



IMPORTANCE OF MONETARY POLICY

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ABSTARCT

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. Monetary policy aims at influencing the economic activity in the economy mainly through two major variables, money or credit supply, and the rate of interest.

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

Monetary policy is not an end in itself, but a means to an end. It involves the management of money and credit for the furtherance of the general economic policy of the government to achieve the predetermined objectives.

The goals of monetary policy refer to its objectives such as reasonable price stability, high employment and faster rate of economic growth. The targets of monetary policy refer to such variables as the supply of bank credit, interest rate and the supply of money.

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.

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 remains unanswered.





The monetary policy has the limited scope in the underdeveloped countries because of the following reasons:

- There exists a large non-monetized sector in most of the underdeveloped countries which act as a great hurdle in the successful working of the monetary policy.
- Small-sized and unorganized money market and limited array of financial assets in underdeveloped countries also hinder the effectiveness of monetary policy.
- In most of the underdeveloped countries, total money supply mainly consists of currency in circulation and bank money forms a very small portion of it. This limits the operation of central bank's monetary policy which basically works through its impact on bank money.
- The growth of nonbank financial institutions also restricts the effective implementation of monetary policy because these institutions fall outside the direct control of the central bank.
- In the underdeveloped countries many commercial banks possess high level of liquidity. In these cases, the changes in monetary policy cannot significantly influence the credit policies of such banks.
- Foreign-based commercial banks can easily neutralize the restrictive effects of tight monetary policy because these banks can replenish their resources by selling foreign assets and can also receive help from international capital market.
- The scope of monetary policy is also limited by the structural and institutional realities of the underdeveloped countries, weak linkage between interest rate, investment and output, particularly due to structural supply rigidities.

When investment is increased as a result of a fall in the rate of interest, increased investment may not expand output due to the structural supply constraints, such as inadequate management, lack of essential intermediate products, bureaucratic rigidities, licensing restrictions, lack of interdependence within the industrial sector. Thus, higher investment, instead of increasing output, may generate inflationary pressures by raising prices.

Monetary policy can serve the following developmental requirements of developing economies:

Developmental Role

In a developing economy, the monetary policy can play a significant role in accelerating economic development by influencing the supply and uses of credit, controlling inflation, and maintaining balance of payment. Once development gains momentum, effective monetary policy can help in meeting the requirements of expanding trade and population by providing elastic supply of credit.





Creation and Expansion of Financial Institutions:

The primary aim of the monetary policy in a developing economy must be to improve its currency and credit system. More banks and financial institutions should be set up, particularly in those areas which lack these facilities. The extension of commercial banks and setting up of other financial institutions like saving banks, cooperative saving societies, mutual societies, etc. will help in increasing credit facilities, mobilising voluntary savings of the people, and channelising them into productive uses. It is also the responsibility of the monetary authority to ensure that the funds of the institutions are diverted into priority sectors or industries as per requirements of the development plan of the country.

Effective Central Banking:

To meet the developmental needs the central bank of an underdeveloped country must function effectively to control and regulate the volume of credit through various monetary instruments, like bank rate, open market operations, cash-reserve ratio etc. Greater and more effective credit controls will influence the allocation of resources by diverting savings from speculative and unproductive activities to productive uses.

Integration of Organized and Unorganized Money Market:

Most underdeveloped countries are characterized by dual monetary system in which a small but highly organized money market on the one hand and large but unorganized money market on the other hand operate simultaneously. The unorganized money market remains outside the control of the central bank. By adopting effective measures, the monetary authority should integrate the unorganized and organized sectors of the money market.

Developing Banking Habits:

The monetary authority of a less developed country should take appropriate measures to increase the proportion of bank money in the total money supply of the country. This requires increase in the bank deposits by developing the banking habits of the people and popularising the use of credit instruments (e.g, cheques, drafts, etc.).

Monetisation of Economy:

An underdeveloped country is also marked by the existence of large non-monetised sector. In this sector, all transactions are made through barter system and changes in money supply and the rate of interest do not influence the economic activity at all.





The monetary authority should take measures to monetise this non-monetised sector and bring it under its control.

Debt Management:

Debt management is another function of monetary policy in a developing country. Debt management aims at- (a) deciding proper timing and issuing of government bonds, (b) stabilising their prices, and (c) minimising the cost of servicing public debt. The monetary authority should conduct the debt management in such a manner that conditions are created “in which public borrowing can increase from year to year and on a big scale without giving any jolt to the system. And this must be on cheap rates to keep the burden of the debt low.” However, the success of debt management requires the existence of a well- developed money and capital market along with a variety of short- term and long-term securities.

Maintaining Equilibrium in Balance of Payments:

The monetary policy in a developing economy should also solve the problem of adverse balance of payments. Such a problem generally arises in the initial stages of economic development when the import of machinery, raw material, etc., increase considerably, but the export may not increase to the same extent. The monetary authority should adopt direct foreign exchange controls and other measures to correct the adverse balance of payments.

Controlling Inflationary Pressures:

Developing economies are highly sensitive to inflationary pressures. Large expenditures on developmental schemes increase aggregate demand. But, output of consumer's goods does not increase in the same proportion. This leads to inflationary rise in prices.

Thus, the monetary policy in a developing economy should serve to control inflationary tendencies by increasing savings by the people, checking expansion of credit by the banking system, and discouraging deficit financing by the government.

Long-Term Loans for Industrial Development:

Monetary policy can promote industrial development in the underdeveloped countries by promoting facilities of medium-term and long-term loans to tire manufacturing units. The monetary authority should induce these banks to grant long-term loans to the industrial units by providing rediscounting facilities. Other development financial institutions also provide long-term productive loans.





Reforming Rural Credit System:

Rural credit system is defective and rural credit facilities are deficient in the under-developed countries. Small cultivators are poor, have no finance of their own, and are largely dependent on loans from village money lenders and traders who generally exploit the helplessness, ignorance and necessity of these poor borrowers.

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