

Monetary policy of india essay sample

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Monetary policy is the process by which monetary authority of a country, generally a central bank controls the supply of money in the economy by exercising 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). is so designed as 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

Overfilling of stocks and products becoming outdated due to excess of stock often results in sickness of the unit.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 organization Promotion of Exports and Food Procurement Operations

Monetary policy pays special attention in order to boost exports and facilitate the trade. It is an independent objective of monetary policy. Desired

Distribution of Credit

Monetary authority has control over the decisions regarding the allocation of credit to priority sector and small borrowers. This policy decides over the specified percentage of credit that is to be allocated to priority sector and small borrowers. Equitable Distribution of Credit

The policy of Reserve Bank aims equitable distribution to all sectors of the economy and all social and economic class of people To Promote Efficiency It is another essential aspect where the central banks pay a lot of attention.

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

RBI tries to bring about the flexibilities in the 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. Contents [hide] * 1 Monetary operations * 2 Major Operations * 3 Key Indicators * 4 References

[edit]Monetary operations

Monetary operations involve monetary techniques which operate on monetary magnitudes such as money supply, interest rates and availability of credit aimed to maintain Price Stability, Stable exchange rate, Healthy

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Balance of Payment, Financial stability, Economic growth. RBI, the apex institute of India which monitors and regulates the monetary policy of the country stabilizes the price by controlling Inflation. RBI takes into account the following monetary policies:

Major Operations

Open Market Operations

An open market operation is an instrument of monetary policy which involves buying or selling of government securities from or to the public and banks. This mechanism influences the reserve position of the banks, yield on government securities and cost of bank credit. The RBI sells government securities to contract the flow of credit and buys government securities to increase credit flow. Open market operation makes bank rate policy effective and maintains stability in government securities market.

CRR Graph from 1992 to 2011[2]

Cash Reserve Ratio

Cash Reserve Ratio is a certain percentage of bank deposits which banks are required to keep with RBI in the form of reserves or balances . Higher the CRR with the RBI lower will be the liquidity in the system and vice-versa. RBI is empowered to vary CRR between 15 percent and 3 percent. But as per the suggestion by the Narshimam committee Report the CRR was reduced from 15% in the 1990 to 5 percent in 2002. As of November 2012, the CRR is 4.25 percent.[3]

SLR Graph from 1991 to 2011[4]

Statutory Liquidity Ratio

Every financial institution has to maintain a certain quantity of liquid assets with the RBI for time and demand liabilities. These assets can be cash, precious metals, approved securities like bonds etc. The ratio of the liquid assets to time and demand liabilities is termed as the Statutory liquidity ratio. There was a reduction of SLR from 38.5% to 25% because of the suggestion by Narshimam Committee. The current SLR is 23%. [5]

Bank Rate Graph from 1991 to 2011

Bank Rate Policy [6]

Bank rate is the rate of interest charged by the RBI for providing funds or loans to the banking system. This banking system involves commercial and co-operative banks, Industrial Development Bank of India, IFC, EXIM Bank, and other approved financial institutes. Funds are provided either through lending directly or rediscounting or buying money market instruments like commercial bills and treasury bills. Increase in Bank Rate increases the cost of borrowing by commercial banks which results into the reduction in credit volume to the banks and hence declines the supply of money. Increase in the bank rate is the symbol of tightening of RBI monetary policy. Bank rate is also known as Discount rate. The current Bank rate is 8.75%. Credit Ceiling

In this operation RBI issues prior information or direction that loans to the commercial banks will be given up to a certain limit. In this case commercial bank will be tight in advancing loans to the public. They will allocate loans to limited sectors. Few example of ceiling are agriculture sector advances, priority sector lending. Credit Authorization Scheme

Credit Authorization Scheme was introduced in November, 1965 when P C Bhattacharya was the chairman of RBI. Under this instrument of credit regulation RBI as per the guideline authorizes the banks to advance loans to desired sectors.[7] Moral Suasion

Moral Suasion is just as a request by the RBI to the commercial banks to take so and so action and measures in so and so trend of the economy. RBI may request commercial banks not to give loans for unproductive purpose which does not add to economic growth but increases inflation. Repo Rate and Reverse Repo Rate

