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The Function of Monetary Policy in Developing Countries

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Abstract

The Reserve Bank of India is the country's central bank, in charge of regulating banking and financial activity in the economy. It is responsible for developing and overseeing the monetary policy framework, including the use of suitable monetary instruments to fulfil the objectives outlined in the Reserve Bank of India Act, 1934 ("Act"). A monetary policy, as defined by the Act, is a policy aimed at maintaining price stability while promoting simultaneous growth in the Indian economy. This research article aims to gain a better knowledge of the monetary policy framework as it applies in India by researching the evolution of the objectives of monetary policy and its scheme, with a focus on the function of instruments.

Keywords: Reserve bank of India, RBI, monetary policy, monetary policy framework, instruments, covid-19

Introduction

In order to accomplish the goals outlined in the governing legislation, the central bank of a country will establish a monetary policy outlining the specifics of how to use monetary tools that are under its authority.

The Reserve Bank of India Act, 1934 ("RBI Act") emphasizes the need for a modern monetary policy framework in order to meet the problems and difficulties that arise in a developing economy like ours. The monetary policy framework has in fact changed over time as the Indian economy has grown in terms of finance and macroeconomic conditions. According to a statement, "in practise, the nature of the framework depends upon two crucial concerns. The degree of financial market and institution development comes first, followed by the economy's level of trade and capital flow openness. Like in the majority of other nations, India's monetary policy framework has changed as a result of and in response to financial changes and alterations in the fundamental transmission mechanism.

A) **Reserve Bank of India:** The Reserve Bank of India ("RBI") is the central bank in India and has the authority to formulate, carry out, and administer monetary policy. In accordance with Section 3 of the RBI Act, the RBI was created and incorporated on April 1, 1935, as a body corporate to administer the currency and conduct banking operations. Its duties include controlling the issuance of bank notes and preserving the nation's monetary stability. It runs the monetary and credit systems of the economy in the country's favour v The RBI's head office, which was formerly located in Kolkata, has been in Mumbai since 1937. Central office is meant to refer to the RBI Governor's office in this context. Notably, RBI used to be privately held. Only after the process of nationalization in 1949 is believed to have it come under the full control of the Government of India. Depending on how they are classified, RBI's functions fall under many headings. The RBI's responsibilities as a monetary authority include formulating, implementing, and monitoring monetary policy.

B) **Monetary Policy:** The policy of the central bank, that is, the RBI, with regard to the employment of monetary instruments under its control to achieve the aims stipulated in the RBI Act" is the definition given for monetary policy. A monetary policy's principal goal is to maintain price stability while also focusing on economic growth. Monetary Policy is the exclusive subject of Sections 45Z to 45ZO of Chapter IIIF of the RBI Act. The chapter has precedence over the other Act requirements thanks to Section 45Z. The details of the inflation target, the composition and eligibility requirements of the Monetary Policy, the operations of the Monetary Policy Committee, the Monetary Policy Report, and the authority of the central government to establish regulations regarding the operation, the appointment of members, and any other matter relating to the Monetary Policy and Monetary Policy Committee as may be prescribed are all laid out in Chapter IIIF.

Objective of Monetary Policy

As stated, maintaining price stability while simultaneously focusing on growth is the key goal of our monetary policy. Specifically, this goal has been added to the RBI Act through the Finance Act of 2016. In the early years of the RBI, monetary policy worked to ensure that the nation's reserves were expressed in terms of sterling and maintained sterling parity with the exchange rate. One of the numerous nations of the former British Empire to accomplish this was India. The

