CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

2.1 Introduction:

Monetary policy is a product of recent age. It has been found in the literature of economics only after 19th century where it was used to maintain the gold standard.\(^1\)

Monetary policy talks of the monetary system of a country and related to the measures and decisions of a monetary nature. The monetary system is in fact used to influence the economic and social conditions.\(^2\) Monetary policy uses money both as a means and as an end. Further, Monetary policy can be broadly defined as the deliberate effort of the central bank to influence the economic activity by making changes in the money supply, in the availability of credit or in the interest rates in order to achieve the set objectives. Monetary policy in a narrow sense has been identified with the central banking policy regarding the appropriate use of credit control measures in order to influence financial flows with the aim of ensuring optimum constellation of output, employment, inflation and balance of payments etc. Thus, monetary policy is a hub of all those measures, which help the central banking authority of a country in the manipulation of the various instruments of credit control.

Monetary policy has also been defined in terms of cheap money and dear money. It is said to be the cheap money policy when money is made available easily at low rates of interest. Further it is a dear
CHAPTER-2  MEANING AND CONCEPT OF MONETARY POLICY

Money policy when money is made available with difficulty and of high rates of interest.

Different economists have defined monetary policy in different ways-

According to Dr. Paul Einzig, "Monetary policy is the attitude of political authority towards the monetary system of the community under its control". The Govt. of a country can either decide to take certain measures to achieve certain economic or social objectives or it abstains from taking certain measures. The former is known as active monetary policy while the latter can be called passive monetary policy. Geoffrey Crowther says that the monetary policy takes into account the steps taken to reduce the disadvantages to a minimum level that flow from the existence and operation of the monetary system. Paul Einzig has made an amendment over this definition by suggesting that the aim of monetary policy should be to increase the advantages and reduce the disadvantages that flow from the monetary system.

According to the report of the commission on money and credit, monetary policy directly deals with the provision of money and includes currency and demand deposits at commercial banks.

Prof. Wrightsman defines monetary policy as the deliberate efforts made by the central bank to control the money supply and credit
According to P.D. Jha, "Monetary policy is one important segment of an over all financial policy which has to be operated in the overall milieu prevailing in the country." 

In the words of R.P. Kant, "Monetary Policy is the management of the expansion and contraction of the volume of the money in circulation for the explicit purpose of attaining a specific objective of full employment." 

Milton Fried man has made the difference between the credit policy and monetary policy. The credit policy means the objects of the motions of the monetary authorities on the rates of interest, terms of lending etc. while monetary policy means the effects of the motions for monetary authorities on stock of money.

Monetary policy depends 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. 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, which are 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. A policy is referred to as contractionary if it reduces the size of the money supply or raises the interest rate. An expansionary policy increases the size of the money supply, or decreases the interest rate. Further monetary policies are described as accommodative if the interest set by central monetary authority is intended to sour economic growth, neutral if it is intended to neither spur growth or combat inflation, or tight if intended to reduce inflation or "cool" an economy.

Thus in a nutshell, it can not be an exaggeration to say that monetary policy is an economic policy of the government in monetary field and the central bank of a country uses monetary policy in order to influence the quantity of money directly or indirectly with the help of general instruments of bank rate, open market operations, variable reserve ratio and selective instruments such as margin requirement, moral suasion, minimum interest rate etc. to achieve certain objectives set by state. Further the aspects that constitute the monetary policy consist of the policies relating to the issue of currency and coinage, monetary standard, statutory reserves for issue of currency and also policies regarding exchange rate and foreign exchange transactions.

2.2 Types of Monetary Policy:

It is very much practical that all types of monetary policy involve the modification of the amount of base currency (M0) in circulation. This
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

process of changing the liquidity of base currency is called open market operations.

The regular market transactions by the monetary authority modify the liquidity of currency and this influences the other market variables such as short term interest rates, the exchange rate and the domestic price of spot market commodities such as gold. Open market operations are undertaken with the objective of stabilizing one of these market variables.

The difference between the various types of monetary policy lies primarily with the market variables that open market operations are used to target the process of achieving relative stability in the target variable.

The different types of monetary policy can be mentioned under the following heads:

2.2.1 Inflation Targeting:

Under this policy approach the target has been fixed to keep inflation, under a particular definition such as Consumer Price Index, at a particular level.

The inflation target is achieved through making the periodic adjustments in the Central Bank interest rate. The interest rate used is generally the inter bank rate at which banks lend to each other over
night for cash flow purposes. Depending on the country this particular interest rate might be called the cash rate.

The interest rate target is maintained for a specific duration using open market operations. Typically the duration that the interest rate target is kept constant varies between months and years. An appointed policy committee usually reviews this interest rate target on a monthly or quarterly basis.

The changes in the interest rate target depend on the responses of various market indicators in an attempt to forecast economic trends and in doing so keep the market on track towards achieving the defined inflation target.

This monetary policy approach was pioneered in New Zealand. It is currently used in the Euro zone, Australia, Canada, New Zealand, Sweden, South Africa, Norway and the United Kingdom.

2.2.2 Price Level Targeting:

Price level targeting is similar to inflation targeting except that CPI growth in one year is offset in subsequent years such that over time the price level on aggregate does not move.

The approach of price targeting was tried in the 1930s by Sweden, and seems to have contributed to the relatively good performance of the Swedish economy during the Great Depression. As
of 2004, no country operates monetary policy based on a price level target.

2.2.3 Monetary Aggregates:

In the 1980s several countries used an approach based on a constant growth in the money supply. This approach was refined to include different classes of money and credit (M0, M1 etc). In the USA this approach to monetary policy was discontinued with the selection of Alan Greenspan as Fed Chairman.

This approach is also sometimes called monetarism. While the very monetary policy focuses on a price signal of one form or another, this approach is focused on monetary quantities.

2.2.4 Fixed Exchange Rate:

This policy is based on maintaining a fixed exchange rate with a foreign currency. Currency is bought and sold by the central bank on a daily basis to achieve the target exchange rate. This policy somewhat abdicates the responsibility for monetary policy to a foreign government.

This type of policy was used by China. The Chinese Yuan was managed in such a way that its exchange rate was fixed with the United States dollar.
2.2.5 Gold Standard:

The gold standard is a system in which the price of the national currency as measured in units of gold is kept constant by the daily buying and selling of base currency. This process is called open market operations.

