

What is Monetary Policy

- >> Monetary policy refers to the programs of the central bank's variation in total supply of money and cost of money in order to achieve certain predetermined objectives. One of the primary objectives of monetary policy is to achieve economic stability. The conventional instruments through which central bank carries out monetary policies are: *open market operation, changes in bank rate (or discount rate), changes in variable reserve ration*. Briefly speaking open market operation by the central bank is the sale and purchase of government bonds, treasury bills, securities etc. to and from the public. Bank rate is the rate at which central bank discounts the commercial banks' bills of exchange. The variable bill ratio is the proportion of commercial banks' time and demand deposits which they are required to deposit with the central bank or keep cash in vault.

Functions of Monetary Policy

- >> The major functions of monetary policy are as follows:
 - To ensure the banking sector's optimum growth
 - To control (increase/decrease) economy's aggregate demand
 - To prevent inflation from heating up
 - To ensure consistency of business cycle by influencing money supply
 - To ensure a stable interest rate in domestic banking system

Monetary Policy for a Developing Economy

- >> In a developing economy, monetary policy has a vital role to play. A developing economy has to make a very large-scale mobilization of productive resources of all types and has to organize their most efficient allocation. The task of implementing the development plans of sizable dimensions is a big task and an all-out effort is required on the part of all authorities to ensure their successful implementation. The monetary authorities [central bank] have to play their full part.
- One important requirement for steady economic growth is the environment or atmosphere of comparative price stability and absence of inflation. For a steady and sound economic progress, for optimum utilization of domestic resources, for avoidance of distortion and dislocation of investment program, for the promotion of objective of greater economic equalities or lessening inequalities of income and wealth; it is essential that there should prevail an atmosphere of general financial stability including price and exchange stability. And in this context, monetary policy plays the most vital part to create stability in the domestic economy. By applying all the instruments of this policy such as *open market operation, changes in bank rate (or discount rate), changes in variable reserve ration*; the economy can be stabilized in a

smooth manner. Therefore, all the instruments of monetary policy will have to be used in combination with each other to ensure the requisite atmosphere for the successful implementation of development plans and thus to promote steady and optimum growth of the economy.

Role of Monetary Policy for Stabilizing Economy

With a view to stabilizing the economy, there are two types of monetary policies: 1) expansionary monetary policy; 2) contractionary monetary policy. In the following part we are going to briefly discuss both these types.

Expansionary monetary policy is used to eliminate recessionary GDP gap. When the economy is operating at an equilibrium level of real GDP that falls short of potential real GDP, a recessionary GDP gap will be

