UNIT 21 MONETARY POLICY

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21.0 OBJECTIVES

After going through this unit, you will be able to:
• Describe the concept of monetary policy;
• Discuss the instruments of monetary policy;
• State the objective of monetary policy;
• Explain the monetary policy framework;
• Describe the overview of monetary policy in India;
• Discuss the monetary policy rule; and
• Explain the monetary policy transmission.

21.1 INTRODUCTION

Monetary policy is the macroeconomic policy laid down by the central bank of an economy. The policy involves an operational framework which uses certain instruments and targeting mechanisms to achieve macroeconomic objectives like price stability, reviving consumption, growth and liquidity. The Reserve Bank of India (RBI) is vested with the responsibility of conducting monetary policy. This responsibility is explicitly mandated under the Reserve Bank of India Act, 1934. Monetary policy thus involves the use of monetary instruments under the control of the central bank to regulate magnitudes such as interest rates, money supply and availability of credit with a view to achieve certain objectives of economic policy. In this Unit, you will learn the instruments, goals and framework of Monetary Policy. You will further learn the overview of Monetary Policy, Monetary Policy rule and Monetary Policy Transmission.
21.2 EXPANSIONARY MONETARY POLICY VERSUS CONTRACTIONARY MONETARY POLICY

The monetary policy response depends on the economic state of affairs of the economy. Based on which, the monetary policy may be categorized in one of two ways: expansionary monetary policy or contractionary monetary policy.

a) Expansionary Monetary Policy: This is known as loose monetary policy, expansionary policy increases the supply of money and credit to generate economic growth. A central bank may deploy an expansionist monetary policy to reduce unemployment and boost growth and investment during hard economic times. The overall goal of any expansionary policy is to encourage spending and borrowing. This is done by reducing the interest rate, subsequently providing easier and cheaper loans to the borrowers. According to economic theory, more money available to individuals and businesses at lower cost will result in the increased purchase of goods and services, thus stimulating growth.

b) Contractionary Monetary Policy: Tight or contractionary monetary policy is used to prevent inflation due to economy growing too fast (over-heating). It aims at reducing the money supply, raising the interest rates and therefore, discouraging borrowing in the economy. Business investment will decline because it is less attractive for firms to borrow money. In addition, higher interest rates will also discourage consumer borrowing for big-ticket items like houses and cars.

Figure 2 gives a schematic representation of how the above two policies change the output and price level in an economy:

Rule-Based Versus Discretionary Monetary Policy

Academics and policymakers debate whether central banks should follow a predetermined, fixed rule or should have discretion in monetary policy. Supporters of central bank discretion argue that a simple monetary policy rule is incompatible with the complexity of an economy. A rules-based approach can be considered reliable on account of the following reasons:

1. A good monetary policy rule specifies a plan of action which the central bank cannot later ignore, while discretion allows central bankers to react—and often overreact—to economic indicators as they see appropriate.

2. The rules-based approach has been criticized for being too rigid, but it provides certainty in the market that the central bank will not sacrifice long-term stability for short-term gain.
In sum, a simple and easily communicated rule is better able to manage the complexity of the economy than a central bank operating with discretion.

### 21.3 INSTRUMENTS OF MONETARY POLICY

There are several direct and indirect instruments that are used for implementing monetary policy.

1. **Bank Rate**: It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers.

2. **Cash Reserve Ratio (CRR)**: The average daily balance that a bank is required to maintain with the Reserve Bank as a share of such per cent of its Net demand and time liabilities (NDTL). The Reserve Bank may notify CRR from time to time in the Gazette of India.

3. **Statutory Liquidity Ratio (SLR)**: The share of NDTL that a bank is required to maintain in safe and liquid assets, such as, government securities, cash and gold. Changes in SLR often influence the availability of resources in the banking system for lending to the private sector.

4. **Open Market Operations (OMOs)**: These include both, outright purchase and sale of government securities, for injection and absorption of durable liquidity, respectively.

5. **Repo Rate**: The (fixed) interest rate at which the Reserve Bank provides overnight liquidity to banks against the collateral of government and other approved securities under the liquidity adjustment facility (LAF).

6. **Reverse Repo Rate**: The (fixed) interest rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF.

7. **Liquidity Adjustment Facility (LAF)**: The LAF consists of overnight as well as term repo auctions. It is used to make temporary and swift adjustments in liquidity within the banking system mainly using the repo and reverse repo rates.

8. **Marginal Standing Facility (MSF)**: A facility under which scheduled commercial banks can borrow additional amount of overnight money from the Reserve Bank. This provides a safety valve against unanticipated liquidity shocks to the banking system.

