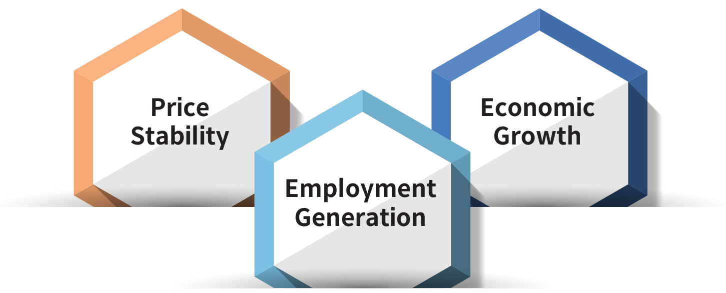
Mirae Asset Mutual Fund

De:CODE

MONETARY POLICY AND ITS TOOLS

Monetary policy is an economic policy implemented by the central banks. It involves the management of overall money supply in the economy as well as to promote economic growth.

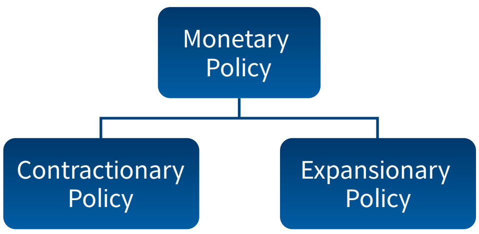
OBJECTIVES OF MONETARY POLICY



Some of the main objectives of the monetary policy are-

1. Price Stability: One of the prime objectives of a monetary policy - to control the inflation rate of the economy.
2. Employment Generation
3. Promote Economic Growth
4. Interest Rates Stability
5. Financial Market Stability
6. Foreign Exchange Market Stability

TYPES OF MONETARY POLICY



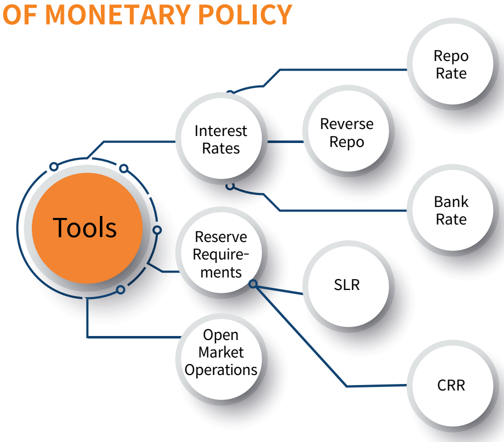
Contractionary Policy

- ➢ Focused on decreasing the money supply in the economy.
- ➢ Achieved by raising the interest rates, selling government bonds, and increasing the reserve requirement for banks.
- ➢ Mostly used to control the inflation levels.

Expansionary Policy

- ➢ Focused on increasing the money supply in the economy.
- ➢ Achieved by decreasing the interest rates, purchasing government bonds and lowering the reserve requirement for the banks.
- ➢ Lowers unemployment and stimulates business activities and consumer spending.
- ➢ However, can lead to higher inflation.

TOOLS OF MONETARY POLICY



CRR – Cash Reserve Ratio, SLR – Statutory Liquidity Ratio.

Central banks use a variety of tools to implement monetary policies in the economy.
Below are the quantitative tools -

1. Interest Rate Adjustment

- **Repo Rate:** The interest rate at which commercial banks borrow funds by selling their security to the Reserve Bank of India (RBI). It serves as a short term facility.
  - ✓ When the RBI plans to revive the Indian economy, it incentives the banks by providing them with lower repo rates. This helps banks to lend more money for commercial purposes and vice versa.
- **Reverse Repo Rate:** In contrast, RBI can also borrow money from commercial banks to maintain liquidity in the market.
  - ✓ When the central bank wants to reduce liquidity in an economy, it can hike the reverse repo rate to pull that money from the economy.
- **Bank Rate:** Minimum rate at which the central bank lends money to commercial banks for longer term.

2. Open Market Operations (OMO)

This involves the simultaneous buying and selling of government securities and Treasury Bills by the Reserve Bank of India in order to control inflation levels in an economy.

- ✓ When the liquidity in the system is excess, RBI sells Government securities and treasury bills and sucks the extra liquidity and vice versa.

3. Reserve Requirements

- **Statutory Liquidity Ratio (SLR):** This represents the minimum percentage of deposits that every commercial bank must hold in liquid cash or other securities.
- **Cash Reserve Ratio (CRR):** Under CRR, commercial banks must maintain a specific amount of reserves with the RBI.
  - ✓ If the RBI plans to lower the lending activity of banks, they could increase the CRR and vice versa.

In addition to the above quantitative tools, there are also many qualitative tools to regulate credit flow and cost of credit to the economy.