The gold standard might be regarded as a special case of the "Fixed Exchange Rate" policy. And the gold price might be regarded as a special type of "Commodity Price Index".

Today this type of monetary policy is not used anywhere in the world, although a form of gold standard was used widely across the world prior to 1971.

2.2.6 Mixed Policy:

In practice a mixed policy approach is most like "inflation targeting". However some consideration is also given to other goals such as economic growth, unemployment and asset bubbles. The Federal Reserve used this type of policy in 1998.

2.3 Theory of Monetary Policy:

The policymakers have been rendered the responsibility to make credible announcements regarding their monetary policies. If private agents (consumers and firms) believe that policymakers are committed to lowering inflation, they will anticipate future prices to be lower
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

(adaptive expectations). If an employee expects prices to be high in the future, he or she will draw up a wage contract with a high wage to match these prices. Hence, the expectation of lower wages is reflected in a wage-setting behaviour between employees and employers (lower wages since prices are expected to be lower). Since wages are in fact lower, there is no demand-pull inflation because employees are receiving a smaller wage and there is no cost-push inflation because employees are paying out less in wages.

However, to achieve this low level of inflation, policymakers must have credible announcements, that is, private agents must believe that these announcements will reflect actual future policy. If an announcement about low-level inflation targets is made but not believed by private agents, wage setting will anticipate high-level inflation and so wages will be higher and inflation will rise. A high wage will increase a consumer's demand (demand pull inflation) and a firm's costs (cost push inflation), so inflation rises. Hence, if a policymakers announcements regarding monetary policy are not credible, policy will not have the desired effect.

However, if policymakers believe that private agents anticipate low inflation, they have an incentive to adopt an expansionist monetary policy (where the marginal benefit of increasing economic output outweighs the marginal cost of inflation). However, assuming private
agents have rational expectations, they know that policymakers have this incentive. Hence, private agents know if they anticipate low inflation, an expansionist’s policy will be adopted that causes a rise in inflation. Therefore, unless policymakers can make their announcement of low inflation (credible), private agents expect high inflation. This anticipation is fulfilled through adaptive expectation (wage-setting behaviour) and so there is higher inflation (without the benefit of increased output). Hence, unless credible announcements can be made, expansionary monetary policy will fail.

Announcements can be made credible in various ways. One is to establish an independent central bank with low inflation targets (but no output targets). Hence, private agents know that inflation will be low because it is set by an independent body. Central banks can be given incentives to meet their targets (for example, larger budgets, a wage bonus for the head of the bank). A policymaker with a reputation for low inflation policy can make credible announcements because private agents will expect future behaviour to reflect the past.

2.4 Objectives of Monetary Policy:

The central bank of a country adopts monetary policy in order to achieve the objectives that are consistent with those of economic policy. Thus interpreted monetary policy has no objectives of its own and at best a handmaid of general economic policy.¹⁰
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

The objectives of monetary policy can differ from one country to another and even in the same country from time to time.

2.4.1 Evolution of Objectives:

The objectives of monetary policy change depending upon the needs and prevailing conditions in economic system.

Under the gold standard, the action and purposes of monetary authority were predetermined and it was only after the disappearance of gold standard the need for emphasis on the objectives of monetary policy was realised.

Since then, the price stabilisation became the main objective of monetary policy. The linking of monetary policy with the price stabilisation was based on the quantity theory of money.

It was opined by many economists that monetary policy could be pressed into service to promote price stability. Both the problems of inflation or deflation could have been solved if arose. For example, in case of inflation a contractionary monetary policy would be of more
importance by decreasing the money supply. On the other hand, in the case of deflation, the expansionary monetary policy could be adopted and the problem of deflation would be ended up with the speed up the growth in money supply. This objective was considered as sine-qua-non in the economy partly because it would not disturb the functioning of the economy and partly because it would help to mitigate the problem of business fluctuations. Thus in the pre Keynesian period, monetary policy was the only instrument of over all economic policy and price stability was its main objective.

The second objective was introduced by Keynesian revolution that of maintenance of full employment, which might conflict, with the objective of price stability. Keynes pointed out that a competitive economy if left free would not be able to reach the level of full employment i.e. why he emphasised for the intervention of the state which could take the deliberate measures so that economy could move towards the full employment level. Thus many Governments as one of the main and primary objectives accepted maintenance of a high and stable level of employment.

Following the war, debt management has been an instrument. Many economists have added the third objective of rapid growth of the economy. It has been further emphasised with the introduction of growth models by Harrod-Domar and Schumpeter where the state not
only aims at fully utilising the given resources but also tries to increase the volume of supply of these productive resources. Thus the main objective of economic policy becomes the maximisation of economic growth.

Moreover, the socialists have often emphasised to introduce equitable distribution of wealth and income objective in the list of economic objectives.

In the context of those countries where foreign trade constitutes a considerable part of National Income, should aim at maintaining the stability of external or exchange value of money.

In recent times following objectives have been considered as the common objectives of monetary policy:

1. **Full Employment**: The ultimate objective of monetary policy is to achieve and maintain permanently a condition of full employment of resources. For this purpose monetary policy takes as its basis the Keynesian idea that effective demand determines the level of employment. Effective demand is composed of the two components of consumption demand and investment demand. The Keynesian proposition that as income increases, consumption demand becomes increasingly inelastic is also useful in this connection. Monetary policy and govt. policy concentrate on stimulating demand on both the investment front and the consumption front. The central
monetary authority by stimulating effective demand can bring out full employment of resources. The obvious objective of monetary policy, therefore, is to attain an equilibrium between saving and investment at the point of full employment.\textsuperscript{11}

2. \textbf{Price Stability}: The price stability has been the dominant objective of monetary policy. It is a hard fact that the fluctuations in the prices bring uncertainty and instability to the economy. Further, rising and falling prices are not supposed to be very much healthy from the view of economic prosperity because they bring unnecessary loss to some and undue advantage to others. It is therefore; the question of monetary policy has been a subject of paramount significance. Monetary policy, primarily aims at preventing maladjustments occurring, that is, at eliminating the causes of recession. To achieve this, investment finance, has to be regulated through appropriate variations in the rate of interest in the capital market. The rate of interest is a vital link that connects the volume of money and investment in a given economy. The success at other wise of a monetary policy largely depends on the influence, which the rate of interest can be expected to wield on the investment and consumption decisions at the community. Thus in a nutshell monetary policy helps in reducing inequalities of income and wealth, secures social justice and promotes economic welfare.
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

3. Economic Growth: Economic growth objective has acquired considerable significance in recent years partly because full employment is hardly possible without stepping up the rate of economic growth and partly because on increasing growth rate is also necessitated by universal desire of public to enjoy ever rising living standards.

