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IMPACT OF MONETARY POLICY ON ECONOMIC GROWTH AND INFLATION

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ABSTRACT

Long-term and short-term growth are equally impacted by monetary policy. In this study, the examination of monetary policy and its effects on the Indian economy are the main topics. The central bank monitors the amount of money supply in an effort to maintain price stability. As a dependent variable, the study uses the gross domestic product (GDP), whereas the independent variables are the repo rate, reverse repo rate, unemployment, foreign direct investment, and inflation. These variables were used to demonstrate how completely dependent they are on a country's economy. The GDP calculation used different inputs. The study's goals are to evaluate the efficiency of Indian monetary policy and the effects of particular financial instruments on the domestic economy.

Keywords: *monetary policy, gross domestic product (GDP), repo rate, reverse repo rate, unemployment, foreign direct investment, and inflation.*

INTRODUCTION

In this commentary we deal with the objectives of monetary policy and not its operating rules. The usual set of objectives from which a central bank chooses are inflation, the state of the balance of payments or the behaviour of the exchange rate, output or output growth, and unemployment. However, in an increasing number of countries the sole objective for monetary policy is to control inflation. Central banks announce a target inflation rate that they seek to achieve. Recently, the Reserve Bank of India (RBI) also adopted inflation targeting as the framework for the conduct of its monetary policy. This has been a controversial step as many analysts argue that inflation targeting is not appropriate for India. In this commentary we study how the objectives of monetary policy have changed over the years and why countries are adopting the framework of inflation targeting. We finally examine whether inflation targeting is appropriate for India.

we study the objective of monetary policy in different periods. We distinguish the following periods, the gold standard (GS), immediate aftermath of the Second World War (SWW) and later in the 1950s and 1960s when central banks used monetary policy to control inflation. The objective of monetary policy for many years during the operation of the gold standard (GS), especially before the First World War, was to maintain a stable exchange rate which entailed controlling the rate of inflation which in turn required control of the government’s budget deficit. In the immediate aftermath of the Second World War to lower the cost of servicing the large government debt inherited from the SWW, central banks kept interest rates low. It was only gradually as the rate of inflation picked up that monetary policy was geared to reduce the rate of inflation. The stagflation of the 1970s proved to be a challenge to central banks. We next examine how

central banks reacted to this challenge. we note that monetary theory came to increasingly see the role of central banks in anchoring expectations as that would provide a stable environment for investors. It was in this context that central banks came to adopt inflation targeting. we study the evolution of policy by the RBI and why finally it adopted inflation targeting. we study what has been the outcome of the RBI adoption of inflation targeting. we analyse more generally from a sample of developing countries whether adoption of IT has resulted in lower inflation, and higher growth.

Monetary policy

Monetary policy is the policy adopted by the monetary authority of a nation to affect monetary and other financial conditions to accomplish broader objectives like high employment and price stability (normally interpreted as a low and stable rate of inflation). Further purposes of a monetary policy may be to contribute to economic stability or to maintain predictable exchange rates with other currencies. Today most central banks in developed countries conduct their monetary policy within an inflation targeting framework, whereas the monetary policies of most developing countries' central banks target some kind of a fixed exchange rate system. A third monetary policy strategy, targeting the money supply, was widely followed during the 1980s, but has diminished in popularity since then, though it is still the official strategy in a number of emerging economies.

The tools of monetary policy vary from central bank to central bank, depending on the country's stage of development, institutional structure, tradition and political system. Interest rate targeting is generally the primary tool, being obtained either directly via administratively changing the central bank's own interest rates or indirectly via open market operations. Interest rates affect general economic activity and consequently employment and inflation via a number of different channels, known collectively as the monetary transmission mechanism, and are also an important determinant of the exchange rate. Other policy tools include communication strategies like forward guidance and in some countries the setting of reserve requirements. Monetary policy is often referred to as being either expansionary (stimulating economic activity and consequently employment and inflation) or contractionary (dampening economic activity, hence decreasing employment and inflation).

