

Managing Inflation Through Monetary Policy

Monetary policy is the process by which the government with help of the central bank controls:

- (i) the supply of money (Adding money into the economy)
- (ii) availability of money (Taking some money out of circulation)
- (iii) cost of money or rate of interest (Cost of credit)

These steps are taken to induce growth of the economy in a stable manner. When the economy grows in an unbridled manner, it causes an increase in the rate of inflation. Hence this growth has to be managed in such a way that inflationary forces are contained while the economy grows.

Monetary policy is generally referred to as either being an **expansionary** policy or a **contractionary** policy.

An expansionary policy increases the total supply of money in the economy while a contractionary policy decreases the total money supply in the economy.

Expansionary policy is traditionally used to combat a recession by lowering interest rates. Lowered interest rates means lower cost of credit which induces people to borrow and spend thereby providing steam to various industries and kick starting a slowing economy. An expansionary policy is also known as “accommodative” as it helps to spur growth of the economy.

On the other hands a contractionary policy results in increasing interest rates to combat inflation (or cool an otherwise overheated economy). An economy growing in an uninhibited manner leads to inflation which is referred to as an overheated economy. Hence increasing interest rates increases the cost of credit thereby making people borrow less. Due to lesser borrowing the amount of money

in the system reduces which in turn brings down inflation and slows or cools the economy. A contractionary policy is also known as a tight policy as it tightens the flow of money to contain inflationary forces.

Otherwise the monetary policy is neutral which neither aids growth nor slows it down.

It should be noted that be monetary policy should always be aligned to the fiscal policy of the government. (Fiscal policy is the government's borrowing, spending and taxation plans)

Monetary policy rests on the relationship between the interest rates 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.

There are several monetary policy tools available to achieve these ends.

1. Increasing interest rates (repo rates, reverse repo rates, etc).
2. Reducing liquidity by sucking out excess money from the system.
3. Increasing reserve (CRR) requirements.

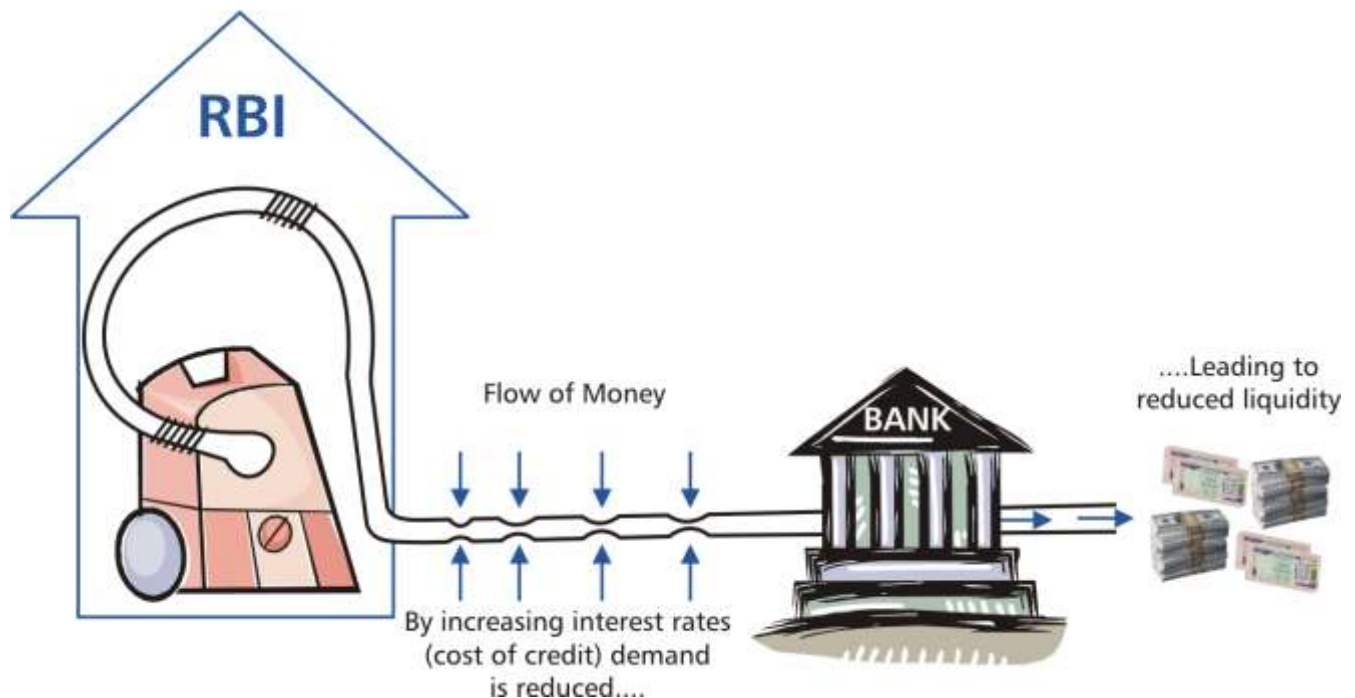
All of the above tools have the effect of contracting the money supply and if reversed, they help in expanding the money supply.