Economic growth has been defined as the persistent increase in the real per capita income of the country over a long period of time.

Now the question arises as to what extent monetary policy can lead to economic growth. Monetary policy influences economic growth by having a control on the interest rate which is inversely related to the investment. Monetary policy can proceed by following an easy credit policy-lowering rate of interest and in turn raising the level of investment, which will promote economic growth. Further, by helping to sustain stability of income and prices, monetary policy contributes towards growth. Because fluctuations in the rates of inflation have an adverse impact on growth, monetary policy helps in controlling hyperinflation. Moreover, tight monetary policy affects small firms more in comparison to large firms, and higher interest rates have to greater impact on small investments in comparison to large industrial investment. That is why monetary policy should be formulated in the way that it may encourage investment and
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

simultaneously control the inflation in order to enhance growth and put a control on economic fluctuations.

To review the working of monetary system the committee was appointed by RBI under the chairmanship of Sukhamoy Chakravarti in 1982; the committee submitted its comprehensive report on the objectives in 1985 that the monetary system should seek to perform the following tasks.

a) Mobilisation of saving of the community and enlargement of the financial savings pool.

b) Promoting efficiency in the allocation of the savings of the community to comparatively more productive purposes in accordance with the national economic goals.

c) Enabling the resource needs of the major entrepreneur in the country e.g. Govt. to be met in adequate measure.

d) Promoting price stability and e) Promoting an efficient payment system.

It should be noted that among all the objectives of monetary policy, the objective of price stability could be considered as the core of monetary policy.

In recent years, the objectives of monetary policy in India have been two fold. It has to facilitate the flow of an adequate volume of bank credit to industry, agriculture and trade to meet their genuine needs and
provide selective encouragement to sectors which stand in need of special assistance such as the weaker sections of society and the neglected sectors and areas in the country. At the same time, to keep inflationary pressures under check it has to restrain undue credit expansion and also ensure that credit is not directed for undesirable purposes. As the central monetary authority, the RBI’s chief function is to ensure the availability of credit to the extent that is appropriate to sustain tempo of development and promote the maintenance of internal price stability.\textsuperscript{12}

The first decade of plan era saw the revival of the traditional weapons of monetary control; during the second half of that decade the regulating functions were developed. In the sixties, the problem of stabilisation was replaced by a greater concern for economic growth and control over the accompanying increases in money supply. By the 1970s and through 1980, the twin objectives of provision of credit for attaining faster economic growth and price stabilisation assumed importance. This policy has come to be known as controlled expansion.

Indian monetary policy is not able to achieve its objectives because of its limited success in regulating money supply growth in the economy. The use of different monetary regulations/instruments requires pre-requisite conditions, which are not fully existent in India. Some of them can be mentioned as follows:
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

1. High currency deposit (C-D) Ratio: In India, the large part of the money stock is still held in the form of currency. There is lack of cultivation of the currency. There is lack of cultivation of the banking habits among the savers. RBI's control is exercised on deposits/banks and hence as long as share of deposits in money supply is less, effectiveness of monetary regulation is not fully realised. However, the currency deposit ratio in India (C/T+D) has steadily fallen from 1.53 in March 1951 to 0.25 in March 1990-91.

2. Underdeveloped financial markets: The Indian money market is dichotomous in nature. It comprises of two sectors (i) organised and (ii) unorganised.

The organised money market works within the provisions of Indian Banking Companies Act (1956) and its accounts are open to audit. This market comprises:

a) RBI and commercial banks including co-operative credit system and regional rural banks and-

b) Sub-markets.
   1) Treasury Bill Market
   2) Commercial Bill Market
   3) Call Money Market
   4) Inter Corporate Funds Market and
   5) Certificate of Deposit Market
The sub-markets in India are not fully developed and the monetary authority mainly regulates them.

The unorganised money market operates outside the provisions of the Indian Banking Companies Act (1956). This sector comprises indigenous bankers, moneylenders, *nidhis* as well as chit Funds. The unorganised sub-markets meet a large part of working capital requirements of the Indian economy such as wholesale trade, retail trade, export trade, manufacturing industries units; construction, firm production and hotels etc. About 30% to 70% of total credit used in urban sector and these markets provide rural sector. In rural areas these markets are the largest single source of credit to agriculture and village artisans. Rates of interest in these markets are high. Both white and black money flow in this market.

Inspite of the exorbitantly higher interest rates in the unorganised money market the borrowers approach this market. It is because of their easy access to this market and not many formalities as required to get loans from the organised financial institutions. But the lenders in this sector of the money market generally exploit borrowers.

As the unorganised sector is beyond the provisions of the public bodies to control, implementation of monetary policy in the economy lags behind in its effectiveness. Squeeze in credit from the organised sector is liable to be implemented by resource to the unorganised
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

sector. Hence for proper implementation of the monetary policy, these two sectors of the money market require to be integrated. Alternatively the RBI should enlarge the organised sector so that the poorest can approach the financial institutions to get the smallest amount demanded.

2.5 Tools of Monetary Policy: A Historical Perspective:

Generally, the reserve bank of India has been using quantitative and qualitative methods in order to control the credit in the economy from time to time.

2.5.1 Quantitative Instruments of Credit Control:

The instruments of quantitative control are formulated to influence the total volume of credit and thereby total supply of money in the economy by affecting the lendable resources of the commercial banks. We can have a brief introspection regarding the quantitative instruments of credit control used by RBI.