Inflation

In economics, inflation is a general increase in the prices of goods and services in an economy. This is usually measured using the consumer price index (CPI). When the general price level rises, each unit of currency buys fewer goods and services; consequently, inflation corresponds to a reduction in the purchasing power of money. The opposite of CPI inflation is deflation, a decrease in the general price level of goods and services. The common measure of inflation is the inflation rate, the annualized percentage change in a general price index. As prices faced by households do not all increase at the same rate, the consumer price index (CPI) is often used for this purpose. Changes in inflation are widely attributed to fluctuations in real demand for goods and services (also known as demand shocks, including changes in fiscal or monetary policy), changes in available supplies such as during energy crises (also known as supply shocks), or changes in inflation expectations, which may be self-fulfilling. Moderate inflation affects economies in both positive and negative ways. The negative effects would include an increase in the opportunity cost of holding money, uncertainty over future inflation, which may discourage investment and savings, and, if inflation were rapid enough, shortages of goods as consumers begin hoarding out of

concern that prices will increase in the future. Positive effects include reducing unemployment due to nominal wage rigidity, allowing the central bank greater freedom in carrying out monetary policy, encouraging loans and investment instead of money hoarding, and avoiding the inefficiencies associated with deflation.

OBJECTIVE TO STUDY

1. Economic growth: This is the process by which a nation's actual per capita income rises steadily over time.

2. Balance of Payments: To keep the balance of payments in balance.

RESEARCH METHODOLOGY

The central bank implements monetary policy to maintain economic stability, keep unemployment low, safeguard the value of the currency, and promote economic growth. A central bank can change the rates of borrowing, spending, and saving through adjusting interest rates, reserve requirements, or through open market operations. By changing the amount of money availability, central banks modify their monetary policy. Typically, they do this by buying or selling securities through the open market. Short-term interest rates are impacted by open market operations, which in turn affect longer-term rates and the economy. Credit rationing, consumer credit regulation, guidelines, margin requirements, and moral persuasion are some of the qualitative weapons of monetary policy. Open Market Operations, Bank Rate, Repo Rate, Reverse Repo Rate, Cash Reserve Ratio, Statutory Liquidity Ratio, Marginal Standing Facility, and Liquidity Adjustment Facility (LAF) are all included in the list of quantitative instruments. Studying the effects of monetary policy requires the use of secondary data. For the study, a variety of resources from the RBI website and other journals were used to pursue a major.

The factors that determine how well monetary policy achieves price stability were identified. The country's GDP growth comes first, and other factors that affect it include the inflation rate, unemployment rate, foreign direct investment (FDI), and changes in the money supply. Using a flow-of-funds methodology, examined both the real and monetary aspects of short-run structural adjustment. It then lays forth an empirical framework based on such a structure. Framework that may integrate the Bank's strategy for meeting financial requirements with the Fund's financial programming model in a way that does away with the current divisions between the real and financial sectors of the economy. The realistic stabilisation policy choices for the Indian economy for the current fiscal year are then suggested using the integrated model, which establishes the balance of the monetary, external, real, and financial sectors. assessed two key problems. First, an assessment of the two-way interactions between business cycles and exchange rates is made: first by looking at some of the primary determinants of exchange rates, followed by consideration of the contribution of currency rates to the stabilisation of business cycles. Second, by formalising the fundamental linkages between the primary macroeconomic variables, the study provides an analytical framework that, among other things, aids in forecasting the exchange rate in the Indian context. In his 2002 book, George Macesich described how money functions in a country's economy and what monetary regimes produce. When it comes to money, the central bank and the ministry of finance share power and authority. The author also provides fascinating historical histories of the rules versus discretion dispute. in order to increase the effectiveness of the Reserve Bank's money market operations through the Liquidity Adjustment

Facility, the automatic availability of the RBI refinancing facility to banks must also be reviewed. Therefore, refinancing facilities may be scaled back or completely eliminated, and access to the non-collateral call money market may be restricted as the CRR is decreased and the repo market grows in order to increase the effectiveness of monetary policy behaviour. Monetary policy should react to changes in asset prices and/or financial imbalances beyond their impact on the forecast for inflation, according to a 2003 study by the Bank for International Settlements.

The study comes to the conclusion that, even if monetary officials are probably aware of these tendencies, the macroeconomic effects can be properly addressed within an accommodating and prospective formulation of inflation targets. In 2003, Robert Nobay and David Peel examined the best monetary policy, which they defined as a central bank using an asymmetric objective function. Numerous conclusions on the time consistency issue need not hold under asymmetric preferences, according to the findings. They investigated the effects of the central bank having an asymmetric loss function for the best discretionary strategy in this research. When evaluating the stance of monetary policy and shifting monetary conditions, attempted to create a Monetary Condition Index (MCI) for India that simultaneously takes into account interest rate and exchange rate networks. According to their research, interest rates have a greater influence on India's monetary conditions than exchange rates. Deepak Mohanty highlighted the world financial crisis and how India's monetary policy responded. The current emphasis is shifting from crisis management to recovery management both globally and in India. By lowering the liquidity overhang without endangering the growth process, RBI measures can now, in his opinion, help anchor inflationary expectations. Market liquidity is still at a comfortable level.