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bank rate, the cash reserve ratio (“CRR”), and open market operations (OMO) were used to control liquidity.
Since its independence, and in the 30 years that have followed, the RBI has operated according to 4,444 five-year plans formulated by the central government. After nationalizing the banks in 1969, the RBI focused on regulating credit to meet the country’s development needs. In 1982, the Sukhamoy Chakravarti Commission, chaired by Prof. Sukhamoy Chakravarti, was established to make recommendations for the evaluation and development of the Indian monetary system. He recommended the adoption of monetary control principles in monetary policy. It was then observed that financial demand was based on several factors.
With opportunity and nearly the liberalisation, privatisation and globalisation step, RBI transported on and selected diversified sign approach in April 1998, place in “quantity variables to a degree services, credit, amount, business, capital flows and monetary position in addition to from rate variables such as rates of return indifferent markets, swelling rate and rate of exchange were analysed for illustration finances procedure views.
Basis the 2014 document of RBI’s “Expert Committee to Revise and Strengthen the Monetary Policy Framework”, hooked up below the steering of Dr. Urjit R. Patel, bendy inflation concentrated on became followed for Monetary Policy. According to Section 45ZA of the RBI Act, inflation goal, in phrases of purchaser charge index, is decided via way of means of the crucial authorities in session with RBI, as soon as in each 5 years.12 On February 20, 2015, a Monetary Policy Framework Agreement became accomplished among the crucial authorities and RBI with objectives as cited with inside the amended preamble of the RBI Act. The bendy inflation concentrated on framework became officially applied alongside change to RBI Act in 2016, pursuant to this agreement.
The inflation goal became notified to be 4% with ± 2% tolerance band for the term of August 5, 2016 to March 31, 2021.13Further, it became notified that the inflation goal might also additionally stand ignored if “(a) the common inflation is extra than the higher tolerance stage of the inflation goal for any 3 consecutive quarters; or (b) the common inflation is much less than the decrease tolerance stage for any 3 consecutive quarters.

Review of Literature

D. Gupta and Srinivasan (1984) evaluated using a simple Inter-sector model, the effect of administered price Adjustments on sector and overall price movements. The study results clearly show that, without taking into Account their reciprocal relations, the effect of administered Market adjustments on relative and absolute prices cannot be measured. A partial equilibrium model cannot determine the success of administered price revisions as an Instrument for generating additional resource mobilization in the public sector, and the inflation potential of Administered price adjustments is significantly high and the Potential for generating additional savings is much lower than the nominal impact.
Paulson (1989) studies the effect of monetary policy on the Indian economy during the time leading up to the reform. The study shows that reserve money is the only significant Factor affecting the money supply in the economy. He Points out the positive connection between inflationary Pressures and controlled prices, and what is important, he The study results clearly show that, without taking into account their reciprocal relations, the effect of administered market adjustments on relative and absolute prices cannot be measured. A partial equilibrium model cannot determine the success of administered price revisions as an instrument for generating additional resource mobilization in the public sector, and the inflation potential of administered price adjustments is significantly high and the potential for generating additional savings is much lower than the nominal impact.
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Tara pore (1993) elaborated inflation on the poorer parts of Society as a levy. It is also argued that the need for monetary relaxation is advantageous to the poorest Segments of society. There could be nothing farther from the facts. Inflation mitigation is the strongest anti-poverty Initiative for me, and so a robust anti-inflationary monetary Policy is in line with public concerns. It also forecasts that, for the near future, the inevitable changes in the stock Market would entail the development of entirely new skills In the Reserve Bank, the commercial banks.
Ghosh (1994) commented on the interest rate Objection should not mean that all interest rates should be brought down abruptly and precipitously. Two steps are, rather, required. The first is a progressive decrease in the Structure of the interest rate. Secondly, and more significantly, the establishment of an institutional system that would make available adequate and timely credit to Small farmers, small industries, artisans, etc.
Sinha (1995) said that keeping the financial sector in good Shape is very urgent. This calls for the Regulatory Authorities-RBI, SEBI and the Central Government-to be Very careful. It is important to bring down the rate of monetary expansion dramatically. That is the real measure of central banking policy performance. Otherwise, inflation On the part of the government and the RBI would become higher, contrary to the complacency observed in this Regard.
Rangarajan (1996) commended on study conducted by the ASCI during a lecture on Certain Monetary Policy Problems. In fact, many writers conclude that inflation is Endemic in the course of economic growth and inflation is viewed more as a monetary phenomenon than as a systemic Imbalance, he noted. Due to the need to provide specific Guidance to monetary policy makers, the objective question has become relevant.
Partha Ray *et al*. (1998) explored new aspects of the Monetary transmission mechanism were launched in the Liberalization climate of the early 1990s and in the context of growing financial market integration. What inspired the Author was an exploration of the Chakrabarty committee Model in this modified milieu. The article aims to analyse the role of two main variables, namely interest rates and Exchange rates, in the conduct of monetary polic

