tool in their ability to shape market expectations by their public announcements about the central bank's own future policies. Central bank statements and policy announcements move markets, and investors who guess right about what the central banks will do can profit handsomely.

   Some central bankers choose to be deliberately opaque to market participants in the belief that this will maximize the effectiveness of monetary policy shifts by making them unpredictable and not "baked-in" to market prices in advance. Others choose the opposite course of action, being more open and predictable in the hopes that they can shape and stabilize market expectations and curb the volatile market swings sometimes triggered by unexpected policy shifts.

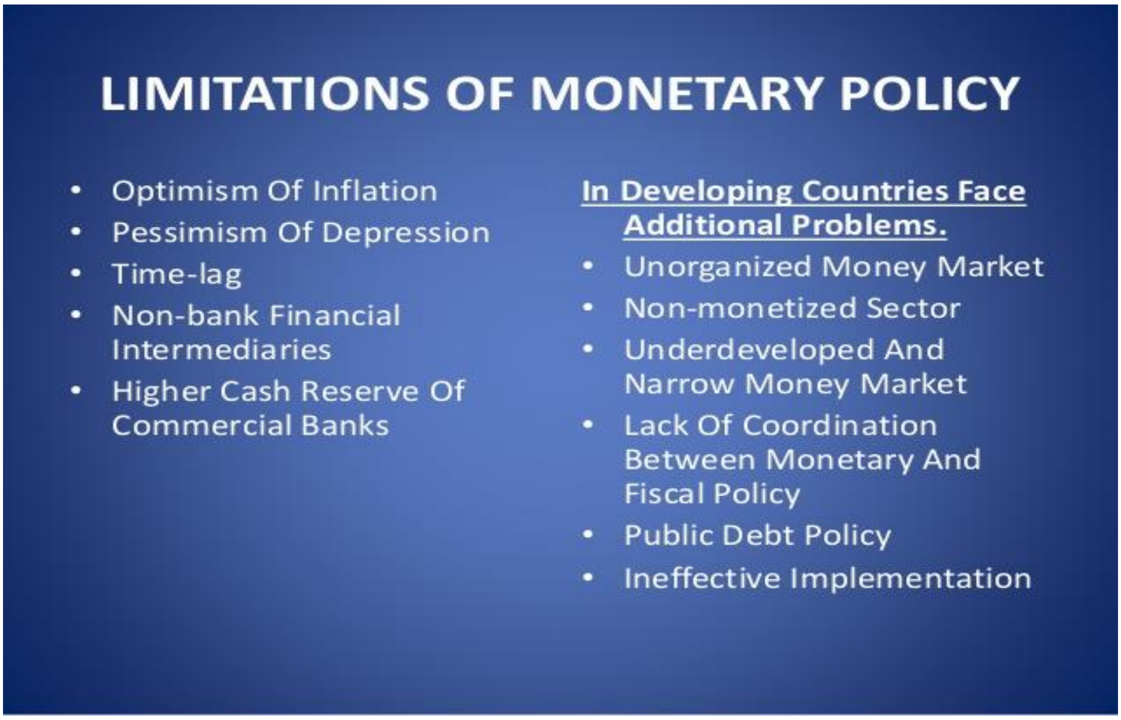
OBJECTIVES OF MONETARY POLICY



OBJECTIVES OF MONETARY POLICY

1. Rapid Economic Growth
2. Price Stability
3. Exchange Rate Stability
4. Balance of Payments (BOP) Equilibrium
5. Full Employment
6. Neutrality of Money
7. Equal Income Distribution
8. Control business cycle
9. Promote export and substitute imports
10. Improvement in Standard of Living
11. Control of Inflation and Deflation

LIMTIATIONS OF MONETARY PLICY



LIMITATIONS OF MONETARY POLICY

- Optimism Of Inflation
- Pessimism Of Depression
- Time-lag
- Non-bank Financial Intermediaries
- Higher Cash Reserve Of Commercial Banks

In Developing Countries Face Additional Problems.

- Unorganized Money Market
- Non-monetized Sector
- Underdeveloped And Narrow Money Market
- Lack Of Coordination Between Monetary And Fiscal Policy
- Public Debt Policy
- Ineffective Implementation

MONEATRY POLICY IN INDIA

Monetary policy is the process by which the monetary authority of a country, generally the 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.[1] In India, the central monetary authority is the Reserve Bank of India (RBI).

It is designed to maintain the price stability in the economy. Other objectives of the monetary policy of India, as stated by RBI, are:

Price stability

Price stability implies promoting economic development with considerable emphasis on price stability. The centre of focus is to facilitate the environment which is favourable to the architecture that enables the developmental projects to run swiftly while also maintaining reasonable price stability.

Controlled expansion of bank credit

One of the important functions of RBI is the controlled expansion of bank credit and money supply with special attention to seasonal requirement for credit without affecting the output.

Promotion of fixed investment

The aim here is to increase the productivity of investment by restraining non essential fixed investment.

Restriction of inventories and stocks

Overfilling of stocks and products becoming outdated due to excess of stock often results in sickness of the unit. To avoid this problem, the central monetary authority carries out this essential function of restricting the inventories. The main objective of this policy is to avoid over-stocking and idle money in the organisation.

Promoting efficiency

It tries to increase the efficiency in the financial system and tries to incorporate structural changes such as deregulating interest rates, easing operational constraints in the credit delivery system, introducing new money market instruments, etc.

Reducing rigidity

RBI tries to bring about flexibilities in operations which provide a considerable autonomy. It encourages more competitive environment and diversification. It maintains its control over financial system whenever and wherever necessary to maintain the discipline and prudence in operations of the financial system.

