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Paper - MIC
Topic - Meaning and Tools of Monetary policy

Introduction

Monetary policy refers to the actions undertaken by a nation's central bank to control money supply and interest rates to achieve macroeconomic objectives like controlling inflation, stabilising currency, achieving full employment, and fostering economic growth. Central banks, such as the Reserve Bank of India (RBI), Federal Reserve (USA), or European Central Bank (ECB), design and implement monetary policy to regulate liquidity in the economy.

Tools of Monetary Policy

Monetary policy tools are broadly categorised into two types:

1.quantitative tools (focused on the volume of money)

2.qualitative tools (focused on the direction of credit)

1. Quantitative Tools

These tools regulate the total volume of money supply in the economy.

- **Open Market Operations (OMO)**

This refers to the buying and selling of government securities in the open market by the central bank.

When the central bank buys securities, it injects liquidity into the economy, increasing money supply.
When it sells securities, it absorbs liquidity, reducing money supply.
OMO is often used to manage short-term liquidity and interest rates.

- **Cash Reserve Ratio (CRR)**

CRR is the percentage of a bank's total deposits that must be maintained as reserves with the central bank.

- ☐ Higher CRR reduces the funds available for lending, curbing inflation.

- ☐ Lower CRR increases funds for lending, stimulating economic growth.

- **Statutory Liquidity Ratio (SLR)**

SLR is the percentage of a bank's net demand and time liabilities (NDTL) that must be invested in approved securities.
- By adjusting SLR, the central bank controls bank lending capacity, indirectly influencing credit growth and money supply.

- **Repo Rate and Reverse Repo Rate**

- ☐ **Repo Rate*:*** The rate at which banks borrow money from the central bank by selling securities. A lower repo rate encourages borrowing, boosting liquidity. A higher rate discourages borrowing, reducing liquidity.
- ☐ **Reverse Repo Rate:**The rate at which banks park excess funds with the central bank. An increase in the reverse repo rate incentivizes banks to deposit more, reducing money supply.

- **Bank Rate**

This is the rate at which the central bank lends to commercial banks without collateral.

- ☐ An increase in the bank rate discourages borrowing and reduces money supply.
- ☐ A decrease in the bank rate encourages borrowing and increases money supply.

2. Qualitative Tools

These tools aim to direct credit to specific sectors of the economy.

- **Margin Requirements**

Margin requirements refer to the difference between the loan amount and the market value of securities offered as collateral.

- ☐ By increasing margins, central banks reduce the borrowing capacity for speculative purposes.
- ☐ Lowering margins promotes credit flow to priority sectors.

- **Credit Rationing**

The central bank imposes restrictions on the amount of credit to certain sectors. This ensures that funds are available for essential sectors like agriculture and infrastructure while discouraging non-essential activities.

- **Moral Suasion**

This involves the central bank persuading or advising commercial banks to adopt specific measures. For example, banks may be encouraged to restrict loans for speculative activities during inflationary periods.

- **Direct Action**

The central bank can take direct measures like penalising banks that fail to meet reserve requirements or comply with other regulations.

3. Unconventional Monetary Policy Tools

During periods of extreme economic stress, central banks may adopt unconventional tools such as:

- **Quantitative Easing (QE):** The central bank buys long-term securities to inject liquidity into the economy.
- **Operation Twist:** Simultaneous buying of long-term bonds and selling of short-term bonds to flatten the yield curve and stimulate investment.
- **Forward Guidance:** Communicating future policy intentions to influence market expectations and behaviour.

Effectiveness of Monetary Policy

Monetary policy is critical for maintaining economic stability, but its effectiveness depends on factors like:

1.Economic Structure: In developing economies, structural issues may limit the impact of monetary tools.

2. **Lag Effect:** The time taken for policy measures to translate into economic outcomes can delay results.

3. Coordination with Fiscal Policy: Effective coordination between monetary and fiscal policy is crucial for achieving overall economic goals.

By controlling liquidity and directing credit, monetary policy plays a pivotal role in achieving economic stability and growth. Central banks must continuously adapt these tools to address evolving economic challenges.