Major Components of Monetary Policy

Instruments refers to the equipment that RBI manages and employs to meet its operational goals. Tools are typically divided into quantitative and qualitative categories, such as reserve ratios, OMOs, policy rates, and bank rates (like

margin requirements, consumer credit regulation, publicity and moral suasion).

Operating targets can be thought of as financial factors that RBI controls with the aid of various tools. The RBI's everyday operations are motivated by these factors. They have an impact on intermediate objectives and help the monetary policy achieve its ultimate objectives. The operating aim for the Monetary Policy is currently the weighted average call rate, in accordance with RBI policy.

When opposed to operational targets, intermediate targets are somewhat closer to monetary policy, although as their name implies, they are still only interim goals. Intermediate targets are impacted by monetary policy in the same way as operational targets are. Intermediate objectives include variables like short-and long-term interest rates as well as monetary aggregates.

The ultimate aims of the monetary policy are goals. They can include anything from price stability to economic expansion to exchange rate stability. These key monetary policy elements are crucial to the execution and eventual accomplishment of objectives.

It has been noted that the aforementioned framework was relevant in two distinct phases, first from 1985 to 1998 and then from 2016 onward. Between the two, from 1998 to 2016, or between the two, RBI had used a multiple indicator strategy for monetary policy.

Even though the overall objectives were the same for the phases of 1985-1998 and 2016-onwards, the multiple indicator technique lacked specificity because it used a wide range of variables.

Tools To Regulate Monetary Policy

Instruments are understood as the tools used in the proper execution of the Monetary Policy. Depending on their nature, the instruments are broadly qualified in two categories: Quantitative Instruments and qualitative instruments. Quantitative instruments or general instruments or traditional instruments directly focus on and regulate the volume or quantity of money in whole of the country's economy. Qualitative instruments or selective instruments are more persuasive in nature and usually have impact in a specified sector of the country's economy. While quantitative instruments affect the total volume of the money supply, qualitative instruments affect the direction of flow or movement of money.

