# MAHATMA GANDHI CENTRAL UNIVERSITY

## MONETARY ECONOMICS : ECON4010

UNIT – 5 (Monetary Policy and Central Banking)

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## Monetary Policy -

The central bank use monetary policy to control the situations of inflation and deflation thought various methods/instruments of credit control. These are called instruments of monetary policy.

Or

Monetary policy is the policy of the central bank to control and regulate the money supply and credit in the economy. During inflation, the supply of money is restricted, and during deflation, the supply of money is liberalized. All the instruments of credit control may broadly be divided into the following two categories

1. Quantitative Methods of credit control

2. Qualitative or selective methods of credit control.

1) **Quantitative Method-** This method includes those policies which affect the total volume of credit into the entire economy.

A. Policy Rate-

a) Bank Rate – It is the rate at which central bank grants loans to commercial banks for a long period.

b) Repo Rate – It is the rate at which central bank grant loan to a commercial bank for a short period.

- If Central bank increases its bank rate/repo rate. It leads to an increase in interest rate which discourages borrowers for taking a loan. It reduces credit creation power of the commercial bank. Bank rate is increased to control inflation.

- If Central bank decreases its bank rate/repo rate. It leads to a decrease in interest rate which induces borrowers to a loan. It increases the credit creation power of the commercial bank. Bank rate is decreases to control recession.

B. Open Market Operations - It refers to buying and selling of Government Security by Central Bank from/to open market.

- In the case of inflation, Central Bank sells a security to commercial banks and collect money from the commercial bank which reduces the money supply in the economy it adversely affects the bank's ability to create credit.

- In case of recession, central bank purchases security from a commercial bank and provide money to a commercial bank, which increases the money supply in the economy it positively, affects the bank's ability to create credit.

C. Legal Reserve Ratio -

a) CCR (Cash Reserve ratio) – Commercial bank has to keep a certain proportion of total deposits as cash reserve with as cash reserve with the central bank it is called CRR.

b) SLR ( Stationary Liquidity Ratio) – Commercial bank has to keep a certain proportion of total assets as liquid assets, like cash, gold etc. it is called SLR.

- In the case of inflation, the Central Bank increase CRR/SLR. Therefore commercial bank will have fewer amounts to grant a loan and credit creation capacity of the bank is reduce.

- In case of recession, Central Bank decreases CRR/SLR commercial banks will have more amounts to a loan, and credit creation capacity of the bank is increased.

2) Qualitative or selective credit control - This method includes those policies which affect credit to specific areas of the economy or a particular use of credit.

A. Marginal Requirement- The commercial banks grant a loan to borrowers against some collateral securities whose value is more than the value of loans granted. The marginal requirement is the difference between loan amount and value of collateral securities offered for a loan.
For example, a bank gives 80 lakhs as a loan on behalf of Mortgaged house worth 1 crore. The marginal requirement, in this case, would be 20 lakhs.

- In the case of inflation, Central Bank will increase marginal requirement, it leads to a reduction in loan eligibility of the borrower which reduces credit of the borrower which increases credit creation capacity of commercial banks.
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B. Rationing of Credit - It refers to fixation of credit quota by RBI into different business activity. The rate of interest may vary across sectors or uses.

- In the case of inflation, RBI reduces the amount of quota.
- In case of recession, RBI increases the amount of quota.

C. Moral Suasion - Under this method, central bank persuades and pressurises the commercial banks to adopt a credit policy which is in line with the overall objectives of the economy.

# Goals and targets of Monetary Policy

The Goals of Monetary Policy are:-

1. Full employment
2. Price stability which also includes controlling economic fluctuations (though some writers mention the latter separately)
3. Economic growth
4. Maintaining balance of payments equilibrium.

Targets of Monetary Policy are:-

1. Money Supply
2. Availability of Credit and Interest Rates
3. Intermediate Targets
4. Market Yield on Equity

# Thank you