

**Economic Environment and Business Strategy**  
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**Week- 05**  
**Lecture- 21**

**Monetary Policy: Objectives and Instruments**

Hi everyone, welcome to this session. Today, we focus on one of the most important aspects of macroeconomic management: monetary policy. For firms and businesses operating in a dynamic economic environment, understanding how central banks influence the money supply, interest rates, and credit conditions is essential. These monetary decisions influence borrowing costs, investment confidence, consumer demand, and even exchange rates. All of which directly impacts business strategy and decision-making. In this session, we will begin by unpacking the concept of the money supply and what constitutes high-powered money, also known as the monetary base.

Next, we will examine the objectives of monetary policy, including maintaining price stability, promoting economic growth, and fostering employment. Our focus will be on the tools of monetary policy. There, we will examine three common instruments used by central banks. It includes open market operations, reserve requirements, and discount policies.

We'll also briefly touch upon the unconventional monetary policy tools that have gained momentum, especially during economic crises, such as quantitative easing and forward guidance. Together, this lecture will equip you with a clearer understanding of how monetary policy influences the broader economic environment in which businesses make strategic decisions, whether they involve investment, pricing, financing, or market expansion. Let's start by examining the foundation, beginning with the concepts of money supply and the monetary base. Before that, I will discuss fiscal policy. In this lecture, our primary focus is on monetary policy, a topic that will also be covered in future lectures.

After completing this discussion, we will proceed to a discussion of fiscal policy. As I mentioned earlier, let me start with the basic aspects of the money supply concept. First, let's define what is meant by money supply. The money supply is a key determinant of interest rates, inflation, and overall economic activity. The formal definition of the money supply is that it is the total stock of money in circulation in an economy at a given time.

Although we say supply is not a flow concept, it is actually the total stock of money in circulation in an economy at a given time. The Reserve Bank of India uses various

definitions for monetary and liquidity aggregates. This is called M1 money. M1 money refers to currency in circulation, plus demand deposits and other deposits held by the public with the RBI. What does it mean? Currency refers to money that is in circulation among the public.

Demand deposits refer to savings bank accounts and current accounts. That means demand can be withdrawn at any time. The examples are found in savings bank accounts, current accounts, and other deposits with the RBI, primarily held by the Prime Minister, former Prime Ministers, and other notable individuals. Additionally, we have M2 money. M2 money refers to M1 plus time deposits with a maturity of less than one year.

What is a time deposit? A time deposit refers to a fixed deposit that you typically place your money in at a bank for a specified period. Time deposits and recurrent bank deposits are considered. If the maturity period is less than a year, then we add this to the M1 to calculate M2 money. M3 money includes M2 plus time deposits with a maturity of one year or more. You might wonder why demand deposits are included.

The reason is that when defining the money supply, it's not only the money held by the public. Demand deposits, such as savings bank accounts, can be withdrawn at any time, which makes them part of the money supply. You can make online transactions with that money, and you can withdraw it at any time. That's almost equivalent to having money on you. That is why the money you deposit in your savings bank account and current account is part of the money supply.

Similarly, with time deposits these days, for example, you make a deposit with the bank for one year, and if you want to withdraw it tomorrow or the day after, you can do so, but at a penalty interest rate. The key characteristic here is that time deposits can also be withdrawn at any time. That is also almost equal to money. That is why we include both time deposits with maturities of less than one year and those with maturities of one year or more as part of the money supply. In short, according to the definition of the money supply, we include not only the money held by the public but also bank deposits.

The reason is that these deposits can be withdrawn at any time or used just like money. It serves the equivalent of having money on you. In India, we refer to this as M3, the broadest measure of the money supply, and it is the concept that the RBI uses to gauge the country's money supply. I'm sharing some screenshots of the money supply definitions. This is for the US, and it's very similar to the Indian one, with only slight variations.