(i) Bank Rate:

The Bank Rate has been defined in Section 40 of the RBI Act as “the standard rate at which the bank is prepared to buy or rediscount bills of exchange or other commercial papers eligible for purchase under this Act”. But in actual practice, in the absence of a genuine bill market and lack of eligible papers for discounting, the Bank Rate in
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

India is essentially the rate at which the Reserve Bank extends advances to various categories of borrowers. The principle underlying the Bank Rate Policy is that changes in the Bank Rate are generally followed by corresponding changes in money market rates, making credit costlier or cheaper, and affecting its demand and supply.

In practice the effect of a change in the Bank Rate depends on several factors such as the extent of commercial banks' dependence on the Reserve Bank for funds, the availability of funds with banks from other sources, the extent to which other interest rates are directly influenced by changes in the Bank rate and the degree of importance attached to a change in the Bank Rate as an indicator of the stance of monetary policy.

The experience in India is that due to the above pre-conditions the Bank Rate as an instrument of monetary control is not very much effective. Factors such as the dominance of the public sector, whose investment requirements are cost inelastic, the high rate of inflation experienced since the mid-sixties and the inherent inflexibility involved in the use of Bank Rate, which rendered any minor change in the Bank Rate ineffective, and restricted availability of refinance facilities to banks over and above these earmarked for specific purposes have together contributed to the ineffectiveness of moderate changes in the Bank Rate.
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

In the opinion of S.B. Gupta, "the experience in India .......... is that even as an instrument for controlling only the amount of bank borrowings, the bank rate is not very efficient. The most important reason is that by varying merely the bank rate, the Reserve bank of India varies the interest rate differential between the lending rates of banks and the cost of borrowed reserves—the factor which determines the extent of profitability to banks from borrowing." ¹³

(II) Open Market Operations:

By adopting the policy of open market operations the Central Bank resorts to the sale and purchase of government securities in the open market to control and regulate the volume of credit in the economy. At the time of inflation a sale of government securities to the commercial banks, insurance companies, business houses and individuals will lead to a fall in money supply or contraction. Conversely, if the monetary authorities decide to stimulate the economy at a time of recession they may decide to buy securities from the institutions and individual and inject more money into circulation.

In India Section 17 (8) of the RBI Act confers legal powers on the Reserve Bank to engage in the purchase and sale of securities of the Central Government or a State Government of any maturity or of such securities of a local authority as may be specified in this behalf by the Central Government on the recommendation of the Bank’s Central...
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

Board. Reserve Bank is also authorized under section 17 (2) (a) of the Act to purchase and sell commercial bills of short-term nature but in actual practice open market operations in India are confined to dealings in Government Securities excluding Treasury Bills. At present the Reserve Bank deals only in the securities issues by the Central Government and not in those of State Governments or local authorities. According to Chakravarty Committee Report (1985), “for the conduct of open market operations as a monetary instrument the market for government securities should be well organized broad based and deep, so that central bank is in a position to sell and buy securities to the extent it considers desirable. A prerequisite for the emergence of such markets is that the rate of interest offered on government securities is competitive. Since these conditions are not met by the Indian capital market, open market operations are of minor importance as a monetary instrument though they save as an adjunct of fiscal policy in India to some extent”.

2.5.2 Reserve Requirement Policy:

The technique of varying the reserve requirements has a sure and identifiable impact on the credit creating capacity of banks and subsequently on the liquidity of the banking system. An increase in the reserve ratio is a contractionary measure, which reduces the credit creating potential of the banks. While a reduction in the reserve ratio is
an expansionary measure the Reserve Bank of India directly regulates the liquidity of the banking system by two complementary methods: (a) First, depositing in cash with the Reserve Bank of an amount equal to the percentage of deposits with each bank as prescribed from time to time, which is known as Cash Reserve ratio (CRR), and (b) second maintenance by the bank of a proportion of its deposite liabilities in the form of specified liquid assets, which is known as the Statutory Liquidity Ratio (SLR).

(a) **Cash Reserve Ratio (CRR):**

Before October 1956, under the provisions of Reserve Bank of India Act, scheduled banks were required to maintain with the Reserve Bank, at the close of business on any day, a minimum cash reserve of 5 percent of their demand liabilities and 2 percent of their time liabilities in India. The RBI Act was amended in October 1956 empowering the Reserve Bank to vary the minimum reserves between 5 percent and 20 percent of the banks demand liabilities in India. Since October 1956 the minimum reserve requirement relates to the average daily balance of banks with the Reserve Bank of India, i.e. the average of the balances held at the close of business on each day of the week Saturday to Friday. With an amendment to the RBI Act since March 29, 1985, these average balances are to be maintained over each fortnight. The RBI Act was amended in September 1962 in which the distinction
between demand and time liabilities for the purpose of reserve requirements was removed and a uniform minimum reserve requirement of 3 percent of the aggregate of demand and time liabilities of banks was fixed. The Amendment Act also empowered the RBI to vary the cash reserve ratio between 3 percent and 15 percent.

Under section 18 of the banking Regulation Act the CRR applicable to co-operative banks and non-scheduled banks is 3 percent of their total demand and time liabilities in India and this ratio is not being varied by the Reserve Bank unlike in the case of scheduled banks. These categories of banks are allowed to maintain the cash reserve in the form of cash with himself or herself or in current account with the Reserve Bank, the State Bank of India or any other bank notified in this behalf, or partly in cash or partly in such current account.

The term "liabilities" of a bank for the purpose of computation of the CRR include net inter-bank liabilities (excess of inter-bank liabilities over-bank assets) and liabilities to others excluding the paid-up capital, reserves, credit balance in the profit and loss account, and loans taken from the Reserve bank, Industrial Development Bank of India (IDBI), Export Import Bank (EXIM) of India (with effect from January 1, 1982 when the bank was established) and the National Bank for Agriculture and Rural development (NABARD) (with effect from July 12, 1982 when it was established). If Inter-bank assets exceed inter-bank liabilities, the
excess is ignored in calculating net liabilities. Any shortfall in the maintenance of CRR attracts for payment of penal interest by a scheduled bank at the rate of 3 percent above the bank rate for the first week of default. But if the default is not made good at the rate of 5 percent above the Bank rate in respect of the second and each subsequent week till the stipulated minimum balance is restored. In addition to the penalty the Reserve Bank since March 30, 1979 disallowed access to its refinance/rediscount facility to defaulting banks and also charged additional interest of 3 percent on the portion of the accommodation already obtained by them from the Reserve Bank equivalent to the extent of shortfall. Apart from these stipulations defaults in regard to CRR attract graduated penalties from January 1, 1982 by way of loss of interest on the portion of their cash reserve eligible for payment of interest by the Reserve Bank. Under the graduated penalties scheme the penalty on the short fall was waived as long as the short fall did not exceed 4 percent of the absolute amount of cash balances required to be maintained. In the case of shortfalls up to 3 percent the banks were paid interest on the eligible balances actually maintained.