9. **Corridor**: The MSF rate and reverse repo rate determine the corridor for the daily movement in the weighted average call money rate.

10. **Market Stabilisation Scheme (MSS)**: This instrument for monetary management was introduced in 2004. Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-dated government securities and treasury bills.

We have so far discussed the conventional monetary policy instruments. However, sometimes there may be problems in the monetary policy transmission mechanism (discussed later) or if policy rate cannot be reduced further then the central banks may employ unconventional monetary policy tools. For example, large scale asset purchases, lending operations, forward guidance, and negative interest rate. The objective of unconventional tools is to supplement the conventional monetary policy tools especially in the easing cycle to boost economic growth. More recently, with the slowdown in 2019 followed by the extraordinary collapse in...
economic activity due to COVID-19 pandemic, unconventional monetary policy tools supplemented the conventional monetary policy measures to stimulate growth in the economy.

### 21.4 GOALS OF MONETARY POLICY

Goals refer to the final policy objectives of the monetary policy. In any monetary policy framework, a key ingredient is the enunciation of its objectives as its actions are guided foremost by the objectives. These may include: price stability, economic growth and financial stability. Let us learn them.

1. **Price Stability:** The primary objective of monetary policy is to maintain price stability while keeping in mind the objective of growth. Price stability is a necessary precondition to sustainable growth. In May 2016, the Reserve Bank of India (RBI) Act, 1934 was amended to provide a statutory basis for the implementation of the flexible inflation targeting framework.

2. **Economic Growth:** One of the most important objectives of monetary policy in recent years has been the rapid economic growth of an economy. The RBI, by keeping the prices steady and maintaining overall financial stability, has the ability to promote economic growth, leading to prosperity over time.

3. **Financial Stability:** Financial system stability means the effective functioning of the financial system (financial institutions and markets) and the absence of banking, currency, balance of payments and exchange rate crisis. By forestalling or mitigating the consequences of financial instability for the economy, the central banks help alleviate liquidity pressures and boost public confidence. Formulating appropriate financial regulations, implementing effective bank supervision, and operating or overseeing efficient payment systems are few ways through which central banks help to offset the risks of financial instability.

The choice of a dominant objective arises essentially because of the multiplicity of objectives and the inherent conflict among such objectives. The fundamental reason to adopt price stability as the dominant objective is that inflation is economically and socially costly. It is also important to observe that the objective of control of inflation is not independent of the objective of growth. For example, the amendment Act of 2016 relating to RBI says (GoI, 2016) “Whereas the primary objective of monetary policy is to maintain price stability while keeping in mind the objective of growth”.

### 21.5 MONETARY POLICY FRAMEWORK

Monetary Policy is conducted through specification of the Monetary Policy Framework. The Monetary policy framework in India has evolved over the past few decades owing to the changing macroeconomic conditions and financial developments in the economy. Instruments and targeting mechanisms that ensure smooth operation of the monetary policy have undergone significant changes. The overall framework includes well-defined objectives/goals of monetary policy along with instruments, operating targets and intermediate targets. They ensure proper implementation of monetary policy and realization of the definite objectives. A schematic representation of a monetary policy framework is shown in Figure 2.
Instruments are tools that the central bank has control over and are used to achieve the operational target. Examples of instruments include open market operations, reserve requirements, repo rate etc. Operational targets are the financial variables that can be controlled by the central bank to a large extent through the monetary policy instruments and guide the day-to-day operations of the central bank. These can influence the intermediate target and thus help in the delivery of the final goal of monetary policy. Examples of operational targets include reserve money and short-term money market interest rates. Intermediate targets, on the other hand, are variables that are closely related with the final goals of monetary policy and can be affected by monetary policy. Intermediate targets may include monetary aggregates and short-term and long-term interest rates.

### 21.6 AN OVERVIEW OF MONETARY POLICY IN INDIA

The story of contemporary Indian Monetary policy can be understood by going back to the history of how this policy has undergone transformations over a period of time. The 1970s and 1980s were marked by fiscal dominance, wherein monetary policy almost entirely played a supporting role in financing fiscal needs. Till about the mid-1980s, monetary policy in India was more suitably considered as “credit planning”. The key objective was to channel credit at cheap administered rates for the developmental pursuits, with public sector banks acting as the main intermediaries. Monetary policy formulation from the mid-1980s to 1998 functioned on the lines of the recommendations of Chakravarty Committee (1985). In view of that, monetary targeting was adopted, wherein the targeted path of monetary expansion was designed to fund the ‘desired growth of GDP in nominal terms’, i.e., growth after accounting for tolerable inflation.