There's also a section here that details the money supply definitions used by the RBI in India, formatted in a table. Additionally, there's information about the money supply in Canada. All the details are provided in the table below. Please go through this and

understand how the money supply is measured in India. Let's now move on to another related concept, known as the monetary base.

It is also referred to as high-powered money. The monetary base refers to the currency in circulation plus reserves. Currency in circulation refers to currency held by the general public, which constitutes the monetary base. Reserve means bankers' deposits with the RBI (Reserve Bank of India) plus cash on hand. I have provided a clear definition; further details about this concept include bankers' reserves.

Required reserves plus excess reserves. Required reserve means that, especially for commercial banks in India, they must keep a certain fraction of their total deposits with the Reserve Bank of India, which is approximately 4.5% plus an excess reserve. If there is excess money in their central bank account, it is treated as excess reserves. The cash held physically by banks in their vaults to meet deposit withdrawal demands is referred to as the monetary base or high-powered money.

Using this monetary base, the central bank of any country controls the money supply in its respective country. Let us now move to another important aspect of the monetary policy's goals. Before that, we knew who the monetary policy authority was. Normally, central banks are the monetary policy authorities in each country. Central banks play a crucial role in ensuring economic and financial stability, so they conduct monetary policy to achieve low and stable inflation along with high economic growth.

This makes them the apex monetary authority, often referred to as the bankers' bank or the central bank, and they serve as the lender of last resort for the country's banking system. For commercial banks and other banks, if they fall short of sufficient funds to operate, the central bank will act as a lender of last resort. Before proceeding, let us briefly discuss the Reserve Bank of India, the country's monetary authority. It formulates, implements, and monitors the country's monetary policy. Its main goal is to maintain stable prices and ensure that sufficient credit flows to productive sectors.

The Reserve Bank of India is not only a regulator but also a supervisor of the financial system, especially the banking sector. Its main objective is to maintain public confidence in the system, protect depositors' interests, and provide cost-effective banking services to the public. Now turning to the key goals of monetary policy, one of the main objectives is to achieve price stability. The price stability goal is the main objective of monetary policy, which is to maintain stable prices. Over the past few decades, policymakers worldwide have become increasingly aware of the social and economic costs of inflation and have become more focused on maintaining a stable price level as the primary goal of economic policy.

So, here they use a mechanism to achieve price stability. They rely on a nominal variable, such as inflation targeting or the money supply—also known as a monetary

aggregate—as their primary approach. This method links the price level to help achieve price stability. Apart from the goal of price stability, other key objectives of monetary policy include promoting stable economic growth, maintaining high employment and output stability, ensuring the stability of financial markets, and keeping interest rates stable within the country. Furthermore, another important goal is to ensure stability in the foreign exchange markets.

Especially regarding the exchange rate for their domestic currency, two key concepts have been widely discussed in relation to the goals of monetary policy. One is referred to as the hierarchical mandate, and the other is known as the dual mandate. Clearly, all these objectives, especially the inflation one, focus on inflation and price stability. The second one is economic growth; these are the two key objectives. What happens here is that both objectives typically don't align.

For example, if the economy is in recession and we want to revive economic growth, the commonly suggested remedy is to reduce the interest rate. When our monetary policy aims to reduce the interest rate, the goal is to increase the money supply in the economy. As it does this, the money supply grows and the interest rate declines. Conversely, to lower the interest rate, it will supply more money. When interest rates are low, it indicates a higher money supply, which can help revive economic growth.

But at the same time, you know that if there is more money supply, it will lead to inflation. Therefore, if they want to focus on economic growth, inflation is likely to result. To reduce inflation, they need to decrease the money supply. Reducing the money supply would likely increase interest rates, which could have an adverse impact on economic growth. In this case, they must decide whether to prioritize low inflation or high economic growth.

