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Research Paper

PROMOTIONAL ROLE OF MONETARY POLICY IN INDIA SINCE 1991

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ABSTRACT

Monetary Policy plays an important role both in developed and developing countries alike for their economic growth and stability. Monetary Policy is the macroeconomic policy laid down by the Central Bank. It involves management of money supply and interest and in the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth, and liquidity. Since 1991, India has been experiencing impact of process of economic liberalization in primary, secondary, and tertiary sectors of the Indian economy. The present decade of 21th century economic reforms consist of a broad spectrum of measures including the financial sectors reforms that might have affected the role of monetary policy in promoting financial environment needed for the development of these sectors. After independence, it's a good time to take stock of the past and a good time to establish goals transition. The economy has moved from an isolated and slow growing economy to one that is growing faster and beginning to integrate with the global economy. The transition began with liberalization also changed the framework of monetary policy. Responsibilities of Reserve Bank of India have been increased in taking such measures which can make effective progress in developing economy.

KEYWORDS: Price tools, bank rate, open market operations, control of credit, controlled expansion, interest rates, money.

INTRODUCTION

Monetary policy is the process by which the monetary authority of a country controls the supply of money, often targeting an inflation rate or interest rate to ensure price stability and general trust in the currency. Further goals of a monetary policy are usually to contribute to economic growth and stability, to lower unemployment, and to maintain predictable exchange rates with other currencies. Monetary policy is referred to as either being expansionary or contractionary, where an expansionary policy increases the total supply of money in economy more rapidly than usual and contractionary policy is traditionally used to try to combat unemployment in a recession by lowering interest rates in the hope that easy credit will entice businesses into expanding. Contradictory policy is intended to slow inflation in order to avoid the resulting distortions and deterioration of asset values.

The monetary policy refers to a regulatory policy whereby the central bank maintains its control over the supply of money for the realization of general economic goals. This concept of monetary policy may be right in the context of developed economies, but in less developed countries like India, monetary cannot remain confined only to controlling the supply of money. In other words, monetary policy, if it does not play any positive role will serve only a limited purpose. Aptly summarizing the RBI's monetary policy, S. L. N. Simha has stated, "The Reserve Bank's responsibility is not merely one

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of credit restriction. In a growing economy there has to be a continuous expansion of money supply and bank credit has the duty to see that legitimate credit requirements are met. The Bank's responsibilities in the circumstances is mainly to moderates the expansion of credit and money supply, in such a way as to insure the legitimate requirements of industry and trade and curb the use of credit for unproductive and speculative purpose. That is why the Bank has rightly called its credit policy in recent years as one of controlled expansion."

In its developmental or promotional role, RBI adopted measures to deepen and widen the financial system to promote saving and investment in the Indian economy. Sugat Margit defines economic liberalization as a ray of bright future and according to him economic liberalization brought a new dimension to economic reforms; Deepak Mohanty and A. K. Mitra opine that "during the 1990's often financial sector deregulation, liquidity impact of capital inflows was given more importance over tenacity to monetary targeting. It adversely affected the monetary targeting exercise in India."

Objectives of the Study

The research aimed to determine the following objectives:

1. To study the changing role and importance of selected monetary instrument in India.
2. To analyze the role of economic reforms in promotional aspect of monetary policy in Indian economy for the development of primary, secondary and tertiary sectors.
3. To find out the coverage of monetary policy facilitated economic growth in India and its general impact after economic liberalization.

Significance of the Study

Monetary policy in an underdevelopment country plays an important role in increasing the growth rate of the economy by influencing the cost and availability of credit, by controlling inflation and maintaining equilibrium the balance of payments. So the principal objectives of monetary policy in such a country are to control credit for controlling inflation and to stabilize the price level, to stabilize the exchange rate, to achieve equilibrium in the balance of payments and to promote economic development.

Promotional role of monetary policy of RBI is very important in India. So in the present study, promotional role of the monetary policy has been given more emphasis. It will provide clues to make a balance between promotional and restrictive steps of monetary policy.