RESEARCH DESIGN

The study examined five variables—one of which was a dependent variable, and the other four were independent—to examine the effect of monetary policy on the Indian economy.

Dependent variables -GDP (gross domestic product)

Independent variables- Inflation, Foreign Direct Investment, Unemployment Rate, Policy Rates.

Type of Research- Empirical research is used for analysing the data.

Methods of Data Collection- Secondary-based research, RBI Bulletin, RBI Occasional Articles, RBI Annual Reports, Currency and Finance Report, Economic Survey, Economic and Political Weekly (EPW), Finance and Growth, Economic Diary, The Hindu, ICSSR, Economic Times, IMF Report, Indian Economic Journal, Financial Express, World Bank Reports and Internet, etc. used to collect data.

DATA ANALYSIS

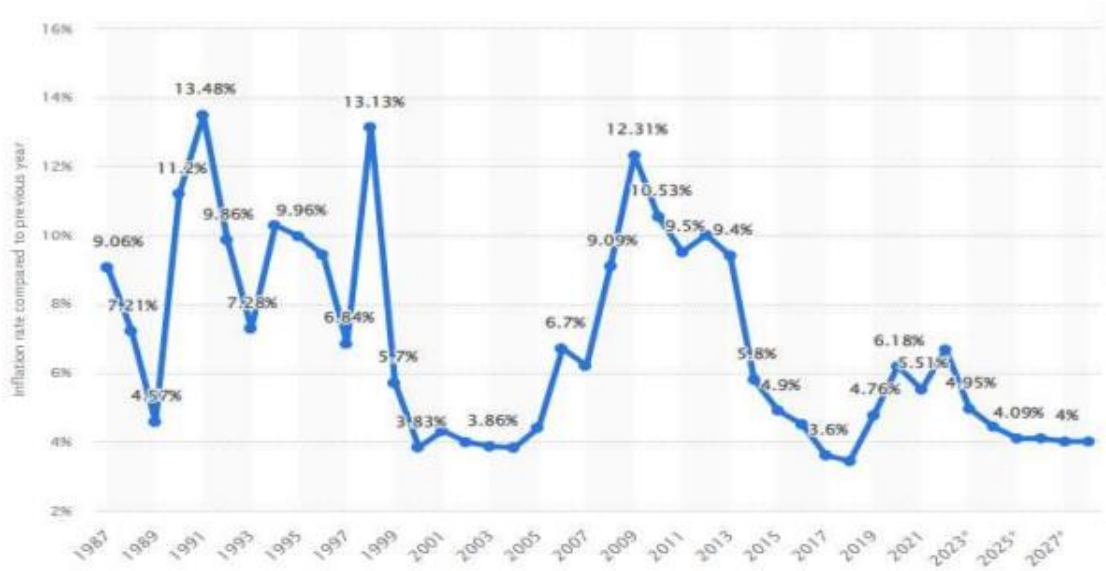
Gross domestic product:

Due to significant capital inflows, the GDP growth rate increased to 8.59% in 2009–10 and 8.91% in 2010–11 after falling to 6.72% in 2008–09 as a result of the global financial crisis. However, because of a domestic policy impasse and tax disagreements, it fell to 6.69% in 2011–12, 4.47% in 2012–13, and 4.74% in 2013–14. The Index of Industrial Production (IIP) for India has decreased, going from 5.6% YoY in June 2014 to

2.95% in the June 2019 quarter. Since the demonetization, IIP has decreased by 1.54%. Due to low revenue, India's budget deficit is expected to increase to 3.6% of GDP this fiscal year from 3.4% previously.

Inflation:

Between 2005 and 2010, wholesale prices of all goods increased by around 38%, but the cost of food increased by more than 77%. Vegetable prices have increased by 101%, while milk, eggs, meat, and fish prices have increased by 80%. The country saw the worst food inflation in 2009–2010, which was a substantial contributor to overall inflation. As the price of onions, potatoes, and wheat dropped, the increase in the price of other items slowed on the back of a good monsoon, resulting in a sharp drop in food inflation in India from 8% to 4.3% for the week ended December 2015. Over the past four weeks, inflation has dramatically decreased. For the week ending November 2012, it had decreased to just one digit from 12.21%.