A hierarchical mandate means that between inflation and economic growth, they need to prioritize one. Usually, they focus on inflation at times and prefer economic growth at other times. This is what is called a hierarchical mandate. Therefore, monetary authorities will announce whether they prioritize inflation control or economic growth. The other is called dual mandates.

The dual mandate is to give almost equal weight to both, meaning that long-term interest rates will be very high if inflation is high. This statement, in practice, is a dual mandate to achieve two coequal objectives: price stability and maximum employment. Maximum employment means high economic growth because high economic growth ensures maximum employment. To achieve these goals, central banks employ a range of policy instruments, which we refer to as monetary policy instruments. To better understand how these tools are used and how monetary policy is implemented, it's important to recognize

the link between central bank tools, policy instruments, intermediate targets, and the goals of monetary policy.

These tools include open market operations, discount policy, and reserve requirements, which are the three main categories. Conventional tools of monetary policy, which have been widely used globally, are complemented by specific goals. These are the goals we have already discussed. To achieve these goals, we will explore some policy instruments in upcoming sessions, followed by a discussion on intermediate targets. In this session, our focus is mainly on the first component: the tools of the central bank.

One is open market operations, the second is the discount policy, and the third is reserve requirements. The other three tools have been used in most other countries, particularly in the U.S. and other developed nations, in conjunction with the first three tools. These three tools are referred to as conventional monetary policy instruments.

Central banks typically employ three primary tools to manage the money supply and interest rates during normal economic conditions. One is called an open market operation, or simply referred to as OMOs. OMOs involve the central bank buying or selling government securities in the open market to influence liquidity and short-term interest rates. The second one is reserve requirements, which are a mandated portion of deposits that banks must hold as reserves, either with the central bank or in the form of cash. The third one is called discount lending, which involves lending to commercial banks through instruments such as the bank rate or the marginal standing facility.

So, let me go through each one of these in detail. One is called the first one: open market operations. The formal definition is as follows: buying or selling government bonds, treasury bills, and other financial instruments in the open market by the central bank. The main purpose is to regulate the money supply and short-term interest rates by influencing the level of reserves in the banking system. The mechanism is that if the central bank conducts an open market operation by selling government securities it holds, it withdraws liquidity from the banking system.

This means that when it sells, the central bank aims to reduce the country's money supply. To do that, it first needs to decrease the money supply within the banking system. That means the liquidity within the banking system decreases. When the central bank sells government securities to commercial banks, the banks buy these securities from the central bank, and in return, they repay the central bank. This process reduces the amount of money within the banking system.

Consequently, as the money in the banking system declines, the flow of money into the economy also decreases, which is a method used to tighten the money supply. At the same time, if the objective of the RBI, the central bank, is to increase the money supply

in the economy, then it will conduct open market purchases. Open market purchases refer to the central bank buying government securities from the banking system. You are aware that commercial banks allocate a certain percentage of their total funds to government securities. That means they will hold government securities, which are safer investments.

If the central bank wants to increase the money supply in the economy, it will first increase liquidity within the banking system. To do this, it purchases government securities from the banking system through open market operations. This means banks will receive more money in return. This means that the liquidity within the banking system increases. When banks have more money, they are more likely to lend to the public.

To increase the money supply, a central bank will conduct open market operations by purchasing government securities. In India, the RBI conducts OMOs to manage liquidity and influence interest rates in line with monetary policy goals. The second tool is the reserve requirement. In the Indian context, there are two types of reserve requirements.

One is called the cash reserve ratio. This is also known as the RRR, or required reserve ratio. It is a required percentage of a bank's total deposits that must be kept in cash with the RBI. That means it functions as a tool to manage liquidity and control inflation in the economy. For example, as of July 2025, the CRR is 4.5% of a bank's net demand and time liabilities. Liabilities refer to deposits. That means every commercial bank in the country must maintain 4.5% of its total deposits at the central bank.