MONEY MARKET

The money market refers to trading in very short-term debt investments. At the wholesale level, it involves large-volume trades between institutions and traders. At the retail level, it includes money market mutual funds bought by individual investors and money market accounts opened by bank customers.

In all of these cases, the money market is characterized by a high degree of safety and relatively low rates of return.

The money market is one of the pillars of the global financial system. It involves overnight swaps of vast amounts of money between banks and the U.S. government. The majority of money market transactions are wholesale transactions that take place between financial institutions and companies.

Institutions that participate in the money market include banks that lend to one another and to large companies in the eurocurrency and time deposit markets; companies that raise money by selling commercial paper into the market, which can be bought by other companies or funds; and investors who purchase bank CDs as a safe place to park money in the short term. Some of those wholesale transactions eventually make their way into the hands of consumers as components of money market mutual funds and other investments.

In the wholesale market, commercial paper is a popular borrowing mechanism because the interest rates are higher than for bank time deposits or Treasury bills, and a greater range of maturities is available, from overnight to 270 days.1 However, the risk of default is significantly higher for commercial paper than for bank or government instruments.

Individuals can invest in the money market by buying money market funds, short-term certificates of deposit (CDs), municipal notes, or U.S. Treasury bills. For individual investors, the money market has retail locations, including local banks and the U.S. government's TreasuryDirect website. Brokers are another avenue for investing in the money market.

INDIAN MONEY MARKET

The **Money market in India** is a correlation for short-term funds with maturity ranging from overnight to one year in India including financial instruments that are deemed to be close substitutes of money.Similar to developed economies the Indian money market is diversified and has evolved through many stages, from the conventional platform of treasury bills and call money to commercial paper, certificates of deposit, repos, forward rate agreements and most recently interest rate swaps

The Indian money market consists of diverse sub-markets, each dealing in a particular type of short-term credit. The money market fulfills the borrowing and investment requirements of providers and users of short-term funds, and balances the demand for and supply of short-term funds by providing an equilibrium mechanism. It also serves as a focal point for the central bank's intervention in the market.

Structure

Call money market

call money market deals in short term finance repayable on demand, with a maturity period varying from one day to 14 days. S.K. Muranjan commented that call loans in India are provided to the bill market, rendered between banks, and given for the purpose of dealing in the bullion market and stock exchanges. Commercial banks, both Indian and foreign, co-operative banks, Discount and Finance House of India Ltd.(DFHI), Securities trading corporation of India (STCI) participate as both lenders and borrowers and Life Insurance Corporation of India (LIC), Unit Trust of India(UTI), National Bank for Agriculture and Rural Development (NABARD)can participate only as lenders. The interest rate paid on call money loans, known as the call rate, is highly volatile. It is the most sensitive section of the money market and the changes in the demand for and supply of call loans are promptly reflected in call rates. There are now two call rates in India: the Inter bank call rate and the lending rate of DFHI. The ceilings on the call rate and inter-bank term money rate were dropped, with effect from May 1, 1989. The Indian call money market has been transformed into a pure inter-bank market during 2006–07. The major call money markets are in Mumbai, Kolkata, Delhi, Chennai, Ahmedabad.

Treasury bill market

Treasury bills are instrument of short-term borrowing by the Government of India, issued as promissory notes under discount. The interest received on them is the discount, which is the difference between the price at which they are issued and their redemption value. They have assured yield and negligible risk of default. Under one classification, treasury bills are categorised as ad hoc, tap and auction bills. Under another one, it is classified on the maturity period like 91-days TBs, 182-days TBs, 364-days TBs and also 10-days TBs which has two types. In the recent times (2002–03, 2003–04), the Reserve Bank of India has been issuing only 91-day and 364-day treasury bills. The auction format of 91-day treasury bill has changed from uniform price to multiple price to encourage more responsible bidding from the market players. The bills are of two kinds- Adhoc and regular. The adhoc bills are issued for investment by the state governments, semi government departments and foreign central banks for temporary investment. They are not sold to banks and general public. The treasury bills sold to the public and banks are called regular treasury bills. They are freely marketable and commercial banks buy entire quantities of such bills, issued on tender. They are bought and sold on discount basis. Ad-hoc bills were abolished in April 1997.

Ready forward contract

Repo is an abbreviation for Repurchase agreement, which involves a simultaneous "sale and purchase" agreement. When banks have any shortage of funds, they can borrow it from Reserve Bank of India or from other banks. The rate at which the RBI lends money to commercial banks is called repo rate, a short term for repurchase agreement. A reduction in the repo rate will help banks to get money at a cheaper rate. When the repo rate increases borrowing from RBI becomes more expensive.

Money market mutual funds

Money market mutual funds invest money in specifically, high-quality and very short maturity-based money market instruments. The RBI has approved the establishment of very few such funds in India. In 1997, only one MMMF was in operation, and that too with very small amount of capital.

IMPORTANCE OF MONEY MARKET IN INDIA

Importance of Money Market

Money Market is important for the economic growth of the country. The importance of it can be described more clearly below:

1. Money Market fulfills the finance needs of the trade and industry as & when required.
2. For getting the short-term funds of the commercial banks, the Money Market furnishes the beneficial channels.
3. By selling the treasury bills, the government can quickly raise the short-term capital from the market with a low rate of interest.

4. Money Market helps the RBI to formulate and implement the monetary policies, and to accomplish its open market operations on a large scale.
5. Money Market helps the RBI to regulate the funds in the market and provides commercial papers for rediscount.

Conclusion

Money Market is that portion of the financial system where short-term capital is issued for not more than one year. It can be classified into organized and unorganized Money Market.

Organized Money Market consist of financial institutions and unorganized Money Market implies the financial services offered by the domestic bankers which are not regulated by the government.

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