e-Resources Module-XIII

Paper No. : DSE-xiii

Paper Title: Money and Financial Markets

Course: B.A. (Hons.) Economics, Sem.-VI Students of S.R.C.C.

MONETARY POLICY AND OPERATING PROCEDURE

This e-Resources Module has been designed to further clarify students on issues relating to Monetary policy especially the conceptual base and technical terminology relating to it. Broadly speaking, monetary policy refers to controlled changes in the supply of money by the monetary authority with a view to attaining certain pre-determined socio-economic objectives at the macro level such as a high rate of economic growth, price stability, removal of inequalities in the distribution of income and wealth, elimination of poverty and unemployment, a healthy balance in the Balance of Payments etc. Such aims, objectives or goals of monetary policy are typically defined in general terms but once they are quantified and given a time dimension, they are said to be targets of monetary policy. The means or methods through which these policy targets are achieved are in turn known as instruments of monetary policy or simply policy instruments. For example, changes in Statutory Cash Reserve Requirement (CRR), changes in Statutory Liquidity Ratio (SLR), Open Market Operations, Bank Rate policy and Liquidity Adjustment Facility are some prominent instruments of monetary policy. Evidently, as these policy instruments may not have a direct bearing on policy targets such as removal of unemployment and poverty, therefore monetary authority typically chooses an "intermediate target" variable such as money stock, quantum of high-powered money H, interest rate etc., which is directly under its control but can be altered in such a manner that it is conducive to the attainment of its original i.e., final target. At any point of time, the whole set of policy targets, intermediate targets and policy instruments in an economy is referred to as a policy regime, operating regime or operating procedure.

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Any economic policy refers to deliberate attempts on the part of some authority to sub-serve certain well-defined socio-economic objectives or goals at the macro level. Two prominent

forms of economic policy are fiscal policy and monetary policy respectively. The fiscal policy is typically undertaken by the fiscal authority *viz.*, Government and pertains to issues like taxation, subsidies, public expenditure and the like. In sharp contrast, monetary policy essentially falls in the domain of Central bank as monetary authority and relates to money supply, bank credit, interest rates etc.

Thus construed, monetary policy means controlled changes in the money stock or supply of money by the monetary authority with a view to attaining certain pre-determined macro objectives such as a high rate of economic growth, price stability, removal of inequalities in the distribution of income and wealth, elimination of poverty and unemployment, a healthy balance in the Balance of Payments etc. The aims, objectives or goals of monetary policy are defined in general terms but once they are quantified and given a time dimension, they are said to be targets of monetary policy. For instance, removal of poverty is a policy goal but it gets converted into a policy target in case we set it as bringing the *head count ratio* or proportion of population below poverty line in an economy to a level of 10% within next five years. In monetary economics, the terms policy goals and policy targets are generally used interchangeably since without being quantified and without being given a time dimension, policy goals have very little meaning for all practical purposes.

Once the objectives or targets of monetary policy are defined by the monetary authority, they have to be achieved through certain means or methods which in turn are called instruments of monetary policy or simply policy instruments. For example, the Central bank in an economy such as Reserve Bank of India may employ quantity-based *direct instruments* such as changes in Statutory Cash Reserve Requirement (CRR), changes in Statutory Liquidity Ratio (SLR) and Selective Credit Controls or instead employ price-based market-friendly *indirect instruments* like Open Market Operations, Bank Rate policy and Liquidity Adjustment Facility relying on Repo-Rate and Reverse-Repo Rate to achieve its policy targets.

Evidently, as these instruments of monetary policy may not have a direct bearing on policy targets such as removal of unemployment and poverty, therefore monetary authority typically chooses an “intermediate target” variable such as money stock, quantum of high-powered money H, disposable H *i.e.*, H adjusted for changes in CRR, interest rate etc., which is directly under its control but can be altered in such a manner that it is conducive to the attainment of its original *i.e.*, final target. Evidently, only that variable shall be chosen as an intermediate target of monetary policy which is under the direct control of monetary authority and is closely

correlated to the final target. Further, the intermediate target variable shall be accurately measurable and reliable data on it shall be available on regular basis with high periodicity.

Apart from operational convenience, the main advantage of choosing an intermediate target of monetary policy is that it shifts the attention of policy makers from politically contentious issues like unemployment and poverty to technical issues like high-powered money or adjusted high-powered money on which there are no political and ideological debates.

At any point of time, the whole set of policy targets, intermediate targets and policy instruments in an economy is referred to as a *policy regime*, *operating regime* or *operating procedure*. For example, ever since the adoption of economic and financial reforms in India, in line with market-orientation and liberalisation approach, the monetary authority in India has moved from 'direct' to 'indirect' instruments of monetary control which clearly signifies an underlying change in prevailing monetary policy regime or operating procedure in the Indian economy.