Monetary Policy

The term 'Monetary Policy' can be defined in a broader sense, as well as in a narrower sense. In a broader sense it refers to the measures taken by the monetary authorities with a view to producing a deliberate impact on the nature and volume of money so as to achieve the objectives of general economic policy. It aims at regulating the flow of currency, credit and other monetary substitutes in an economy with a view to affect the total stock of such assets as well as to influence the demand of the community for such assets. In other words, *the monetary policy is used as an instrument to achieve certain economic aims outside the monetary system.* In this sense, the monetary policy does not constitute an end in itself, but rather a means to an end.

In a narrower sense, monetary policy refers to steps taken by the government and the banking authorities to manage the money and credit supplies including the steps taken from time to time to control and regulate the interest rates. Non-monetary measures having a bearing on the monetary situation may not find a direct place in a monetary policy defined in a narrow sense.

The monetary policy of the country is formulated by the government of the country and is carried out through the agency of the Central bank of the country. In formulating the monetary policy, the government will be in constant touch with the central banking authorities and most of the decisions will be taken with the consent of the Central bank of the country. Monetary policy, taken alone, may not be effective in controlling an inflationary or deflationary situation and hence the monetary policy has to be implemented in conjunction with fiscal and debt management.

While formulating monetary policy, the government may have one or more objectives and it may also be possible that there will be clash of objectives while implementing them. In those cases, the monetary authorities have to take firm decisions on the basis of priorities, depending on the economic situation of the country.

OBJECTIVES OF MONETARY POLICY

Though monetary objectives vary from country to country, broadly speaking, there can be five objectives of monetary policy. They are: (1) Neutrality of money; (2) Price stabilisation; (3) Exchange stabilisation; (4) Full employment; and (5) Economic growth. Let us discuss these objectives :

1. Neutrality of Money

This objective of monetary policy was first suggested by Wicksteed and later on supported by Hayek and Robertson. According to these economists, the monetary authorities should aim at neutrality of money in relation to the economy. According to them, the root cause of all economic fluctuations is the changes in money supply and these monetary changes cause trade cycle, fluctuations and disturbances in the economy. The change in the supply of money causes change in prices, output and employment and according to the advocates of neutralist doctrine, money is the real villain of the piece of economic disturbances and if money supply is kept constant and neutral, the functioning of the economy will be smooth. Money, according to them should strictly remain neutral and should not cause any changes in prices

or other economic entities. It is not expected to encourage or discourage production or consumption in the economy and the money should take a neutral role to play in the functioning of the economy.

We know that this concept is wrong. How can money remain neutral ? Firstly, the supply of money in an economy cannot be maintained at a constant level. It has to be changed from time to time. Depending on the other factors in the economy, the velocity of circulation will change and the same quantity of money with different velocity will have different effects in the economy. The neutralists are of the view that the supply of money should have to be changed in such a way that its supply remains constant ; otherwise, money would cease to play the neutral role expected of it.

The neutrality of money is based on wrong assumptions, placing implicit faith in the Quantity Theory of money which is itself unsatifactory. Secondly, it is very difficult to make adjustments in the money supply so as to make it constant, as desired by the neutralists. We do not have any instruments to measure the hoarding of money by the people or the velocity of circulation of money. Hence, it is impossible to maintain the supply of money at constant level. Thirdly, even if the money supply is kept constant, there is no guarantee that the prices will remain stable. A change in technology will reduce the cost of production and this will create a wave of price fluctuations. Fourthly, this concept is self-contradictory. Based on the principle of *Laissez-faire* and non-intervention by the State, the neutralists want a neutral role of money; and at the same time they want the government to control the money supply by making frequent adjustments. This role conflicts with the philosophy of *Laissez-faire*. Fifthly, this concept of neutrality of money fails to explain why prices fall during the depressionary period even though the supply of money is kept constant. Further, during the depressionary period, the prices do not rise even if the supply of money is expanded; this evidently shows the ineffectiveness of neutrality of money.

The policy of neutral money is unrealistic and also impractical. It is altogether impossible to keep the money supply constant. The dynamic changes in the economy warrant frequent changes in the monetary system. Though this policy was advocated in the early 20th century, now, this has become very obsolete concept, not worth to be considered as an objective.