(b) Statutory Liquidity Ratio (SLR):

The statutory Liquidity Ratio (SLR) was introduced in India to prevent banks from offsetting the impact of variable reserve
requirements by liquidating their Government security holdings. Under the statutory liquidity requirement each bank is required to maintain a prescribed minimum proportion of its daily total demand and time liabilities in the form of designated liquid assets. These liquid assets consist of (a) excess reserves (b) unencumbered Government and "other approved securities", and (c) current account balances with other banks.

Originally, under the Banking Regulation Act, 1949, banks had to maintain at the close of business every day, liquid assets in cash, gold or unencumbered approved securities amounting to not less than 20 percent of the total demand and time liabilities in India is known as the Statutory Liquidity Ratio (SLR). The Reserve Bank of India has stepped up the liquidity ratio for two reasons. (i) higher liquidity ratio forces commercial Banks to maintain a larger proportion of their resources in liquid form and thus reduces their capacity to grant loans and advances to business and industry. This has anti-inflationary impact, and (ii) a higher liquidity ratio diverts bank funds from loan and advances to investment in Government and other approved securities.

However, it is evident from the above study that changes in the Statutory Liquidity Ratio and the Cash Reserve Ratio have the same effect on the capacity of commercial Banks to create credit.
2.6 RBI and Refinancing Facilities:

The system of refinance provided by the RBI to the scheduled commercial banks is another major instrument of credit regulation flexibly used to foster the growth of concessional credit to specific sectors. Major modifications in the refinance facilities were undertaken in 1960. In October 1960 RBI introduced a quota-cum-slab interest rate system. This system operated for four years from October 1960 to September 1964. Under this system banks were given a basic quota equal to a specified percentage of the statutory cash reserve requirement up to this quota banks could borrow from the Reserve Bank at the Bank Rate. In addition to the basic quota additional quotas were also fixed and commercial banks were required to pay an interest rate higher than the Bank rate for borrowings within additional quotas. The lending by the Reserve Bank to the commercial banks beyond their additional quotas was entirely discretionary. This system was not considered as an effective constraint on banks lending operations mainly because it failed to take into account the differences in asset distribution of the different banks and their ability to pass on their higher effective cost of funds to their borrowers by raising lending rates.

To remove the above defects in September 1964 the RBI introduced a system of Differential Interest Rates based on the new liquidity positions of the borrowing banks. The net liquidity assets were
defined as the total of banks cash and balances with the Reserve Bank and other notified banks, balances in current account with other banks, the investment in Government and other eligible securities and less borrowing from the Reserve Bank, the State Bank of India and the Industrial Development Bank of India. The minimum Net liquidity Ratio was initially fixed at 28 percent. The Reserve Bank agreed to grant credit to a bank at the prevailing Bank Rate if it maintained 28 percent of the Net Liquidity Ratio (NLR). For every percentage point decline in the Net Liquidity ratio below 28 percent the rate on entire amount of borrowings was to be raised by 1 / 2 percent. The rationale of the policy of the steady increase in NLR over the period was to discourage commercial banks' indulgence in excessive borrowings from the Reserve Bank of India. "With effect from July 1980 the facility of stand by-refinance was made available only against the collateral of government securities and trustee securities, the rate of interest changed being lower than the discretionary rate.

The effectiveness of refinance as an instrument to regulate credit expansion is positively correlated to the degree of dependence of commercial banks on the Reserve Bank.

2.7 Selective Credit Control (SCC):

The Selective Credit Control weapons aim at regulating the distribution or direction of bank resources to particular sectors of the
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

The RBI has operated Selective Credit Control since May 1956. In India, the Selective Credit Controls have been used to prevent hoarding with the help of bank credit of certain essential commodities like food grains and basic raw materials in order to check an undue rise in their prices.

The main instruments of Selective Credit control used by the RBI are (i) minimum margins for lending against selected commodities (ii) Ceilings on the levels of credit and (iii) changing or minimum rate of interest on advances against specified commodities. All the three tools of control are operated and modified by the Reserve Bank from time to time in such manner as is considered appropriate to meet particular situations or to achieve the desired directional flow of credit. Since the SCC is basically used to discourage financing of speculative activity in the economy, the control mechanism has been so operated as to ensure that the legitimate production or distribution needs of the concerned sector are not affected. The Credit Authorisation Scheme (CAS) introduced by the RBI in November 1965 is also a kind of selective credit control. Under this Scheme "the Reserve Bank regulates not only the quantum but also the terms on which credit flows to the different large borrowers, in order that credit is directed to genuine productive purposes, the credit is in accord with the needs of borrowers, and there is no undue channelling of credit to any single borrower or
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

The CAS has been modified from time to time in the light of the prevailing economic situation. Originally, the minimum limit for prior authorisation for borrowers in the private sector was fixed at Rs. 1 crore. But with effect from April 4, 1986, it has been raised to Rs. 6 crores. Selective Credit Control is considered a useful supplement to general credit regulation and its effectiveness may be greatly enhanced when used together with general credit controls.

2.7.1 Moral Suasion:

Moral Suasion is a combination of persuasion and pressures, which are a Central Bank, apply on banks for the desirable expansion of bank credit. It is exercised through advices, friendly persuasions, policy statements, public pronouncements, or outright appeal warnings that excessive expansion or contraction of bank credit might involve serious consequences for the banking system and the economy as a whole. In India the first experiment in respect of this technique was made just after the devaluation of the Rupee in September 1949 when the Reserve Bank sent a circular letter to commercial banks urging them to exercise resistant in giving advances for speculative purposes. Since then the RBI is using the instrument of moral suasion regularly. The role of moral suasion as an effective instrument in India can be observed in the maintenance of the SLR by the banks. Statutorily banks have to maintain liquid assets equal to 25 percent of their demand and time
liabilities but as a result of moral suasion by the Reserve Bank they actually maintain liquid assets at a much higher level. "Moral suasion is a means of strengthening mutual confidence and understanding between the monetary authority and the banks as well as financial institutions and therefore is an essential instrument of monetary regulation."

