IMPACT OF MONETARY POLICY ON INDIAN ECONOMY

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INTRODUCTION

By monetary policy, we mean policy concerned with changes in the supply of money. Issues connected with monetary policy are: objectives or goals of the policy, instruments of monetary control, its efficacy, implementation, intermediate target of the policy etc. India‘s monetary policy since the first plan period was one of 'controlled expansion-that is, a policy of adequate financing of economic growth ensuring reasonable price stability. Thus, RBI helped the economy to expand via expansion of money and credit and attempted to check rise in prices through monetary and other control measures.

A mild version of the liberalization process in the Indian economy was initiated in the mid 1980s. But, it lacked depth, coverage and self sustaining character. During the fag end of the 1980‘s the economy suffered a big jolt with the eruption of a major macro-economic crisis. It manifested initially in the form of foreign exchange crisis, and then debt and interest payment problems. To meet the crisis India approached the World Bank and the International Monetary Fund (IMF) for a big loan. For granting the loan, World Bank and the IMF stipulated certain conditions. Since India was in a critical situation, she accepted the conditions of the World Bank and the IMF and then provided an immediate context for the realignment of the macro-economic fundamentals, through a programme of economic stabilization. With this end in view, India initiated the new economic policy in July 1991.

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The package of economic reforms, which are expected to have long-term impact on the economy, includes fiscal, monetary, financial, and industrial and export-import (EXIM)sector reforms. The reforms in monetary and credit policies aimed at slowing down monetary expansion and thereby controlling inflation. The financial sector reforms were initiated on the recommendations of Narasimham Committee Report. The first phase of reform started with a reduction of Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR)and permitted a degree of flexibility to the banks in the matter of deposit interest rates.

SIGNIFICANCE OF THE STUDY

The monetary policy strategy of a Central bank depends on a number of factors that are unique to the country and the context. Given the policy objectives, any good strategy depends on the macroeconomic and the institutional structure of the economy. An important factor in this context is the degree of openness in the economy. The second factor is the stage of development of markets, institutions and technological development. In such a set up, where these conditions are satisfactory, it is possible for the Central bank to signal its intention with one single instrument or a combination of instruments. It is important to recognize that all the objectives cannot be effectively pursued by any single arm of economic policy. Hence, there is always the problem of assigning to each instrument the most appropriate target or objective. It is clear from both the theoretical literature and the empirical findings that, among various policy objectives, monetary policy is best suited to achieve the goal of price stability in the economy. In today‘s altered economic context, a low and stable price environment is being increasingly regarded as an essential condition for bringing down the nominal interest rate and for improving the growth and productive potential of the economy.

In India, the emphasis of monetary policy shifted towards control of inflation in 1995-96. Ensuring price stability requires the pursuit of a consistent policy over a period of time.

OBJECTIVES OF THE STUDY

1. To study the changing role and importance of selected monetary instruments in India.
2. To examine the effectiveness of monetary policy in ensuring price stability in India.

3. To find out to what extent monetary policy facilitated economic growth in India and its general impact in the post- reform period.

DATA SOURCE AND METHODOLOGY

This study is based on secondary data. Secondary data were collected from the RBI bulletin, RBI Annual Reports, Report on Currency and Finance, Economic Survey, Economic and Political Weekly (EPW), Finance and Development, Economic Diary, The Hindu, ICSSR, Economic Times, Asian Economic Review, Financial Express, World Bank Reports, Internet etc.

INDIA AND GLOBAL FINANCIAL CRISIS

In India, since the financial system did not face a crisis, the damage to the transmission channel was minimal, even though the pre-global crisis time structural rigidities continued to limit the effectiveness of Reserve Bank‘s monetary policy actions. The recent switch over to the new ‗base rate‘ system is expected to help in improving and enhancing the visibility of the transmission of monetary policy signals to credit markets. (1) Reserve Bank of India has listed high inflation. Consumer price inflation and WPI inflation have been in double digits since February 2010. This suggests that inflation has become much more generalized. The RBI‘s decision to ‗narrow the liquidity corridor‘ – the difference between the repo and reverse repo rates- is significant. The reverse repo has been hiked by a higher margin than the repo rate. Liquidity is tight at the moment. The reference point for banks would be the repo rate, the rate at which they can borrow. The monetary authorities have taken an optimistic view of the outlook for the economy and revised their earlier estimate of 8 percent growth in GDP to 8.5 percent. It has actually been hinted by the monetary authorities done through a reduction in commercial investments of banks, better use of the facility provided by the RBI and distinct improvement in the ways and means position of the Central Exchequer. The monetary authorities should desist from raising key interest rates and contracting money supply.