2. Price Stabilisation

The havoc caused during the period of 'Great Depression' made the economists and administrators realise the importance of price stability in the economy to be embodied as the primary objective of monetary policy. The countries of the world were worst hit during the 'Great Depression' of the 'thirties' with prices falling to the rockbottom level and the attendant evils in the economy. Similarly, the countries had equally experienced the unpleasant adverse effects due to soaring prices at the time of world wars. A rising price level creates problems and hardships to the fixed income group. A declining price level creates complicated problems of production and distribution. Another danger in price instability is its cumulative effect. When once the instability starts, it will gather momentum, threatening in course of time the entire economic order as well as political stability. World economic history gives ample proof to show that periods of fluctuating prices have been the periods of political and economic upheavals.

Keynes advocated price stability as the major goal of monetary policy. Price stability received official recognition during the Depression and it was embodied in the 'New Deal' programme of U. S. A. during the regime of F. D. Roosevelt.

Economists criticise price stability, as a monetary policy, on the following grounds : (a) Internal price changes not only due to monetary causes, but also due to non-monetary causes and hence it cannot be treated exclusively as a goal of monetary policy. (b) If prices are kept stable for a long time, it will not give proper incentive to investment and ultimately this will lead to economic stagnation. (c) Hayak criticises the objective of price stability as ignoring the real requirements of dynamic society. According to

him, the adoption of monetary policy in U. S. had worsened the position and the depression lasted longer. He felt that monetary authorities interfere in economic activity with their instruments either much earlier or much later than it is necessary. (*d*) Further, it is criticised that the objective of the monetary policy should be stabilisation of the prices of factors of production and not prices of commodities. In fact, changes in prices in different sectors of the economy in response to changes in supply and demand will be helpful in correcting maladjustments in the economy; and (*e*) Price stability as a monetary objective is suitable for those countries which are agricultural and large in size and in which foreign trade plays an insignificant role. In other countries, stability of prices does not necessarily lead to stability of business conditions.

3. Exchange stabilisation

Stability of foreign exchange rate is considered to be one of the oldest and traditional objectives of monetary policy. The government of every country is faced with the problem of fluctuating foreign exchange rates. It is a question of choosing between a stable domestic price level and a stable foreign exchange rate. For countries depending mainly on foreign trade, the importance of a stable exchange rate need not be stressed. Changes in the rate of exchange will lead to a number of difficulties. They gave rise to speculative activities in foreign exchange market. This will hinder the inflow of foreign capital and drain the domestic resources and foreign exchange accumulations.

A stable exchange rate is imperative in ensuring successful functioning of international trade, stimulating favourable investment and also of the operation of Gold Standard. The greatest defect of this policy is that prices and employment would fluctuate widely with the movements of gold in and out of the country. Under the Gold Standard, exchange stability was attained at a heavy price of unstable domestic prices and the severe price instability had led many countries to break the 'rules of the gold standard.' With the fall of the Gold Standard, the stability

of exchange rate is not considered to be a very important monetary objective. Rather, maintenance of domestic prices stability is given priority. With the establishment of the *International Monetary Fund*, the importance of this objective is not considered much.

4. Full Employment

With the publication of Keynes 'General Theory', full employment has been advocated as the important goal of monetary policy. Keynes himself has said: "the object of monetary policy should be to reduce the ebb and flow of the trade cycles and bring about equilibrium between savings and investments at the point of full employment."

In the pre-Keynesian days, the monetary policy tried to cure the depression by making more funds available at the low rates of interest. But the inadequacy of such a policy was demonstrated during the period of Great Depression when the desire for liquidity made it impossible to increase funds for investment. Further, Keynes analysis brought to light the need for utilising the available resources to full employment level. He pointed out that the monetary policy should be aimed at solving the unemployment problem by expanding consumption and investment expenditure. Since consumption function is more or less stable during the short period, the monetary policy should stimulate investment expenditure. In order to increase the volume of investment, cheap money policy should be followed to stimulate borrowing and increase the level of employment through multiplier-acceleration effect. When once the level of full employment is reached, then the monetary policy should aim at maintaining the full employment level through equality between savings and investments.

Though the concept of full employment has attained full recognition to be the objective of monetary policy, it is somewhat vague. It would be better if we use the term 'Optimum employment' instead of 'full employment'. The former denotes the level of utilisation of economic resources which leads to the highest national income.