They can't lend that money to anyone. 4.5% of their total deposits with the banking system must be kept as reserves at the central bank. Suppose that means the remaining 95.5% can only be lent within the economic system. Suppose they increase this to 10%. If the central bank wants to reduce the money supply in the country, it increases the reserve requirement to 10%.

This means that only 90% of deposits, not 95.5%, can be lent out by commercial banks. If they want to increase the money supply, they will reduce the cash reserve ratio. If the central bank wants to reduce the money supply, it will increase the cash reserve ratio. Additionally, there is a statutory liquidity ratio known as the SLR. It means the RBI requires banks to keep a certain portion of their net demand and time deposits in liquid assets, such as government securities, gold, or approved bonds, which they need to invest in, but not in cash.

Therefore, approximately 18% of the total deposits should be invested in the most liquid assets, such as government securities, gold, or approved bonds. That means the remainder can only be lent to the general public. That means you can see here that 18% is in SLR and 4.5% is in the form of a required cash reserve. This means the remaining amount can only be lent to the public, which impacts the money supply.

I'm also showing you the reserve requirements in the USA. The reserve requirement is based on the bank's size. Banks with deposits of up to 16.3 million don't need to keep any reserves. However, if they have deposits of this amount or more, they must keep three percent.

For large banks with deposits exceeding \$ 124.2 million, they are required to maintain 10 percent of their deposits in reserves with the central bank. Let us now move to the third tool, which is called the Discount Policy. The Discount Policy is the interest rate at which the central bank lends funds to commercial banks and financial institutions, typically for short-term liquidity needs. The mechanism here is that lending may occur through rediscounting commercial bills, treasury bills, or by directly offering credit. It acts as a signal rate for the broader interest rate structure in the economy.

Simply put, if the central bank reduces the bank rate, it means commercial banks will benefit because they can borrow more money at a lower rate from the central bank. As a result, the liquidity of commercial banks increases, allowing them to lend more to the public. Suppose the objective of the RBI is to increase the money supply, which means there should be more money with the public. If their objective is to increase the money supply, then the RBI will reduce the bank rate, which is the rate at which a commercial bank can borrow from the central bank. When the central bank reduces the bank rate, commercial banks will get cheaper credit.

As a result, their liquidity increases, enabling them to lend more to the public. So, what is its role in monetary policy? A higher bank rate discourages bank borrowing, thereby contracting the money supply. Conversely, a lower bank rate—like the one I mentioned a few seconds ago—encourages commercial banks to borrow more from the central bank, increasing their liquidity and expanding the money supply. In India, the RBI uses the bank rate and repo rate in tandem, though the repo rate has become the more active policy tool. Whenever we discuss monetary policy instruments, we often focus on the repo rate, which is the policy rate that takes center stage.

Let me clarify the distinction between the bank rate and the repo rate. The repo rate involves short-term borrowing by banks with collateral. That means government securities are usually used to manage liquidity in the banking system. In contrast, the bank rate applies to long-term borrowing by banks that does not require collateral. It is used more directly to influence lending rates and overall credit conditions. I have provided a summary of the differences between the bank rate and the repo rate here.

You can observe both the similarities and differences. I'm also providing you with some insights into the use of discount policies in the US. I am just here; they have the primary credit rate. They also have a secondary credit rating. They also have a seasonal discount.

That is for small community banks that require a temporary increase in funds. In addition to conventional tools, the central bank sometimes uses unconventional monetary policy tools during recessions or crisis periods. One is large-scale asset purchases and lending operations. I have described this. What are the financial indicators here? What are the mechanisms, intermediate goals, and applications in India? I have listed the unconventional monetary policy tools here.

I have taken this from P. Dua's writings. In this session, we reviewed the concept of the money supply. Thereafter, we discussed the goals of monetary policy and later talked about the instruments used. In the next session, we will delve into the role of the central bank in influencing a country's money supply and its methods of doing so. We will cover all these topics in the next session.

Thank you for watching this video. I look forward to seeing you in the next session. Thank you.