The monetary policy is set by special institutions called central banks (such as the Bank of England, the European Central Bank, the Federal Reserve System in the United States, the Bank of Japan or Nippon Ginko, the Bank of Canada, RBI etc.)

How does the monetary policy function?

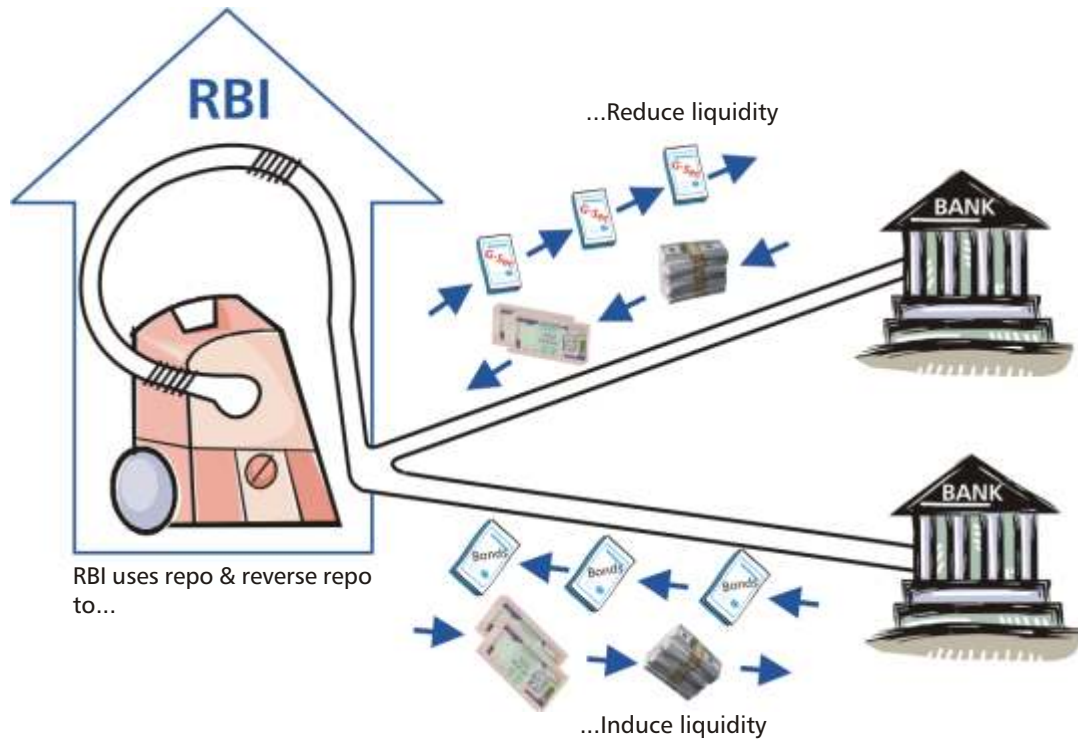
The primary tool of the monetary policy entails managing the quantity of money in circulation through the buying and selling of various credit instruments, foreign currencies or commodities. All of these purchases or sales result in the increase or decrease of the base currency entering or leaving market circulation. The tools that are used by the RBI are as follows:

Increase / decrease in lending rates: From time to time, the RBI makes an adjustment in its lending rate (repo rate) in order to influence the cost of credit. By doing so it makes borrowing expensive, thereby discouraging borrowing. This brings about a reduction in the money in the system and helps lower the inflation rate. However a reduction in borrowing also slows down the economic growth and hence this method needs to be deployed after analyzing and understanding the impact of such a step on the economic growth. Due to this, the central banks resort to other methods as a means to the same end of lowering inflation.