In the wake of challenges posed by financial liberalization and increasing complexities of monetary management, the Reserve Bank of India switched to a multiple indicator approach in 1998-1999. Under this approach Broad money (M3) continued to remain a primary variable; however, focus was also placed on rate channels in monetary policy formulation. Many macroeconomic variables like interest rate along with other indicators like credit flows, inflation rate, exchange rate, foreign exchange reserves etc. were juxtaposed with output data for drawing policy outlooks. In June 2000, the Reserve Bank also introduced a Liquidity Management Facility (LAF) to manage liquidity on a daily basis through reverse repo and repo rates in order to convey interest rate signals to the market. Monetary reforms continued thereafter, eventually freeing the central bank from fiscal dominance. This paved way for greater dependence on market-oriented, price-based, indirect instruments as against the direct measures used earlier on. These changes marked the adoption of a multiple indicator approach by RBI which lasted till 2016.

Another imperative footstep towards an independent and proficient monetary policy framework and its operations was to cut the liability of swelling fiscal deficit. It was attempted in the form of a Fiscal Responsibility and Budget
Management Act, 2003. Under it, the automatic monetization of fiscal deficit of Government of India was to be phased out completely and the RBI was to be relieved of the burden of subscribing government securities in the primary market. This assisted in giving more independence and autonomy to RBI in outlining a balanced monetary policy subject to its goals.

The most important development between 1998 and 2016 has been the emergence of interest rates as the chief tool of monetary intervention. This was a noticeable shift from the prior reliance on bank rate and cash reserve ratio (CRR) by the RBI. Liquidity adjustment facility (LAF), a cornerstone of monetary policy over this period, was used extensively. This was used to make temporary and swift adjustments in liquidity within the banking system mainly using the repo and reverse repo rates. This process culminated in the evolution of the repo rate as the benchmark policy rate, determining the baseline cost of borrowing in the economy today.

The Report of the Committee on Financial Sector Reforms, 2009 under the chairmanship of the then Governor, Raghuram Rajan and headed by the then Deputy Governor Urjit Patel, proposed that RBI can take care of the growth objective in the medium-run only if it focuses on controlling inflation. It would also help serve the purpose of inclusive growth since the poorer sections are least hedged against inflation. Following this, an Expert Committee to Revise and Strengthen the Monetary Policy Framework was appointed on September 12, 2013. The main objectives of the Committee were: i) to devise and redefine the objectives and conduct of monetary policy framework in an open economy environment; ii) to recommend an appropriate nominal anchor for conduct of monetary policy; iii) to review the operating framework and instruments of the monetary policy including the multiple-indicator approach; and iv) to identify the impediments both fiscal and others in the smooth functioning of monetary policy.

The main recommendations of this committee that submitted its report in January 2014 include the following:

(a) **The Choice of Nominal Anchor**: Inflation should be the nominal anchor for the monetary policy framework. This nominal anchor should be set by the RBI as its predominant objective of monetary policy in its policy statements. The nominal anchor should be communicated without ambiguity, so as to ensure a monetary policy regime shift away from the current approach to one that is centered around the nominal anchor. Subject to the establishment and achievement of the nominal anchor, monetary policy conduct should be consistent with a sustainable growth trajectory and financial stability.

(b) **The Choice of Inflation Metric**: The RBI should adopt the new CPI (combined) as the measure of the nominal anchor for policy communication. The nominal anchor should be defined in terms of headline CPI inflation, which closely reflects the cost of living and influences inflation expectations relative to other available metrics.

(c) **Numerical Target and Precision**: The nominal anchor or the target for inflation should be set at 4 per cent with a band of +/- 2 per cent around this target should be set in the frame of a two-year horizon.

(d) **Institutional Requirements of the Monetary Policy Framework**: Consistent with the Fiscal Responsibility and Budget Management (Amendment) Rules, the Central Government needs to ensure that its fiscal deficit as a ratio to GDP is brought down to 3.0 per cent by 2016-17.
The Expert Committee also recommended that decision-making should be vested in a Monetary Policy Committee (MPC). The above recommendations were accepted and from 2016 the monetary authority shifted to flexible inflation targeting with repo rate as its instrument of control.

Thus, the progression of monetary policy was swayed not only by the changing prototype in monetary economics but also by the advances in the financial markets and macroeconomic outcomes.

**Check your progress A**

1) What is the difference between Expansionary Monetary Policy and Contractionary Monetary Policy.

2) Write at least five instruments that are used for implementing monetary policy.