2.8 Interest Rate Policy:

Rate of interest is one of the instruments of monetary regulation. "The interest rate structure that has evolved in post-independence India is described as administered interest rate structure as the government controls a wide range of interest rates charged / offered by banks, financial institutions and other public sector government organization." Here the bank rate is considered as the pace setter to other markets rates of interest because the money marker rates adjust themselves almost automatically according to changes in the Bank Rate.

As the Bazaar bill rate increased from 11.57 percent in 1960-61 to 23.40 percent in 1976-77 advance rate of commercial banks increased from 6 percent in 1960-61 to 14.9 percent in 1976-77, 12-Month Deposit Rate increased from 3.31 percent in 1960-61 to 8 percent in 1984-85 and Bank Rate increased from 4 percent in 1960-61 to 10 percent in 1984-85.
In order to increase the flow of assistance to preferred sector like small-scale sector, agriculture, industrial units in backward areas etc., preferential interest rates were used frequently. Interest rate policy was also used in a flexible manner to attract deposits from non-resident Indian (NRI). However, many economists have criticized the interest rate policy, which has maintained the administered interest rate structure, on several grounds. M.K. Datar (1987) has listed the major points of criticism for the policy of administered interest rates, which are as follows:

(i) The policy has resulted in low level of interest rates to depositors, which affect the incentive for saving in the form of financial asset.

(ii) The interest rate structure is inflexible, that it does not reflect market terms. Further the criterion for deciding the spread between various interest rates remains unspecified and is adhoc.

(iii) The low level of interest rates on government bond adversely affects banks profitability.

(iv) The policy to control distribution of credit among different sectors, etc. gives rise to credit rationing is inefficient.

According to Chakravarty Committee report (1985) the administered interest system has caused an incalculable harm to the Indian financial system and, therefore, it should be modified to meet the needs of government as a major borrower and entrepreneur, argument
CHAPTER-2  MEANING AND CONCEPT OF MONETARY POLICY

the pool of savings, protect the interests of small saver, increase the flexibility to affect counter-cyclical variations in interest rates promote more effective used of credit, etc. Therefore, the Committee has recommended that the ceiling on interest rates on bank loans and call loans should be abandoned and that the Treasury Bill rate, yields on Government Securities of all maturities and bank deposit rates, etc. should be appropriately raised so as to yield realistic and reasonable real rates of return to the holders of the claims. In the view of Committee there is a strong case for a much greater reliance on interest rate technique for promoting the effective use of credit and for short-term monetary management.

2.9 Monetary Policy Frame Work in India:

In consonance with the international experience and the process of liberalization started in the early 1990s the framework of monetary policy in Indian economy has undergone far-reaching changes.

In tune with the process of financial liberalization, there has been a shift from direct to indirect instruments of monetary policy. Moreover, RBI has been able in developing an array of monetary levers designed to manage the market liquidity in order to achieve its objectives of price stability and availability of credit for growth. This was further because of ensuring the orderly conditions in the financial market.
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

While the basic objectives of monetary policy as the price stability and credit availability to ensure growth, have not changed but the operating environment for monetary policy has undergone a significant transformation. The financial stability has been the dominant concern of the monetary policy with the beginning of reforms. Monetary policy has been emphasising to reduce segmentation through better linkages between various segments of the financial markets including money, govt. securities and Foreign exchange markets.

The development of the monetary policy framework has required a great deal of institutional initiatives to ensure efficient functioning of the money market, development of appropriate trading, payments and settlement system, and the technological infrastructure etc.

The study can be divided into the following heads:

2.9.1 Changes in the Framework:

A monetary targeting framework was in place since mid-1980s and till 1997-98 with broad money (m3) as an intermediate target. The aim was to modulate money supply growth, consistent with two parameters, viz., (a) the expected growth in real income, and (b) a projected or a tolerable rate of inflation. On the basis of these two parameters, the targeted monetary expansion was set. In practice, the monetary targeting framework was used in a flexible manner with feedback from developments in the real sector.
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

With the changing inter-relationship between money, output and prices in the wake of financial sector reforms and opening up of the economy, a review was warranted. Accordingly, the Reserve Bank formally switched over in 1998-99 to a multiple indicator approach under the guidance and framework evolved by Dr. Bimal Jalan. As per this approach, interest rates or rates of return in different markets (money, capital and government securities markets), along with data such as on currency in circulation, credit extended by banks and financial institutions, fiscal position, trade balance, capital flows, inflation rate, exchange rate, refinancing and transactions in foreign exchange, which are available with high-frequency, are juxtaposed with the trends in output, with a view to deriving policy perspectives. Keeping in view the intrinsic reporting lags and varying reliability of inflation indicators coupled with the infirmities surrounding the relevant indicators like potential output and unemployment, our efforts have focused on improving the information set, both quantitatively and qualitatively.

2.9.2 Fine-tuning the Operating Procedure:

As regards the operating procedure of monetary policy in India, reliance on direct instruments has been reduced and a policy preference for indirect instruments has become the cornerstone of current monetary policy operations. Liquidity management in the system is carried out through open market operations (OMO) in the form of
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

Outright purchases/sales of government securities and daily reverse repo and repo operations under a Liquidity Adjustment Facility (LAF) introduced in 2000. The LAF has enabled the Reserve Bank to modulate short-term liquidity under varied financial market conditions, including large capital inflows. In addition, it has enabled the Reserve Bank to set, as far as possible, an informal corridor for the short-term interest rates consistent with the policy stance. This has also facilitated a reduction in the levels of statutory pre-emption without engendering liquidity pressures. These operations are supplemented by providing access to the Reserve Bank's standing export credit refinance facility, in a limited manner, and liquidity support to the primary dealers.