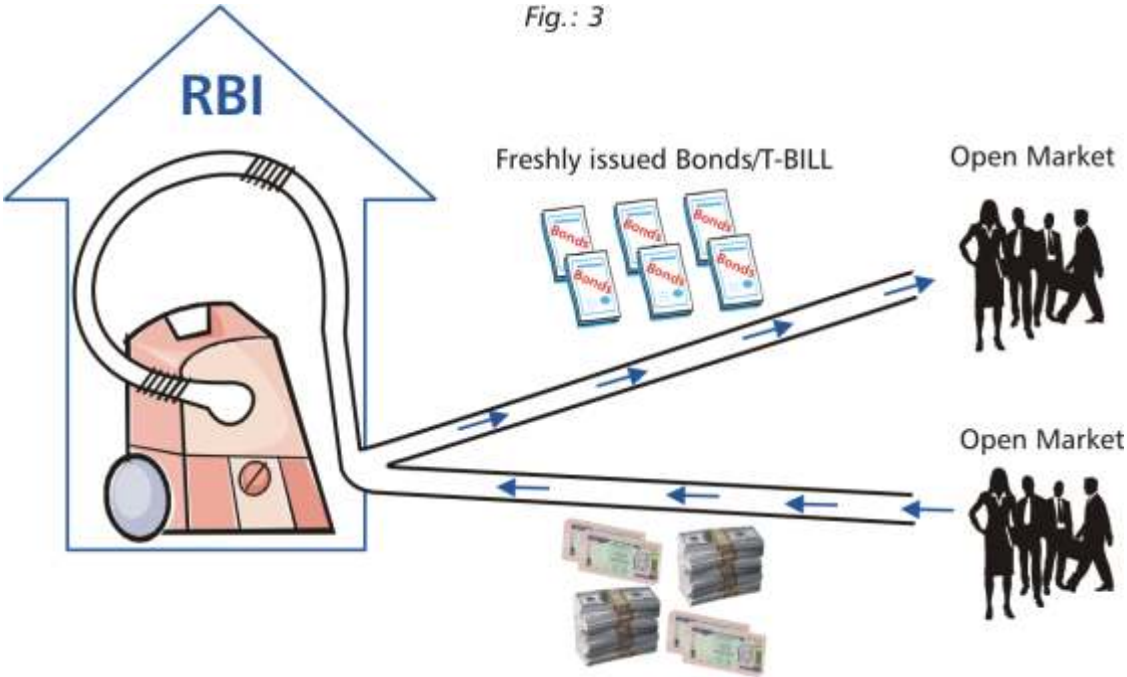


LAF or Liquidity Adjustment Facility: It helps to inject and sterilize liquidity from the economy. Under this, the RBI conducts daily auction of repos and reverse repos to manage liquidity in the system. (Repo is the activity through which banks borrow money from RBI while reverse- repo is the activity through which the RBI absorbs excess money from the system).