3) Write the major goals of monetary policy.

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### 21.7 MONETARY POLICY RULE

Monetary policy and its implementation in India has seen a steady, fundamental shift from the pre-1990s regime of administered interest rates to a market-based system today. The repo rate has emerged as the primary tool of monetary intervention. The theoretical underpinning of the recent policy stance of the RBI can be traced back to the influential Taylor rule. This captured the way forward-looking central banks frame interest rate policies, by taking into account inflationary expectations (based on the Phillips Curve) and the impact of real interest rates on output (based on dynamic IS curve).

#### 21.7.1 Taylor Rule

Taylor rule is a monetary policy rule, which explains its stance of changing the nominal policy interest rate in response to its objectives, viz. inflation, output and other economic conditions.

According to the original version of Taylor rule as per Taylor (1993), the nominal interest rate should respond to divergences of actual inflation from target rates and actual output from the potential output.

\[ i = \pi + r^* + \beta_1(\pi - \pi^*) + \beta_2(y - y^*) \]  

In the above equation, \( i \) is the nominal interest rate set by the central bank; \( r^* \) is the equilibrium real rate of interest; \( \pi \) and \( \pi^* \) are the actual and target rates of
inflation, respectively; and \( y \) and \( y^* \) are logarithms of actual and potential output levels, respectively.

According to the Taylor Rule, the coefficient values \( \beta_1 \) and \( \beta_2 \) should be positive and as a rule of thumb, \( \beta_1 \) and \( \beta_2 \) must be equal to 0.5. The rule thus proposes a higher interest rate, when either inflation is above its target or when output is above its potential or full employment level. In other words, a tight monetary policy, when inflation or output gap is positive and an easy monetary policy, when the gap is negative. During times when an economy experiences conflicting goals such as low growth and high inflation, such as stagflation, the rule recommends, giving relative weights to stimulate output and lower inflation. The magnitude of the weights assigned to the inflation gap and output gap essentially indicate central banks’ tolerance for deviations of output vis-à-vis inflation from respective targets.

21.7.2 Flexible Inflation Targeting

While India formally adopted an inflation target of 4% (within a 2% point range of 2–6%) in 2016. In practice, monetary policy seems to have broadly followed the Taylor rule right through the 2000s decade. With the signing of the Monetary Policy Framework Agreement (MPFA) between the Government of India and the RBI on Feb 20, 2015, Flexible Inflation Targeting (FIT) was formally adopted in India. In May 2016, the Reserve Bank of India (RBI) Act, 1934 was amended to provide a statutory basis for the implementation of the FIT framework. The amended RBI Act, 1934 also provided that the Central Government shall, in consultation with the Bank, determine the inflation target in terms of the Consumer Price Index, once in every 5 years.

In 2016, India thus joined several developed and emerging market economies that have implemented inflation targeting. Figure 3 shows the timeline for adoption of inflation targeting regime starting with New Zealand in 1990 and most recently Argentina and India in 2016.

Inflation Targeting Regime Adoption

Fig. 3
Source: Dua (2020)

21.7.3 Monetary Policy Committee (MPC)

The Monetary Policy Committee (MPC) is one of the main committees of the RBI and is responsible for setting the monetary policy stance (setting the repo rate). In formulating the monetary policy direction, MPC makes assessments and policy decisions based upon data provided by the RBI. Under the amended RBI Act, the MPC is required to meet at least four times in a year.
The minimum number for the meeting of the MPC is four members. Currently as of 2021, MPC is a 6 member committee. Each member of the MPC has one vote, and in the event of an equality of votes, the Governor has a second or casting vote. The resolution adopted by the MPC is published after conclusion of every meeting of the MPC in accordance with the provisions of Chapter III F of the Reserve Bank of India Act, 1934.

On the 14th day, the minutes of the proceedings of the MPC are published which include:

a. the resolution adopted by the MPC;
b. the vote of each member on the resolution, ascribed to such member; and
c. the statement of each member on the resolution adopted.

Once in every six months, the Reserve Bank is required to publish a document called the Monetary Policy Report to explain:

a. the sources of inflation; and
b. the forecast of inflation for 6-18 months ahead.

### 21.8 MONETARY POLICY TRANSMISSION

The transmission mechanism of monetary policy is a process through which monetary actions affect the twin objective of growth with stable inflation. There are various monetary policy tools which are used for achieving the same, but in the recent past interest rate has been predominantly and frequently used. Changes in monetary policy affect the economic activity in general and price level in particular through the following five channels of monetary transmission:

1. **The interest rate channel:** The change in the policy rate affects directly money-market interest rates and, indirectly, lending and deposit rates, which are set by banks to their customers. A reduction in interest rates (an ‘easing’ of monetary policy) reduces the cost of capital thus triggering aggregate demand by motivating business investment and consumption decisions. A tightening in monetary policy has the opposite effect on demand and inflation.