Repo rate is the rate at which RBI lends to commercial banks generally against government securities. Reduction in Repo rate helps the commercial banks to get money at a cheaper rate and increase in Repo rate discourages the commercial banks to get money as the rate increases and becomes expensive. Reverse Repo rate is the rate at which RBI borrows money from the commercial banks. The increase in the Repo rate will increase the cost of borrowing and lending of the banks which will discourage the public to borrow money and will encourage them to deposit. As the rates are high the availability of credit and demand decreases resulting to decrease in inflation. This increase in Repo Rate and Reverse Repo Rate is a symbol of tightening of the policy. As of December 2012, the repo rate is 8 % and reverse repo rate is 7%

Key Indicators

As of 29 January 2013, the key indicators are[8][9]

Indicator| Current rate|

Inflation| 4. 25%|

Bank rate| 8. 75%|

CRR| 4. 00%|

SLR| 23%|

Repo rate| 7. 75%|

Reverse repo rate| 6. 75%|

Fiscal policy

fiscal policy is the use of government revenue collection (taxation) and expenditure (spending) to influence the economy.[1] The two main instruments of fiscal policy are government taxation and changes in the level and composition of taxation and government spending can affect the following variables in the economy: * Aggregate demand and the level of economic activity;

* The distribution of income;

* The pattern of resource allocation within the government sector and relative to the private sector. Fiscal policy refers to the use of the government budget to influence economic activity Meaning of Fiscal Policy ↓

The fiscal policy is concerned with the raising of government revenue and incurring of government expenditure. To generate revenue and to incur expenditure, the government frames a policy called budgetary policy or fiscal policy. So, the fiscal policy is concerned with government expenditure and government revenue.

Stances of fiscal policy

The three main stances of fiscal policy are:

* Neutral fiscal policy is usually undertaken when an economy is in equilibrium. Government spending is fully funded by tax revenue and overall the budget outcome has a neutral effect on the level of economic activity.

* Expansionary fiscal policy involves government spending exceeding tax revenue, and is usually undertaken during recessions. * Contractionary fiscal policy occurs when government spending is lower than tax revenue, and is usually undertaken to pay down government debt. However, these definitions can be misleading because, even with no changes in spending or tax laws at all, cyclic fluctuations of the economy cause cyclic fluctuations of tax revenues and of some types of government spending, altering the deficit situation; these are not considered to be policy changes. Therefore, for purposes of the above definitions, “ government spending” and “ tax revenue” are normally replaced by “ cyclically adjusted government spending” and “ cyclically adjusted tax revenue”. Thus, for example, a government budget that is balanced over the course of the business cycle is considered to represent a neutral fiscal policy stance. [edit]Methods of

funding

Governments spend money on a wide variety of things, from the military and police to services like education and healthcare, as well as transfer payments such as welfare benefits. This expenditure can be funded in a number of different ways: * Taxation

- * Seigniorage, the benefit from printing money
- * Borrowing money from the population or from abroad
- * Consumption of fiscal reserves
- * Sale of fixed assets (e. g., land)

Borrowing

A fiscal deficit is often funded by issuing bonds, like treasury bills or consols and gilt-edged securities. These pay interest, either for a fixed period or indefinitely. If the interest and capital requirements are too large, a nation may default on its debts, usually to foreign creditors. Public debt or borrowing refers to the government borrowing from the public.

[edit]Consuming prior surpluses

A fiscal surplus is often saved for future use, and may be invested in either local currency or any financial instrument that may be traded later once resources are needed; notice, additional debt is not needed. For this to happen, the marginal propensity to save needs to be strictly positive. Main Objectives of Fiscal Policy In India ↓

The fiscal policy is designed to achieve certain objectives as follows :-

1. Development by effective Mobilisation of Resources

The principal objective of fiscal policy is to ensure rapid economic growth and development. This objective of economic growth and development can be achieved by Mobilisation of Financial Resources. The central and the state governments in India have used fiscal policy to mobilise resources. The financial resources can be mobilised by :-

