



MONETARY POLICY

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ABSTRACT

Monetary policy is concerned with the changes in the supply of money and credit. It refers to the policy measures undertaken by the government or the central bank to influence the availability, cost and use of money and credit with the help of monetary techniques to achieve specific objectives.

Keywords: Monetary policy, Credit, Banks, Obligations, Money.

Monetary policy is associated with currency and credit. For many centuries there were only two forms of monetary policy: Decisions about coinage and the decision to print paper money. Interest rates were not generally coordinated with the other responsibility of an authority with "seniorage," or the power to coin. With the advent of larger trading networks came the ability to set price levels between gold and silver, and the price of the local currency to foreign currencies. This official price could be enforced by law, even if it varied from the market price.

Monetary policy is the government or central bank process of managing the money supply to achieve specific goals—such as constraining inflation, maintaining an exchange rate, achieving full employment, or economic growth. Monetary policy can involve changing certain interest rates, either directly or indirectly through open market operations, setting reserve requirements, or trading in foreign exchange markets.

Monetary policy rests on the relationship between the rates of interest in an economy, that is the price at which money can be borrowed, and the total supply of money. The use of monetary policy is dated to the late nineteenth century where it was used to maintain the gold standard. Monetary policy uses a variety of tools to control one or both of these to influence outcomes like economic growth, inflation, exchange rates with other currencies, and unemployment. Where currency is under a monopoly of issuance, or where there is a regulated system of issuing currency through banks tied to a central bank, the monetary authority has the ability to alter the interest rate and the money supply in order to achieve policy goals.

There are several monetary policy tools available to achieve these ends. Increasing interest rates, reducing the monetary base, or increasing reserve requirements all have the effect of contracting the money supply. If reversed, these actions expand the





money supply. A fourth primary tool of monetary policy is open market operations. This entails managing the quantity of money in circulation through the buying and selling of various credit instruments, foreign currencies, or commodities. All of these purchases or sales result in more or less base currency entering or leaving market circulation.

Goals of Monetary Policy:

- Inflation;
- Unemployment;
- Exchange Rates.

Inflation

Contractionary monetary policy is used to target a high level of inflation and reduce the level of money circulating in the economy. Inflation is a rise in prices, which can be translated as the decline of purchasing power over time. The rate at which purchasing power drops can be reflected in the average price increase of a basket of selected goods and services over some period of time. The rise in prices, which is often expressed as a percentage, means that a unit of currency effectively buys less than it did in prior periods. Inflation can be contrasted with deflation, which occurs when prices decline and purchasing power increases. While it is easy to measure the price changes of individual products over time, human needs extend beyond just one or two products. Individuals need a big and diversified set of products as well as a host of services for living a comfortable life. They include commodities like food grains, metal, fuel, utilities like electricity and transportation, and services like health care, entertainment, and labor.

Unemployment

An expansionary monetary policy decreases unemployment as a higher money supply and attractive interest rates stimulate business activities and expansion of the job market. The most frequently used measure of unemployment is the unemployment rate. It's calculated by dividing the number of unemployed people by the number of people in the labor force. Many governments offer unemployment insurance to certain unemployed individuals who meet eligibility requirements.

Unemployment is a key economic indicator because it signals the ability (or inability) of workers to obtain gainful work and contribute to the productive output of the economy. More unemployed workers mean less total economic production.





Unemployed workers must maintain at least subsistence consumption during their period of unemployment. This means that an economy with high unemployment has lower output without a proportional decline in the need for basic consumption.

Exchange Rates

The exchange rates between domestic and foreign currencies can be affected by monetary policy. With an increase in the money supply, the domestic currency becomes cheaper than its foreign exchange. An exchange rate is a rate at which one currency will be exchanged for another currency and affects trade and the movement of money between countries. The exchange rate between two currencies is commonly determined by the economic activity, market interest rates, gross domestic product, and unemployment rate in each of the countries. Commonly called market exchange rates, they are set in the global financial marketplace, where banks and other financial institutions trade currencies around the clock based on these factors. Changes in rates can occur hourly or daily with small changes or in large incremental shifts.

Monetary policy can promote faster economic growth by making credit cheaper and more readily available. Industry and agriculture require two types of credit—short-term credit to meet working capital needs and long-term credit to meet fixed capital needs. The need for these two types of credit can be met through commercial banks and development banks. Easy availability of credit at low rates of interest stimulates investment or expansion of society's production capacity. This in its turn, enables the economy to grow faster than before.

In the long run there is no conflict between the first two objectives, viz., price stability and economic growth. In fact, price stability is a means to achieve faster economic growth. In the context of the Indian economy C. Rangarajan writes, "It is price stability which provides the appropriate environment under which growth can occur and social justice can be ensured." However, in the short run there is a trade-off between price stability and economic growth. Faster economic growth is achieved by increasing the availability of credit at a lower rate of interest. This amounts to an increase in the money supply.

But an increase in the money supply and the consequent rise in consumer demand tends to generate a high rate of inflation. This raises the question of what is the minimum acceptable rate of inflation which does not act as a growth-retarding factor. The question still remains unanswered.

Money supply is directly related to the level of economic activity. An increase in money supply increases economic activity by enabling people to purchase more goods and services, and vice versa. Economists analyze the money supply and develop





policies revolving around it through controlling interest rates and increasing or decreasing the amount of money flowing in the economy. Public and private sector analysis is performed because of the money supply's possible impacts on price levels, inflation, and the business cycle. In the United States, the Federal Reserve policy is the most important deciding factor in the money supply. The money supply is also known as the money stock.

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