In this new operating environment, the Reserve Bank has been increasingly relying on a mix of market-based instruments and changes in reserve requirements, when necessary, for the conduct of monetary policy. Changes in fixed reverse repo/repo rates set by the Reserve Bank from time to time for the conduct of its Liquidity Adjustment Facility (LAF), under which the central bank conducts daily auctions for the banks, have emerged as the main instruments for interest rate signalling in the Indian economy.

The Reserve Bank has also actively encouraged the development of the collateralised segment of money market to facilitate safe and smooth clearing of the short-term liquidity mismatches amongst market
participants. Two types of collateralised markets have merged first, a repo market and second, a market for collateralised borrowing and lending obligations (CBLOs). The latter is a unique product similar to a tri-partite repo. Clearing Corporation of India Ltd. (CCIL) acts as a central counter party and facilitates collateralised lending and borrowing amongst market participants.

The liquidity management was further refined in 2004 with the introduction of a market stabilisation scheme (MSS) under which the Reserve Bank was allowed to issue government securities as part of liquidity sterilisation operations in the wake of large capital inflows and surplus liquidity conditions. While these issuances do not provide budgetary support, interest costs are borne by the fisc; as far as Government securities market is concerned, these securities are also traded in the secondary market, on par with the other government stock.

In brief, currently in its monetary operations, the Reserve Bank uses multiple instruments to ensure that appropriate liquidity is maintained in the system, consistent with interest rate policy and the objective of price stability, so that all legitimate requirements of credit are met. Towards this end, the Bank pursues, inter alia, a policy of active management of liquidity through open market operations (OMO) including Liquidity Adjustment Facility (LAF), Market Stabilization
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

Scheme (MSS) and cash reserve ratio (CRR), and deploys the policy instruments at its disposal, flexibly, as warranted by the situation.

2.9.3 Gains in Operational Autonomy:

The mid 1950s witnessed the beginning of serious erosion of autonomy in the monetary policy function due to the emergence of the system of ad hoc Treasury Bills and automatic monetisation. Under this system, it was agreed that the Reserve Bank would replenish Government's cash balances by creation of ad hoc Treasury Bills issued in the Bank's favour whenever such balances with the Reserve Bank fell below the stipulated minimum. Thus, the ad hoc Treasury Bills, which were meant to meet temporary mismatches between receipts and payments of the Government, became cumulative and eventually emerged as a significant source of monetary financing of the Government expenditure.

The relationship between the Reserve Bank of India and the Government took a significant turn in September 1994 when a supplemental agreement was entered into with the Government, which limited, initially, the net issuance of ad hoc treasury bills. This initiative culminated in the abolition of the ad hoc Treasury Bills in April 1997 and a provision treasury bills replaced the system. This was replaced by a provision for extending limited ways and means advances. The phasing out of automatic monetisation of budget deficit has, thus, strengthened
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

the monetary policy framework, imparting flexibility and operational autonomy.

With the enactment of the Fiscal Responsibility and Budget Management Act (FRBMA) in 2003, the Reserve Bank has withdrawn from participating in the primary issues of Central Government securities with effect from April 2006. There could be exceptions only on the grounds of national security or national calamity or such other exceptional circumstances.

The recent legislative amendments enable a flexible use of the CRR for monetary management, without being constrained by a statutory floor or ceiling on the level of the CRR. The amendments also enable the lowering of the Statutory Liquidity Ratio (SLR) to the levels below the previous statutory minimum of 25 per cent of net demand and time liabilities of banks – which would further improve the scope for flexible liquidity management.

2.9.4 Strengthening the Transmission Channels:

In a market-oriented economy, policy signals are transmitted through an integrated and efficient money, government securities and foreign exchange markets combined with a robust payments and settlement system. The Reserve Bank has therefore, been engaged in developing, widening and deepening of various markets and institutions. The medium-term framework is to keep developing the financial
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

markets, preserving the integrity of financial markets and thereby, improving the transmission of monetary policy impulses. In the area of money market, several measures were taken to refine the overnight and the notice money market, the term money, commercial paper and certificate of deposit markets, besides the repo market. A screen-based, negotiated, quote-driven system for dealings in the call/notice and term-money markets (NDS-CALL) has also been recently launched.

Well functioning market for government securities is necessary, both for effective public debt management and monetary management, while serving the broader interest of development of financial markets in general, and debt markets, in particular. Accordingly, a number of initiatives have been taken over the years to develop both the primary and secondary markets for Government securities. The need for further development assumed greater significance in the context of the imperative prohibition of Reserve Bank from participating in the primary issuance of Central Government securities with effect from April 2006 as per the provisions of the Fiscal Responsibility and Budget Management Act. An Internal Technical Group on Central Government Securities Market (July 2005) was constituted to, inter alia, suggest measures for enhancing the depth and liquidity of the secondary market, in the new environment. The Group envisaged that steps were to be taken over the medium term to develop the Government
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

securities market in terms of instruments. The recommendations are being acted upon in a phased manner.

The corporate debt market in India is relatively under-developed but has a large potential to raise resources particularly for infrastructure projects, housing sector and for the corporates themselves. Development of various market segments including mortgage-backed securities, bond insurance institutions for credit enhancement and greater access to real time gross settlement (RTGS) with state-of-the art technology would provide a strong impetus for growth of corporate bond markets in India. Pursuant to the announcement made in the Union Budget, 2005-2006,a High Level Expert Committee on Corporate Bonds and Securitisation (Under the Chairmanship of Dr. R. H. Patil) was appointed to examine legal, regulatory, tax and market design issues in the development of the corporate bond market. The recommendations of the Committee included enhancing the issuer as well as investor base, simplification of listing and disclosure norms, rationalisation of stamp duty and withholding tax, consolidation of debt, improving trading systems through introduction of an electronic order matching system, efficient clearing and settlement systems, a comprehensive reporting mechanism, developing market conventions and self-regulation and development of the securitised debt market. Actions have been initiated to implement the recommendations of the Committee.
The Indian foreign exchange market has been widened and deepened with the transition to a market-determined exchange rate system in March 1993 and the subsequent liberalisation of restrictions on various external transactions leading up to current account convertibility under Article VII of the Articles of Agreement of the International Monetary Fund in 1994. As a part of the continuing efforts aimed at liberalising and developing the foreign exchange market in India, an internal Technical Group of Foreign Exchange Markets was appointed to undertake a comprehensive review of measures initiated by the Reserve Bank so far and identify areas for further liberalization of restrictions along with a medium term framework. The Committee on Fuller Capital Account Convertibility (CFCAC) chaired by Mr. S.S. Tarapore has also made recommendations for development of financial markets including the foreign exchange market. Several measures have been taken to further liberalise the extant regulations and thereby improve the structure, integration and efficiency of the markets.