1. Taxation : Through effective fiscal policies, the government aims to mobilise resources by way of direct taxes as well as indirect taxes because most important source of resource mobilisation in India is taxation. 2. Public Savings : The resources can be mobilised through public savings by reducing government expenditure and increasing surpluses of public sector enterprises. 3. Private Savings : Through effective fiscal measures such as tax benefits, the government can raise resources from private sector and households. Resources can be mobilised through government borrowings by ways of treasury bills, issue of government bonds, etc., loans from domestic and foreign parties and by deficit financing. 2. Efficient allocation of Financial Resources

The central and state governments have tried to make efficient allocation of financial resources. These resources are allocated for Development Activities which includes expenditure on railways, infrastructure, etc. While Non-development Activities includes expenditure on defence, interest payments, subsidies, etc. But generally the fiscal policy should ensure that the resources are allocated for generation of goods and services which are socially desirable. Therefore, India's fiscal policy is designed in such a manner so as to encourage production of desirable goods and discourage those goods which are socially undesirable.

3. Reduction in inequalities of Income and Wealth

Fiscal policy aims at achieving equity or social justice by reducing income inequalities among different sections of the society. The direct taxes such as income tax are charged more on the rich people as compared to lower

income groups. Indirect taxes are also more in the case of semi-luxury and luxury items, which are mostly consumed by the upper middle class and the upper class. The government invests a significant proportion of its tax revenue in the implementation of Poverty Alleviation Programmes to improve the conditions of poor people in society.

4. Price Stability and Control of Inflation

One of the main objective of fiscal policy is to control inflation and stabilize price. Therefore, the government always aims to control the inflation by Reducing fiscal deficits, introducing tax savings schemes, Productive use of financial resources, etc.

5. Employment Generation

The government is making every possible effort to increase employment in the country through effective fiscal measure. Investment in infrastructure has resulted in direct and indirect employment. Lower taxes and duties on small-scale industrial (SSI) units encourage more investment and consequently generates more employment. Various rural employment programmes have been undertaken by the Government of India to solve problems in rural areas. Similarly, self employment scheme is taken to provide employment to technically qualified persons in the urban areas.

6. Balanced Regional Development

Another main objective of the fiscal policy is to bring about a balanced regional development. There are various incentives from the government for

setting up projects in backward areas such as Cash subsidy, Concession in taxes and duties in the form of tax holidays, Finance at concessional interest rates, etc.

7. Reducing the Deficit in the Balance of Payment

Fiscal policy attempts to encourage more exports by way of fiscal measures like Exemption of income tax on export earnings, Exemption of central excise duties and customs, Exemption of sales tax and octroi, etc. The foreign exchange is also conserved by Providing fiscal benefits to import substitute industries, Imposing customs duties on imports, etc. The foreign exchange earned by way of exports and saved by way of import substitutes helps to solve balance of payments problem. In this way adverse balance of payment can be corrected either by imposing duties on imports or by giving subsidies to export.

8. Capital Formation

The objective of fiscal policy in India is also to increase the rate of capital formation so as to accelerate the rate of economic growth. An underdeveloped country is trapped in vicious (danger) circle of poverty mainly on account of capital deficiency. In order to increase the rate of capital formation, the fiscal policy must be efficiently designed to encourage savings and discourage and reduce spending.

9. Increasing National Income

The fiscal policy aims to increase the national income of a country. This is because fiscal policy facilitates the capital formation. This results in economic growth, which in turn increases the GDP, per capita income and national income of the country.

10. Development of Infrastructure

Government has placed emphasis on the infrastructure development for the purpose of achieving economic growth. The fiscal policy measure such as taxation generates revenue to the government. A part of the government's revenue is invested in the infrastructure development. Due to this, all sectors of the economy get a boost.

11. Foreign Exchange Earnings

Fiscal policy attempts to encourage more exports by way of Fiscal Measures like, exemption of income tax on export earnings, exemption of sales tax and octroi, etc. Foreign exchange provides fiscal benefits to import substitute industries. The foreign exchange earned by way of exports and saved by way of import substitutes helps to solve balance of payments problem.