Scope of the Study

The study will cover the period from the VIII five year plan to XI five year plan i.e. from 1992-93 to 2011-12 and also will cover for an appropriate evolution of impact of economic liberalization. Regarding the analysis of promotional impact, the proposed study will restricted to the promotion of financial environment. There are many tools of monetary policy that have been revisited in the proposed study but the main emphasis will be given to price stability. The impact of price stability changes of credit flow in case of entire economy and in case of primary, secondary, and tertiary sectors of the Indian economy will be covered too.

Review of related literature

The contribution made by various scholars and economists in the field of monetary policy are really praiseworthy. Although various studies have been reviewed, only those works which are closely related to the present study are including here. Hirendra Nath Roy in "The Role of monetary policy in Economic Development" clarified how economic development has become a main objective of monetary policy and how monetary policy contributes to economic growth effectively during the period starting from 1949. The

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difficulties of monetary policy in undeveloped money markets have been also discussed with suggestions for overcoming them. He also emphasized that "although economic developed should be the prime objective of monetary policy stability should not be ignored."

C. Rangarajan Former Governor of RBI, "Until the overall reform process was initiated in 1991, the basic goal of monetary policy was to neutralize the impact of fiscal deficits..... Monetary management took the form of compensatory increase in the cash reserve ratio (CRR) for banks, controls on growth of commercial credit (mainly to the enterprises sector) and adjustments of administered interest rates. The fixation of CRR and SLR at their maximum levels crowded out credits for the commercial sector."

The Chakravarty Committee made an attempt to assess the importance of developmental role of monetary policy and emphasize of monetary policy of RBI should seek to perform many important task such as, mobilizing of saving of the community and enlarging the financial saving pool, enabling the resource needs of the major 'entrepreneur' in the country and also promoting an efficient payments systems. Y. V. Reddy, a former Governor of Reserve commenting on the monetary policy of pre-reform period prior to 1991 writes, "given the command and controlled nature of the Indian economic, the RBI had to resort to direct instruments like interest rate regulation, selective credit control and cash reserve rate (CRR) as major monetary instruments. These instruments were used to naturalize the monetary impact of the Government's budgetary operations."

RBI with economic growth assuming a new urgency since independence, the range of the Reserve Bank's functions have steadily widened. The Bank now performs a variety of developmental and promotional functions, which at one time, were regarded as normal scope of Central Banking. C. Rangarajan former governor of RBI "as India's monetary policy rests in good hands, let me talk about a topic. I know has been as important a concern for the Central Bank-as it has been for your colleagues in other emerging market countries. I am referring of course, to the unconventional monetary easing in the large advanced economies following the global financial crisis."

Y. V. Ready, "remarks that in order to gain greater effectiveness in money market of operations of RBI through Liquidity Adjustment Facility, the automatic access of refinance from the RBI to banks also to be reassessed. Thus, as CRR gets lowered and Repo market develops, the refinance facilities may be lowered or altogether removed and the access to the non-collateralized call money market restricted with the objective of imparting greater efficiency to the conduct of monetary policy."

K.K. Sharma presented a survey of the Indian monetary policy during the planning period. He put forward the view, "that monetary policy is not a separate and independent entity in itself but it is a particular form of economic policy evolved by the Central Bank in collaboration with the state to suit the economy of a country at a particular time." In his study, he concluded that "a mix monetary and fiscal discipline an which emphasis must be laid in the present economic set up of the country. Production must expand to relieve inflationary pressures and monetary and fiscal discipline should be such as may help production to rise, only then will growth with stability be secured."

Control of Credit

The instruments of monetary policy may be classified according to the area of their greatest initial impact-whether they operate principally on the supply of money through changing either

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the stock of reserve money or the multiplier, or on the demand for credit through cost and other influences.