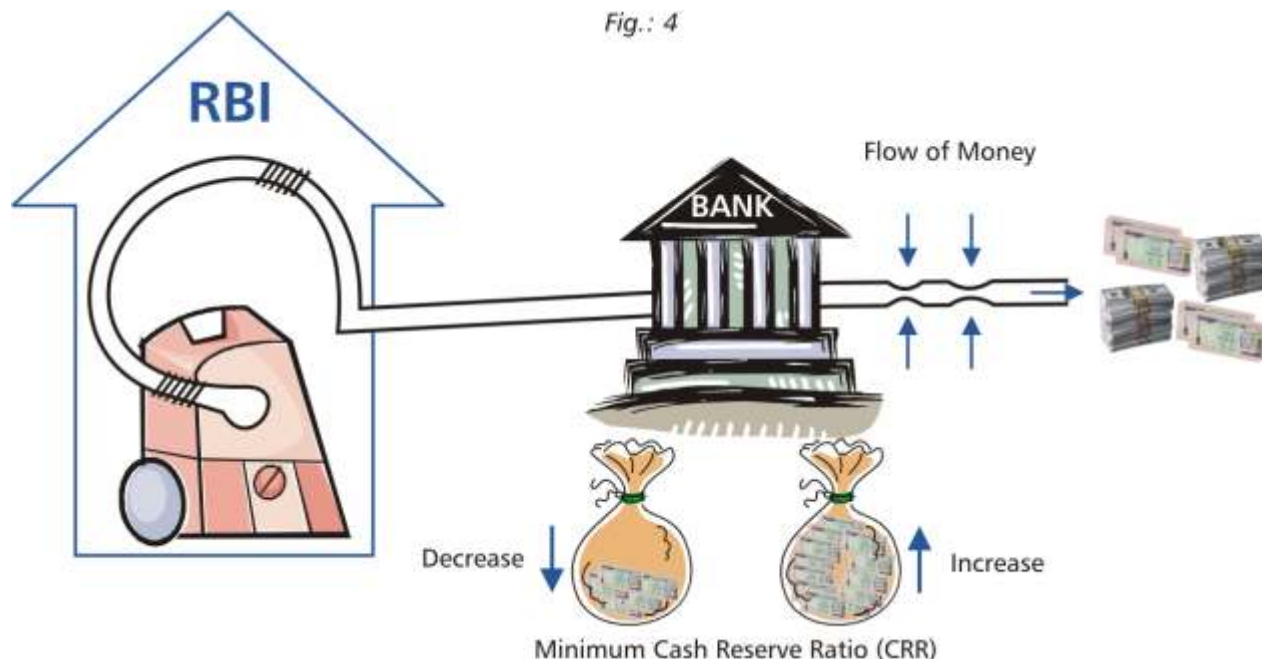
In other words, if the RBI wants to reduce money supply, it will absorb money against security of government securities. On the other hand if RBI wants to inject money into the system it would do so in exchange for bonds that is available in the banking system.



MSS or Market Stabilization Scheme: Whenever liquidity in the system increases, the RBI intervenes to stabilize the system. The central bank does this by issuing fresh Bonds and Treasury Bills in the open market. By injecting the bonds and sucking out the excess money, the RBI contains the inflationary forces and cools the economy. This tool was used extensively at the time when dollar inflows into our economy were very high, resulting in rupee appreciation. In order to stabilize the exchange rates, the RBI first bought additional dollars thereby stabilizing the rate of exchange. The excess rupees for the dollar purchases was subsequently sterilized through MSS. The MSS is generally a short term action and is independent of the government's borrowing program.



CRR: Cash reserve ratio is the statutory requirements levied by RBI, for banks to set aside cash with the RBI. The reserve requirement is a bank regulation that sets the minimum cash reserves each bank must hold in order to meet withdrawal demands. It is defined as the percentage of total deposits that the bank holds as cash. The reserve ratio is sometimes used as a tool to contain inflation. By increasing the CRR, the RBI decreases the lending capacity of the bank to the extent of the increase in the ratio. Thus when the CRR was raised from 7.5% to 8.25% the banks were deprived of lending to the extent of 75 basis points of their deposit value.



The People's Bank of China too uses change in reserve requirements as an inflation-fighting tool and has raised the reserve requirement nine times in 2007 alone.

However, there are several western countries that do not deploy this tool for inflation containment. Cash reserve ratio in several countries across the world are depicted in the table as under:

Cash reserve ratio in various countries

Country	Required Reserve Ratio (%)
Australia	None
Canada	None
Mexico	None
New Zealand	None
Sweden	None
United Kingdom	None

Country	Required Reserve Ratio (%)
Eurozone	2.00
Slovakia	2.00
Switzerland	2.50
Chile	4.50
Pakistan	7.00
India	8.25
Latvia	8.00
Burundi	8.50
Hungary	8.75
Ghana	9.00
United States	10.00
Sri Lanka	10.00
Bulgaria	12.00
China	16.50
Estonia	15.00
Zambia	17.50
Croatia	19.00
Tajikistan	20.00
Suriname	35.00
Jordan	80.00