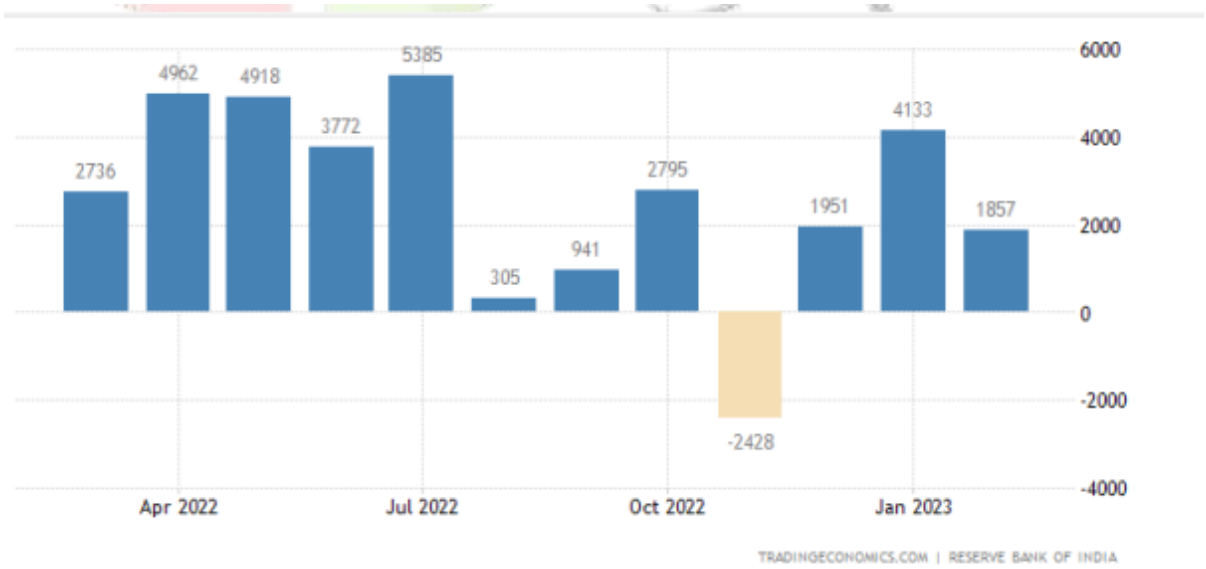


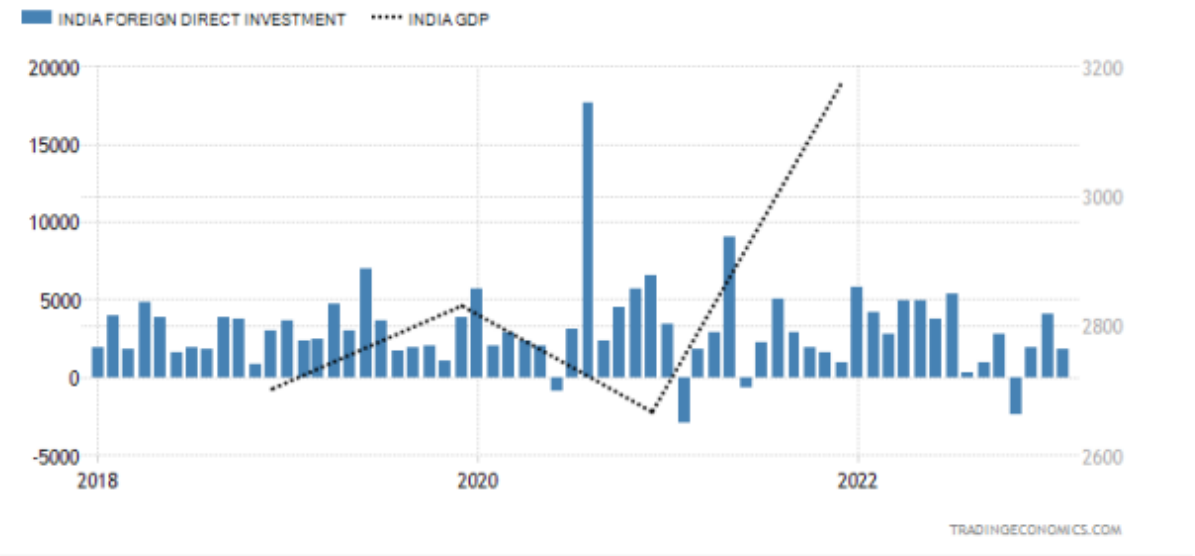
(SOURCE: STATISTA 2023) India: Inflation rate from 1987 to 2028

The graph clearly shows how the inflation rate has changed over time. The inflation rate was rather high in several years, such as 1995 and 2007, hitting 13.48% and 12.31%, respectively. Other years, including 2015 and 2025, had comparatively low inflation rates, at about 3.86% and 4.4%, respectively. Additionally, the graph illustrates by horizontal lines that there have been years where the inflation rate was the same as the year before. For instance, the horizontal line indicates that the inflation rate in 2008 was 9.09%, which was the same as the rate in the prior year.