A) Quantitative Instruments

1. **Cash Reserve Ratio:** Cash Reserve Ratio ("CRR") is defined as "the average daily Balance that a bank is required to maintain with the RBI as a share of such per cent of its Net Demand and Time Liabilities ("NDTL") that the RBI may notify from time to time in the Gazette of India"18. This amount is to be maintained by the scheduled banks (that is, the banks enumerated in Second Schedule of RBI Act) with the RBI as cash.
2. **Statutory Liquidity Ratio:** Statutory Liquidity Ratio ("SLR") is defined as "the share of NDTL that a bank is required to maintain in safe and liquid assets, such as, unencumbered government securities, cash and gold. Changes in SLR often influence the Availability of resources in the banking system for lending to the private sector".
3. **Open Market Operations:** OMOs refer to selling and purchasing of government Securities by the RBI in the open market for absorbing and injecting liquidity into the Market. RBI executes OMOs via commercial banks and do not involve the public directly.
4. **Bank Rate:** Bank Rate is "the rate at which the Reserve Bank is ready to buy or Rediscount bills of exchange or other commercial papers". This rate is made public by The RBI timely under the RBI Act21 and is determined in alignment with Marginal Standing Facility rate and changes in accordance with the same.
5. **Liquidity Adjustment Facility:** Liquidity Adjustment Facility ("LAF") is "a facility Extended by RBI to the scheduled commercial banks (excluding regional rural banks) and Primary dealers to avail of liquidity in case of requirement or park excess funds with RBI In case of excess liquidity on an overnight basis against the collateral of government Securities including state development loans". LAF helps RBI to manage liquidity on a Daily basis, and can be overnight or for a term.23 it was recommended by the Narasimham Committee Report on Banking Reforms in 1998. This facility covers repo rate and reverse Repo rate. Repo rate is "the (fixed) interest rate at which the RBI provides overnight liquidity to banks against the collateral of government and other approved securities under the LAF" whereas reverse repo rate is "the (fixed) interest rate at which the RBI absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF".
6. **Marginal Standing Facility:** Introduced in May, 2019, Marginal Standing Facility ("MSF") is "a facility under which scheduled commercial banks can borrow additional amount of overnight money from the RBI by dipping into their SLR portfolio up to a limit at a penal rate of interest". Due to its penal nature, MSF is higher than repo rate.

B) Qualitative Instruments

1. **Fixing Margin Requirements:** Margin is "proportion of the loan amount which is not financed by the bank", and marginal requirement is "the difference between the market value of the assets and its maximum loan value". if inflation is to be curbed, margin requirement is increased in a Monetary Policy, and if deflation is to be curbed margin requirement is decreased in a Monetary Policy.
2. **Consumer Credit Regulation:** Herein supply of credit to consumers is regulated depending on the case that is if the Monetary Policy is to curb inflation, supply of credit is reduced and if the Monetary Policy is to curb deflation, supply of credit is increased. This is done by way of changes in easy monthly instalments and down-payments among other things.
3. **Publicity:** RBI resorts to publicity as a tool to educate and influence the public and their Opinion by publishing and disseminating adequate relevant information for enabling them to make informed decisions. This can be done by way of various publications.
4. **Moral Suasion:** Moral suasion refers to the persuasion and pressure put by RBI on banks Inter alia by way of guidelines and directives, to ensure that monetary policy is executed properly. This pressure is sans any sanction or penalty.
5. **Direct Action:** At times, RBI takes action on the banks in case of deviant behaviour. It may impose penalties and curtail banking activities apart from taking actions in relation to credit borrowing of the banks.

The Process of Determining Monetary Policy

A) Establishing the Monetary Policy Committee: As previously mentioned, Chapter IIIF of the RBI Act covers monetary policy. The creation of the Monetary Policy Committee is provided for in Section 45ZB. It is in charge of figuring out the policy rate necessary to hit the inflation target. The Monetary Policy Committee's decisions must be followed by RBI. "The rate for repo transactions" is the policy rate. Monetary Policy Committee is mandated to meet a minimum of four times a year and RBI is mandated to publish the resolutions adopted by the committee, on conclusion of each of the Meetings.

B) Working of Monetary Policy Committee: Monetary Policy Committee is assisted by the Monetary Policy Department of RBI in drafting Of the Monetary Policy. Consideration is given to the views of the major stakeholders along With the analytical work of the RBI for determining policy repo rate. Monetary policy is operationalized by Financial Markets Operations Department by way of liquidity management Operations on daily basis. Alignment of the operating target of the weighted average call money Rate with repo rate is ensured by Financial Markets Committee in its daily meetings for review of liquidity conditions. It is observed that Monetary Policy Committee was constituted in 2016, replacing its Predecessor, the Technical Advisory Committee which was constituted in 2005. RBI was advised on Monetary Policy by Technical Advisory Committee before 2016, wherein the Committee was only an advisory committee.