2.9.5 Payment and Settlement System:

The Reserve Bank has also initiated a number of steps – institutional, procedural and operational for making the payment systems safe, secure and efficient. A Board named the Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) has been set up as a Committee of the Central Board of the
Reserve Bank of India, with the Governor as its Chairman and all the four Deputy Governors and two external Central Board Directors as its members. The BPSS lays down the policies and standards relating to the regulation and supervision of both the existing and the evolving payment and settlement systems.

For efficiency enhancements and risk reduction, usage of the Real Time Gross Settlement (RTGS) System and other electronic payment mechanisms are being encouraged in a big way. Almost 40 per cent of the 70,000 plus bank branches in the country are now RTGS enabled. Sometime back, the Reserve Bank examined India's position with regard to compliance with the Core Principles of Systemically Important Payment Systems. It was found that we were largely compliant with all Core Principles except the first one, i.e. "well founded legal basis". The Reserve Bank, with the concurrence of the Government of India, has drafted a Payment and Settlement Systems Bill and this Bill is under consideration of the Parliament. This Bill, when enacted, will not only authorise the Reserve Bank to lay down the policies relating to regulation and supervision of the payment systems, but also provide legal recognition to "netting" and "settlement finality".

Given the critical requirements of information technology and in its endeavour to sustain the progress and provide direction to the IT initiatives of the financial sector, the Reserve Bank has set out a Vision
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

Document which provides a bird’s eye view of the plans for IT development in the medium term, with the required focus on corporate governance.

2.9.6 Strengthening Institutional Setting:

Monetary policy formulation is carried out by the Reserve Bank in a consultative manner. The Monetary Policy Department of the Bank organises discussions between the top management of the Bank and the select commercial banks as also with the industry associations, bodies representing markets and the significant industry groups. It also holds monthly meetings with select major banks and financial institutions, which provide a consultative platform for issues concerning monetary, credit, regulatory and supervisory policies of the Bank. Decisions on day-to-day money market operations, including management of liquidity, are taken by a Financial Markets Committee (FMC), which includes senior officials of the Bank responsible for monetary policy and related operations in money, government securities and foreign exchange markets. The Deputy Governor, Executive Director(s) and heads of four departments in charge of monetary policy and related market operations meet every morning as financial markets open for trading. They also meet more than once during a day, if such a need arises.

Besides FMC meetings, Monetary Policy Strategy Meetings take place once every month. The strategy meetings take a near-term view
of the monetary policy and consider key projections and parameters that can affect the stance of the monetary policy. In addition, a Technical Advisory Committee on Money, Foreign Exchange and Government Securities Markets comprising academicians and financial market experts, including those from depositories and credit rating agencies, provides support to the consultative process. The committee meets once a quarter and discusses proposals on instruments and institutional practices relating to financial markets.

In pursuance of the objective of strengthening the consultative process in monetary policy, a Technical Advisory Committee (TAC) on Monetary Policy has been set up with four external members drawn from the areas of monetary economics, central banking, financial markets and public finance. The TAC meets ahead of the annual policy and reviews of annual policy. The TAC reviews macroeconomic and monetary developments and advises on the stance of monetary policy.

2.9.7 Emphasising Communication:

Faced with multiple tasks and a complex mandate, clear communication on the part of the Reserve Bank of India assumes special significance in the area of monetary policy. We emphasise three kinds of communications, viz., (a) analysis of the economy, (b) policy measures, and (c) reasons behind such policy measures. In fact, by international standards, the Reserve Bank of India has a fairly
extensive and transparent communication system. The bi-annual policy statements traditionally communicated the Reserve Bank’s stance of monetary in the immediate future of six months to one year. Since July 2005, a system of publishing quarterly reviews in addition to the bi-annual statements has been put in place. Speeches by the top executives of the Bank also form an important part of communication process of the Reserve Bank. We have taken a middle path of sharing our analysis, in addition to information, with the market participants, to enable them to develop their own perceptions. In doing so, we have the benefit of the process of two-way communication, of information as well as perceptions, between the market participants and the RBI. Several formal structured meetings with industry associations, through standing advisory committees, and adhoc committees and technical/working groups, also enable the two-way process.

2.9.8 Aligning With International Best Practices:

The Reserve Bank has adopted a multi-pronged strategy based on international best practices with suitable adaptations to promote development and stability of institutions, markets and the financial infrastructure. Benchmarking our financial sector to international standards and best practices has been very useful to us. In this context, our effort to assess the status and implementation of international standards and codes of various standard setting bodies including the
IMF was one of the cornerstones of the recent initiatives which helped us to understand our relative position vis-à-vis international standards. The approach to implementation of financial standards and codes was based on the efficiency-enhancing elements of the standards and codes, and on the need to consider them as part of the process of institutional development in the country, while not ignoring their relevance to domestic as well as external financial stability. The process enabled an objective, independent and 'external' assessment of the domestic economy. Such a participative and consultative approach with emphasis on gradualism was advocated to secure a convergence of viewpoints and, hence, to evolve a favourable environment for bringing about necessary changes with harmony.

Government of India, in consultation with the Reserve Bank, have again constituted in September 2006 a Committee on Financial Sector Assessment to undertake a self-assessment of financial stability and to further update the status and implementation of various standards and codes.
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

2.10 CONCLUSION:

The stability in price has become the dominant objective of the Reserve Bank of India. So far as the conduct of monetary policy is concerned, the uncertain transmission channels have posed a considerable challenge on it after liberalisation. Thus with the growing interdependence across the countries more need of coordination in policy action and higher degree of openness on the choice of monetary policy strategy are required by the Reserve Bank of India. Finally we can say in a nutshell that the growth with price stabilisation has been the dominant objective of the Reserve Bank of India.
CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY

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CHAPTER-2 MEANING AND CONCEPT OF MONETARY POLICY


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