Conclusion On Fiscal Policy ↓

The objectives of fiscal policy such as economic development, price stability, social justice, etc. can be achieved only if the tools of policy like Public Expenditure, Taxation, Borrowing and deficit financing are effectively used. Though there are gaps in India's fiscal policy, there is also an urgent need for making India's fiscal policy a rationalised and growth oriented one. The

success of fiscal policy depends upon taking timely measures and their effective administration during implementation.

Impacts

The Impact of Monetary Policy Impulses on the Economy

Every monetary policy impulse (e. g. an interest rate change by the central bank, change in the monetary base resulting from changes in the minimum reserve rate) has a lagged impact on the economy. Moreover, it is uncertain how exactly monetary policy impulses are transmitted to the price level or how real variables develop in the short and medium term.

The difficulty of the analysis is to adjust the effects of the individual channels for external factors. The effect of such external factors - e. g. supply and demand shocks, technical progress or structural change - may be superimposed on the effect of central bank measures, and it is difficult to isolate monetary policy effects on various variables for analytical purposes. Moreover, the time lag in the reaction of the real sector to monetary measures renders the analysis more difficult. Hence, monetary policy must be forward looking.

The individual transmission channels are described in detail below:

Interest rate channel: An expansion of the money supply by the central bank feeds through to a reduction of short-term market rates through this channel. As a result, the real interest rate and capital costs decline, raising investment. Additionally, consumers save less and opt for current consumption over future consumption. This, in turn, causes demand to

strengthen. However, this stepped-up demand may cause prices and wages to rise if goods and labor markets are fully utilized.

Credit channel: The credit channel in effect breaks down into two different channels: 1. Bank lending channel: Central banks' monetary policy decisions influence commercial banks' refinancing costs; banks are inclined to pass the changes on to their customers. If financing costs diminish, investment and consumer spending rise, contributing to an acceleration of growth and inflation. However, following an increase in interest rates, the risk that some borrowers cannot pay back their loans in due course may increase so much that banks will not grant loans to these borrowers. As a result, borrowers would be forced to cut back on planned expenditure. 2. Balance sheet channel: Monetary policy may have a direct impact on corporate policy, because companies may borrow to improve return on equity as long as the return on debt – in effect the lending rate – is lower than the return on assets. Hence, the return on assets is a weighted arithmetic mean of the return on equity and the lending rate, which are respectively weighted by the share of equity and debt in total assets. Consequently, lower interest rates improve the return on equity.

For this reason, nonprofitable enterprises may show a positive return on equity. However, this may reinforce the influence of interest rates on investment behavior, which is referred to as the financial accelerator effect.

Exchange rate channel: Expansionary monetary policy affects exchange rates because deposits denominated in domestic currency become less attractive than deposits denominated in foreign currencies when interest

rates are cut. As a consequence, the value of deposits denominated in domestic currency declines relative to that of foreign currency-denominated deposits and the currency depreciates. This depreciation makes domestic goods cheaper than imported goods, causing demand for domestic goods to expand and aggregate output to augment.

This channel does not operate if a country has a fixed exchange rate; conversely, the more open an economy is, the stronger this channel is. Exchange rate fluctuations may also influence aggregate demand by affecting the balance sheets of banks and companies whose balance sheets include a large share of foreign currency-denominated debt. Interest rate reductions that entail a depreciation of the national currency raise the debt of domestic banks and companies which have foreign currency-denominated debt contracts. Since assets are typically denominated in domestic currency and therefore do not increase in value, net worth declines automatically. If balance sheets deteriorate, the risk that some borrowers cannot pay back their loans in due course may increase so much that banks will not grant loans to these borrowers. As a result, borrowers would be forced to cut back on planned expenditures.

Wealth channel: Monetary policy impulses are also transmitted through the price of assets such as stocks and real estate. Fluctuations in the stock or real estate markets that are influenced by monetary policy impulses have important impacts on the aggregate economy. The expansionary monetary policy effects of lower interest rates make bonds less attractive than stocks and result in increased demand for stocks, which bids up stock prices.

Conversely, interest rate reductions make it cheaper to finance housing, causing real estate prices to go up. There are three different types of transmission mechanisms involving asset prices: 1. Investment effects: Tobin's q theory explains an important mechanism through which movements in stock prices can affect the economy. Tobin's q is defined as the market value of firms divided by the replacement cost of capital.