C) Monetary Policy Report: A Monetary Policy Report is in the form of a document which is published by RBI bi-annually, wherein "(a) the sources of inflation; and (b) the forecasts of inflation for the period between Six to eighteen months from the date of publication of the document" are explained.

D) Failure in Maintenance of Inflation Target: In case of failure to maintain the inflation target, RBI is mandated to report to the central Government the following:

a) The reasons for failure to achieve the inflation target
b) Remedial actions proposed to be Taken by the Bank;
c) An estimate of the time-period within which the inflation target shall be achieved pursuant to timely implementation of proposed remedial actions."

E) Monetary Policy Transmission: The policy rate is determined basis the developing macroeconomic situation, and liquidity is accordingly adjusted to tie money market rates on or around the repo rate. The changes in repo rate reach the entire financial system by way of money market, subsequently impacting aggregate demand which is a major determining factor in growth and inflation. This process of transmission of the impact of Monetary Policy on the whole of the economy is called Monetary Policy Transmission.

After the announcement of repo rate, the operating framework works towards daily liquidity management so as to tie the operating target of weighted average call rate as per the repo rate. Though continual updates are made to the operating framework basis development in financial market and monetary conditions, it is ensured that the essence of Monetary Policy is maintained.

Transmission of Monetary Policy may take place by way of five channels, namely, asset price channel, exchange rate channel, expectations channel, credit channel and interest rate channel. Monetary Policy in India majorly uses the interest rate channel.

Two factors play important role in execution of Monetary Policy-"first is how far the signals sent out by the central bank are picked up by the commercial banks (also known as 'inner leg') and the second is how far the signals sent out by the banking system influence the real sector (also known as 'outer leg')". Speed and degree of change in both subsequently impact the efficiency of the Monetary Policy.

Conclusion

Monetary Policy, as a idea has developed with the an increasing number of complicated financial system of ours. For the latest development, it's been nearly 4 and a ½ of years due to the fact that bendy inflation focused on framework turned into officially applied at the side of modification to RBI Act in 2016, pursuant to Monetary Policy Framework Agreement and the inflation goal turned into notified to be4% with ± 2% tolerance band for the term of August 5, 2016 to March 31, 2021.39Further, provision for Monetary Policy Committee turned into made with inside the RBI Act, which replaced the Technical Advisory Committee.

It is to be referred to that Monetary Policy Committee so added in 2016 has proved to be more stringent in assessment to its contemporaries. The world over similar balloting process of Monetary Policy Committee displays the holistic technique with inside the assessment of the members. Forty one Transparency and duty is given choice with the aid of using manner of guide of resolutions followed with the aid of using the committee42 and that of the court cases of every of the meetings.43Basis the look at it could be inferred that even as RBI has genuinely come an extended manner in addressing the dreams of rate balance and simultaneous attention for growth, there nevertheless stay certain problems which may be attributed to the following:

1. Though inner leg of monetary transmission is comparatively faster than outer leg, however, it in itself is not quick enough as unlike US, RBI is not the primary source of Supply of money in Indian economy.
2. Small saving instruments usually provide for higher rates of interest, and in case of Slashing of rate of interest on bank deposits, customers move to them.
3. There is substantial lack of financial inclusion due to number of factors, due to which Borrowers tend to seek private moneylenders instead of banks.
4. Workings of Monetary Policy and that of the fiscal policy is not coherent, subsequently affecting the efficiency of either.
5. Profitability of banks has been affected by high non-performing assets, because of which they keep the weighted average lending rate at a higher value in comparison of the marginal lending rate.
6. Economy is still not monetized in some of the rural areas, wherein barter system Prevails over banking solutions.

Given the above, it is only imperative that a multi-dimensional approach comprising fiscal, Monetary and other policy measures is adopted in these unprecedented times, to protect our Economy and its growth. As highlighted in all Monetary Policy Statements published March 2020 onwards, it only the coordination between monetary and fiscal

measures, with support of other policy measures that can significantly shield the economy in these testing times.

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