Instruments of Monetary Policy

The instruments of monetary policy are of two types:

1. Quantitative, general or indirect (CRR, SLR, Open Market Operations, Bank Rate, Repo Rate, Reverse Repo Rate).

2. Qualitative, selective or direct (change in the margin money, direct action, moral suasion)

These both methods affect the level of aggregate demand through the supply of money, cost of money and availability of credit. Of the two types of instruments, the first category includes bank rate variations, open market operations and changing reserve requirements (cash reserve ratio, statutory reserve ratio). Policy instruments are meant to regulate the overall level of credit in the economy through commercial banks. The selective credit controls aim at controlling specific types of credit. They include changing margin requirements and regulation of consumer credit.

We discuss them as under:

a. Bank Rate Policy:

The bank rate is the minimum lending rate of the central bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. When the central bank finds that inflation has been increasing continuously, it raises the bank rate so borrowing from the central bank becomes costly and commercial banks borrow less money from it (RBI)

The commercial banks, in reaction, raise their lending rates to the business community and borrowers who further borrow less from the commercial banks. There is contraction of credit and prices are checked from rising further. On the contrary, when prices are depressed, the central bank lowers the bank rate.

It is cheap to borrow from the central bank on the part of commercial banks. The latter also lower their lending rates. Businessmen are encouraged to borrow more. Investment is

"Thus, in the industrially and financially less developed countries credit and banking policies are much more than a more brake on undue credit inflation."

Even in industrially advanced countries there is scope for effective anti-depression credit (monetary) policy as long as real estate credit, consumer instalment credit and other particular types of credit remain restricted by high interest rates.

Even if credit policy is incapable by itself of turning the tide of depression, it can increase overall liquidity via open market operations and other conventional methods, thereby creating the monetary atmosphere necessary for the successful operations of more effective measures of fiscal and other policies.

Monetary Policy during Inflation:

Inflation is characterised by rising prices, income output and employment. There is a general wave of optimism as a result of which business activities expand rapidly. In response, more cash is released by banks making additions to consumers' income and outlay.

Traders, faced with reduced stocks of goods and continuously rising demand, make frantic efforts for producing and holding additional stocks they consider appropriate. The improved prospects of business and the high values of securities in the stock exchanges make the banking authorities willing to expand credit which is used in making additions to plant and machinery.

One might expect that this goes on forever. Unfortunately, this does not happen. When consumer spending and investment spending reach a high pitch, banks find it difficult to cope with the increased demand for credit.

Under inflation the aims of monetary policy are to slow down the rate of expansion of money, to reduce the volume of liquid assets, to reduce consumption by means of high interest rates. Such a monetary policy during inflation is necessary to achieve stabilisation and also to avoid a sudden collapse. The idea is to check inflation and to level off the boom conditions.

It is believed that the effectiveness of monetary policy during inflation is much greater. It is easier to raise interest rates than to lower them, and the can be raised as high as the monetary authorities wish. This is followed by