If q is high, the market price of firms is high relative to the replacement cost of capital, and new plant and equipment capital is cheap relative to the market value of firms. Companies can then issue stock and get a high price for it relative to the cost of the facilities and equipment they have bought. Investment spending will rise because firms can now buy a relatively large amount of new investment goods with only a small issue of stock. An interest rate cut entailing a rise in stock prices will therefore reduce companies' capital costs and consequently boost investment spending.

2. Wealth effects: Modigliani's life cycle model states that consumption is determined by the lifetime resources of consumers. These life cycle resources consist primarily of financial assets, mostly stock, and real estate. Interest rate cuts entail a rise in stock and real estate prices and accordingly boost household wealth. At the same time, consumers' life cycle resources expand, in turn lifting consumer spending and aggregate demand. 3.

Balance sheet effects: A rise in stock and real estate prices improves corporate and household balance sheets alike. Higher net worth translates into higher collateral for lending to companies and households. This in turn

increases lending, investment spending and hence higher aggregate spending. Impacts of fiscal policy in Indian economy

Governments use fiscal policy to influence the level of aggregate demand in the economy, in an effort to achieve economic objectives of price stability, full employment, and economic growth. Keynesian economics suggests that increasing government spending and decreasing tax rates are the best ways to stimulate aggregate demand. This can be used in times of recession or low economic activity as an essential tool for building the framework for strong economic growth and working towards full employment. In theory, the resulting deficits would be paid for by an expanded economy during the boom that would follow; this was the reasoning behind the New Deal.

Governments can use a budget surplus to do two things: to slow the pace of strong economic growth and to stabilize prices when inflation is too high. Keynesian theory posits that removing spending from the economy will reduce levels of aggregate demand and contract the economy, thus stabilizing prices. Economists debate the effectiveness of fiscal stimulus.

The argument mostly centers on crowding out, a phenomena where government borrowing leads to higher interest rates that offset the stimulative impact of spending. When the government runs a budget deficit, funds will need to come from public borrowing (the issue of government bonds), overseas borrowing, or monetizing the debt. When governments fund a deficit with the issuing of government bonds, interest rates can increase across the market, because government borrowing creates higher demand for credit in the financial markets. This causes a lower aggregate

demand for goods and services, contrary to the objective of a fiscal stimulus. Neoclassical economists generally emphasize crowding out while Keynesians argue that fiscal policy can still be effective especially in a liquidity trap where, they argue, crowding out is minimal. Some classical and neoclassical economists argue that crowding out completely negates any fiscal stimulus; this is known as the Treasury View, which Keynesian economics rejects. The Treasury View refers to the theoretical positions of classical economists in the 4. B

5. British Treasury, who opposed Keynes' call in the 1930s for fiscal stimulus. The same general argument has been repeated by some neoclassical economists up to the present. In the classical view, expansionary fiscal policy also decreases net exports, which has a mitigating effect on national output and income. When government borrowing increases interest rates it attracts foreign capital from foreign investors. This is because, all other things being equal, the bonds issued from a country executing expansionary fiscal policy now offer a higher rate of return. In other words, companies wanting to finance projects must compete with their government for capital so they offer higher rates of return. To purchase bonds originating from a certain country, foreign investors must obtain that country's currency. Therefore, when foreign capital flows into the country undergoing fiscal expansion, demand for that country's currency increases. The increased demand causes that country's currency to appreciate. Once the currency appreciates, goods originating from that country now cost more to foreigners than they did before and foreign goods now cost less than they did before. Consequently, exports decrease and imports increase.

Other possible problems with fiscal stimulus include the time lag between the implementation of the policy and detectable effects in the economy, and inflationary effects driven by increased demand. In theory, fiscal stimulus does not cause inflation when it uses resources that would have otherwise been idle. For instance, if a fiscal stimulus employs a worker who otherwise would have been unemployed, there is no inflationary effect; however, if the stimulus employs a worker who otherwise would have had a job, the stimulus is increasing labour demand while labour supply remains fixed, leading to wage inflation and therefore price inflation