Causes of Global Financial Crisis

- Proximate causes
    - Sub-prime lending
    - Originate and distribute model
    - Financial engineering, derivatives
    - Credit rating agencies
    - Lax regulation
    - Large global imbalances
- Fundamental cause
    - Excessively accommodative monetary policy in the US and other advanced economies.

Global Financial Crisis Current Account Balance (per cent to GDP)

Country	1990-94	1995-99	2000-04	2005	2006	2007	2008
China	1.4	1.9	2.4	7.2	9.5	11.0	10.0
India	-1.3	-1.3	0.5	-1.3	-1.1	-1.0	-2.8
Russia	0.9	3.5	11.2	11.0	9.5	5.9	6.1
Saudi Arabia	-11.7	-2.4	10.6	28.7	27.9	25.1	28.9
United Arab Emirates	8.3	4.6	9.9	18.0	22.6	16.1	15.8
United States	-1.0	-2.1	-4.5	-5.9	-6.0	-5.3	-4.7

Memo:							
Euro area	n.a.	0.9	0.4	0.4	0.3	0.2	-0.7
Middle East	-5.1	1.0	8.4	19.7	21.0	18.2	18.8
Source: World Economic Outlook Database, April 2009, International Monetary Fund.							
Note: (-) indicates deficit.							

The Financial Sector Reforms in India

The objectives of the financial sector reform process in India initiated in the early 1990s were the following:

1. Removal of financial repression that existed earlier.
2. Creation of an efficient, productive and profitable financial sector industry.
3. Enabling price discovery, particularly by the market determination of interest rates that then help in efficient allocation of resources.
4. Providing operational and functional autonomy to institutions.
5. Preparing the financial system for increasing international competition.

Effectiveness of Monetary Policy

According to the Keynesians, monetary policy is ineffective and less reliable because of the following reasons. Monetary policy is only among many factors that determine the level of nominal national income in the short-run. Changes in money supply may lead to opposite changes in velocity and thereby limit the effectiveness of the monetary policy. Finally, during recession, investment is unresponsive to interest rate changes. Keynesians believe that the economy operates under liquidity trap range (horizontal LM curve). The IS curve is vertical or interest inelastic. It is a depression economy in which prices, income level, rate of interest and velocity of money are very low and speculative demand for money is very high. In such a situation, monetary policy is ineffective. An increase in money supply does not shift the LM curve and therefore, there will be no change in the income level and interest rate. The monetarists consider the monetary policy to be effective at least in the short period. They have produced empirical evidence to show that changes in nominal national income, employment and the price level are more closely related to changes in the money stock than to changes in Government expenditures and taxes.

Monetary Policy and Price Stability

The RBI is now more able and more responsible for controlling the overall growth of money and credit in a manner best suited for moderating inflation, while meeting the genuine credit needs of the economy. Its capacity for effective monetary management or any inflation control needs to be further strengthened through rapid deepening and broadening of primary and secondary markets for Government securities. With greater autonomy comes more responsibility.

The role of monetary policy has too long been a passive one, confined to financing the fiscal deficit at administered interest rates in order to minimize the cost to the Government. This has in the past encouraged fiscal profligacy with growing fiscal deficits, and larger and larger components of monetization which in turn has generated inflationary pressure and has distorted the financial system raising interest rates to the productive sector. It was necessary to make a decisive break from this pattern. With the reduction in the fiscal deficit, the Government was working towards a situation where interest rate distortions were reduced and monetary policy could be actively used for short-term macro-economic management. The Government has progressed towards this aim in the past years with a number of initiatives. The statutory liquidity ratio has been reduced, releasing resources to the banks for deploying additional funds in the commercial sector. Government borrowing was also being shifted to market-related rates; the

364-day bills were introduced with market-related interest rates. Other interest rates on securities were raised to bring them closer to market rates. Reserve Bank of India also conducted repurchase operations in securities for short-term liquidity management.

Conclusion

India‘s GDP is a combination of all the differential factors, contributing to the welfare of the Indian economy. India‘s GDP gives us a combined report of the performance of the Indian economy. 'Cost factor' or 'Actual price' method - these are the two methods to calculate Indian Gross Domestic Product. The main factor that contributed to the growth of India GDP post 1990s was the opening-up of the Indian economy. The markets were opened up; the Government leveraged the entry of private investments. As a result of this, more investments flowed into the markets. Monetary policy rules can be active or passive. The passive rule is to keep the money supply constant, which is reminiscent of Milton Friedman‘s money growth rule. The second, called a price stabilization rule, is to change the money supply in response to changes in aggregate supply or demand to keep the price level constant. The idea of an active rule is to keep the price level and hence inflation in check. In India, this rule dominates our monetary policy. A stable growth is healthy growth.

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