Table 1: Principal areas of impact of that major Monetary Policy Instruments

Reserve money	Multiplier	Demand Side
Reserve Bank refinance to banks, and to the commercial sector	Cash Reserve Ratio Credit ceilings	Bank rate, Interest rate policy
Margin requirements	Open market operation, Statutory liquidity ratio	Selective credit policies Credit norms (Tandon and chore committee recommendations)

Alternatively, we can classify these methods of control under two heading:

(a) Quantitative Controls, and

(b) Selective Credit Controls

Quantitative Controls

Bank Rate

The bank rate (BR) has been defined in the Reserve Bank in India Act as the standard rate at which it (the Bank) is prepared to buy or rediscount bills of exchange or other commercial papers eligible for purchase under this act. But for all practical purposes, the Bank Rate is the rate charged by the Central Bank for lending funds to commercial banks.

Open Market Operation

Open Market (OM) operations, as defined by the RBI, refer "broadly to the purchase and sale by the Central Bank of a variety of assets such as foreign exchange, gold, government securities and even company shares." In practice, however, they are confined to the purchase and sale of government securities.

Variable Reserve Requirements (VRR)

The RBI also uses the method of VRR to control credit in India. By changing the ratio of reserves that the commercial banks are required to keep in the form of cash against their deposits, the RBI seeks to influence the credit creation power of the commercial banks.

These requirements are of two kinds, viz.

1. Cash reserve ratio (CRR), and
2. Statutory liquidity ratio (SLR)

Cash Reserve Ratio

Cash reserve ratio, refers to a portion of deposits (as cash) which banks have to keep /maintain with the RBI. It ensures that a portion of bank deposits is totally risk-free and secondly it enables that RBI control liquidity in the system and thereby, inflation.

Statutory Liquidity Requirements

SLR refers to that portion of total deposits of a commercial bank which it has to keep with itself in the form of cash reserves. SLR supplements CRR and are so designed as to prevent commercial banks from offsetting the impact of CRR by liquidity their government security holdings.

Liquidity Adjustment Facility

The LAF is an important indirect instrument for the conduct of monetary policy. It operates through overnight fixed repo and reserve repo rates. It is assigned the objective of meeting day-to-day liquidity mismatches in the system, smoothening volatility in short- term money

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market rates and steering these rates consistent with monetary policy objectives.

Selective Credit Controls

Selective credits control (SCCs), introduced for the first time in 1956, and are considered by the RBI as a useful supplement to general credit regulation. They are designed specifically to curb excess in selected areas without affecting other types of credit. It should, however, be noted that prices are determined by the interaction of supply and demand and when supply is substantially short, what SCCs are likely to accomplish is to moderate the price rise rather than arrest the basic trend.

SCCs during planning era

The major techniques of the SCCs used by the RBI are

- Minimum margins for lending against specific securities;
- Ceiling on the amounts of credit for certain purpose;
- Discriminatory rates of interest charged on certain types of advances.

At present, the SCCs are used against the following commodities: (i) food grains, (ii) cotton and kapas, (iii) oilseeds and oil, vanaspati, (iv) sugar, khandsari, gur, and (v) cotton textiles including yarn

CONCLUSION

Monetary authorities in underdeveloped economies have to frame their policies according to the economic situations and the changing ideas of the times prevalent there, because in a country, where the process of economic development is a regular segment, monetary policy assumes a significant role. When India launched the First Five- Year plan, concept of both promotional and restrictive role of monetary policy was initiated by RBI for the required situations in a planned economy. The role of monetary policy is changing with liberalization, deregulation and globalization, and the entire structure brining new challenges and even increasing opportunities.

In India, price stability is the key objective of monetary policy among the other objective of monetary policy since the inception of planning. But economic growth also assumed the importance as the objective of monetary policy both the objectives have equal importance. To attain price stability objective monetary policy adopts short-run vision while for economic growth long-run vision. In India it is rightly considered that the most important objective of monetary policy of RBI is economic growth and price stability. In the era of economic liberalization financial stability also assumed the importance as the objective of monetary policy with the entering global trade; the exchange rate stability is also one of the most important objectives of RBI because stability of exchange rate is essential for maintaining the international financial prestige.

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