5. Economic Growth

The concept of ' Economic Growth ' as the objective of monetary policy is the outcome of modern welfare aims practised by Socialistic States. It is a step forward in establishing welfare ideals in the economy. It has been recognised by modern welfare states that achieving full employment level is not enough, but the standard of living of the people should go up by making the economy grow up at an accelerated pace.

Economic Growth implies qualitative and quantitative increase in the volume of goods and services produced in the economy. It signifies the sustained increase in the per capita real income of the people. For this two things are essential : (*a*) that the economy's productive capacity should increase; and (*b*) there should be a corresponding increase in demand for goods and services whose supply has increased. If the productive capacity is larger and the demand lesser, there will be idle plant capacity resulting in unemployment. On the other hand, if the demand is in excess of productive capacity of the nation, prices will rise and ultimately the economy has to face inflationary spiral. So, the monetary policy should aim at maintaining equilibrium between total money demand and total productive capacity.

' Growth with stablity ' has become the new objective of developing economies. The monetary policy is aimed at regulating the money supply on one side and encourage productive activities on the other side with care to see that speculative activities are curbed.

RECONCILIATION OF CONFLICTING OBJECTIVES

The objectives of monetary policy discussed may be inconsistent with each other. In practical implementations, they may be even conflicting. For example, after the war, many sectors would face post-war recession. Employment and income would start declining. At the same time, the prices of consumer goods continue to rise for several months after the war period. In such a situation the objectives would become conflicting. Rising

prices would warrant a policy of tight money to stablise the price level; but the declining employment and the business activity would warrant easy money condition. In such contexts, the monetary authorities had to make choices. The choice should be in the best interest of the country as a whole depending on the circumstances.

LIMITATIONS OF MONETARY POLICY

Before the Great Depression of thirties, the monetary policy occupied a position of prestige and the countries used to place excessive reliance on it to achieve economic stability. But with the advent of the Great Depression, governments began to realise that the economies could not be recovered from depressionary conditions merely by adopting the elementary principles of credit control and supply of money as envisaged in the monetary policy. Under the influence of Keynes, the monetary policy lost its reputation and fiscal policy came into prominance. Keynes stated that the monetary policy could be expected to play only a limited role. Keynes wanted that the State should have to exercise a guiding influence on the propensity to consume through its scheme of taxation.

Why is monetary policy ineffective in generating recovery from Depression ?

To fight depression, everyone would suggest *cheap money policy* in the belief that such a policy would promote new investments in the economy. It is on this ground a low rate of interest was advocated during the depressionary period. But in actual practice, the cheap money policy with low rates of interest fail to push up investments in the economy, the reason being that during depression, investments generally becomes *interest-inelastic*, i.e., a low rate of interest fails to promote new investments in the economy. Why is this so ? Interest is an insignificant element in the production cost. During depression, new investments are influenced more by future business prospects rather than the rate of interest. Hence, cheap money policy and

monetary expansion with low rate of interest may not be able to lift the economy out of depression. Further, there are certain non-monetary factors which play an important role in bringing about depression in the economy. The monetary policy could do little to effectively check those non-monetary forces. On the contrary, fiscal policy might prove more effective in combating non-monetary factors in the depressionary period. For example, effective demand can be raised during depression only by increased consumption expenditure. This can be influenced more by fiscal policy rather than monetary policy. It is on these grounds that monetary policy often proves ineffective during times of depression and unemployment. It is only the fiscal policy which would prove effective during depression and unemployment.

But, monetary policy is decidedly superior in checking inflationary pressures. But there are certain limitations. (*a*) While adopting anti-inflationary measures and reduction of money supply and credit to combat inflation, the operation might be inadvertently carried too far so as to give birth to deflationary forces in the economy. In that case the economic growth will receive a set back. Further, during an inflationary period, the adoption of policy of *dear money* by the monetary authorities will not be relished by bankers, businessmen and producers. (*b*) Banks may subvert monetary policy by finding new reserves through deposit mobilisation. (*c*) An excessive time-lag between the application of monetary measures and their actual effects may make the monetary policy ineffective. (*d*) There may be some political opposition to high interest rates and restrictive monetary policy. (*e*) Monetary policy will be blunt if prices and wages are flexible upwards but inflexible downwards. A tight money policy may create unemployment, instead of restraining the rise in prices.