![Interest Rate Channel Diagram](https://www.bot.or.th/English/MonetaryPolicy/MonetPolicyKnowledge/Pages/TransmissionMechanism.aspx)
2. **The exchange rate channel:** Lower domestic interest rates could lead to a depreciation of the domestic currency. On the one hand, making exports more competitive in the global market and adding to domestic demand and economic activity. On the other hand, it could also have a direct upward impact on the rupee prices of imported inputs, making imports (for example, crude oil) costlier.

![Exchange Rate Channel Diagram]

Source: https://www.bot.or.th/English/MonetaryPolicy/MonetPolicyKnowledge/Pages/TransmissionMechanism.aspx

3. **The credit channel:** Through this channel, an expansionary monetary policy leads to higher deposits. Consequently, the banks disburse higher credit, which in turn increases the investment and output in the economy. Further, debt obligations of businesses may also change due to a change in the interest rate. For instance, if the policy rate falls, debt obligations of firms may decrease, strengthening their balance sheets. As a result, financial institutions may be more willing to lend to businesses, thus increasing investment spending.

![Credit Channel Diagram]

Source: https://www.bot.or.th/English/MonetaryPolicy/MonetPolicyKnowledge/Pages/TransmissionMechanism.aspx

4. **The asset price channel:** Asset prices and people's wealth influence how much they can borrow and how much they spend in the economy. The asset prices and wealth channel typically affects consumption and investment. Lower interest rates support asset prices (such as housing and equities) by...
encouraging demand for assets. Higher asset prices also increase the equity (collateral) of an asset that is available for banks to lend against. This can make it easier for households and businesses to borrow. An increase in asset prices increases people's wealth. This can lead to higher consumption and housing investment as households generally spend some share of any increase in their wealth.

5. **The expectations channel**: Inflation expectations also matter for the transmission of monetary policy. By having an inflation target, the central bank can anchor inflation expectations. In this case, economic agents do not have to increase their prices for fear of higher inflation or reduce them for fear of deflation. This should increase the confidence of households and businesses in making decisions about saving and investment because uncertainty about the economy is reduced.
Fiscal and Monetary Policy

Check your progress B

1) What do you mean by Taylor Rule.

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2) What is meant by monetary policy transmission?

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3) What do you mean by Flexible Inflation Targeting?

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21.9 LET US SUM UP

Monetary policy refers to the use of monetary instruments under the control of the central bank to regulate magnitudes such as interest rates, money supply and availability of credit with a view to achieving the ultimate objective of economic policy. The primary objective of monetary policy in India is to maintain price stability while keeping in mind the objective of growth. Price stability is a necessary precondition to sustainable growth.

The monetary policy framework aims at setting the policy (repo) rate based on an assessment of the current and evolving macroeconomic situation; and modulation of liquidity conditions to anchor money market rates at or around the repo rate. Repo rate changes transmit through the money market to the entire financial system. This in turn, influences aggregate demand—a key determinant of inflation and growth. The MPC determines the policy interest rate required to achieve the inflation target. The monetary policy framework adopted by India and many other countries is correctly described as ‘flexible inflation targeting’. Most of these countries set not only an inflation target but also provide a range within which it can fluctuate. This flexibility is extremely important because it emphasizes the uncertainties against which central bank have to operate. Monetary policy, therefore, has an important role in flattening the recession curve by ensuring easy and sufficient liquidity in the economy, so that people have money to spend even if they are unemployed. Lastly, a healthy monetary-fiscal policy co-ordination is essential to achieve macroeconomic stability and prevent any future growth impairment in India.

21.10 KEY WORDS

Expansionary Monetary Policy: This is known as loose monetary policy, expansionary policy increases the supply of money and credit to generate economic growth.

Bank Rate: It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers.
**Repo Rate:** The (fixed) interest rate at which the Reserve Bank provides overnight liquidity to banks against the collateral of government and other approved securities under the liquidity adjustment facility (LAF).

**Reverse Repo Rate:** The (fixed) interest rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF.

### 21.11 TERMINAL QUESTIONS

Q1. Write down the major instruments of monetary policy?

Q2. What do you mean by monetary policy framework?

Q3. Discuss the monetary policy committee formed for the purpose of monetary policy rule.