FDI:

In 2009, FDI decreased by 35.6%, while in 2010, it decreased by 6.75%.The Indian economy experienced its slowest growth (GDP fell to 5.5) and struggled with risks related to high inflation as a result. As a result, investor confidence was impacted, and FDI inflows to India significantly decreased. In 2011, FDI increased by 31.56%, and it did so again in 2012. But after 2013, it continued to rise until 2016, and the MAKE IN INDIA campaign was what caused it. From 2013 to 2016, FDI surged in India by 91%.



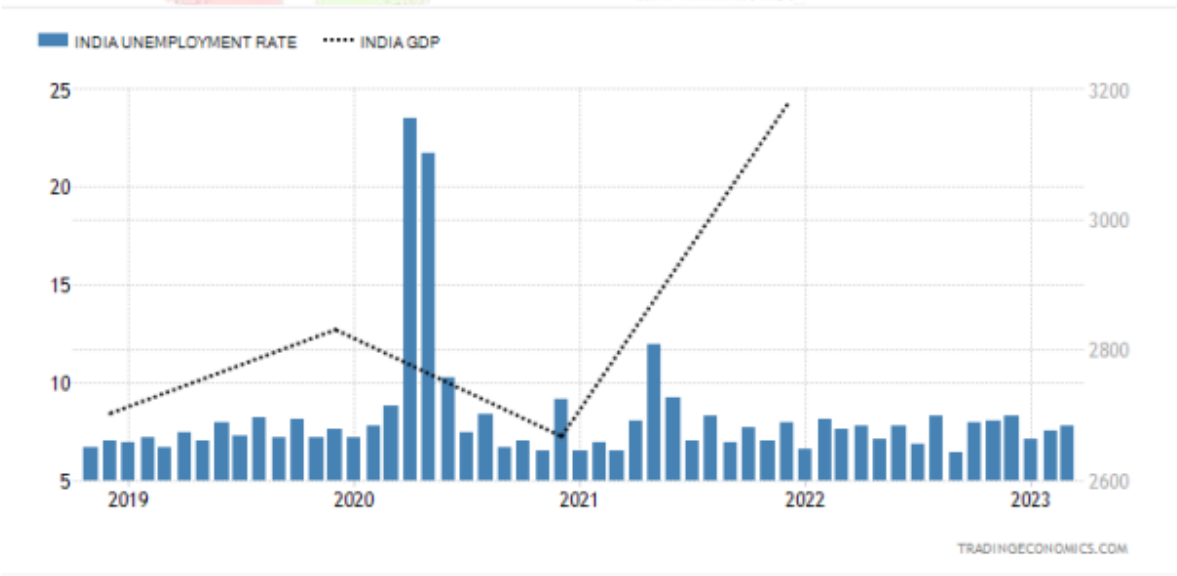


The graph shows that, with a few changes throughout the years, FDI inflows into India have been rising gradually. The amount of FDI inflows, which ranged from $2 billion to $5 billion from 1995 to 2003, remained very modest. Even Nevertheless, there have been sporadic decreases in FDI inflows into India since 2004, with a peak of almost $81 billion in 2021. The graph also demonstrates that there have been some years, like 2008 and 2020, where FDI inflows have decreased relative to the prior year. This may be because of a number of factors, including the state of the global economy, modifications to governmental regulations, or difficulties unique to a given sector of the economy. Overall, the graph shows that India has grown to be a more alluring location for FDI over time, with higher FDI inflows, which may have favourable effects on economic expansion, job creation, and technology transfer.

Unemployment Rate:

The financial crisis began in 2008, and when the economy stabilises in 2009, employment rates also start to rise. Later, a poor monsoon season caused a decline in employment, with the employment rate falling to

3.54 in 2010 and 2011. The year when there is sporadic employment is 2012. Then, FDI is started in India, which increases employment opportunities and raises the employment rate to 6.1 in 2018.



The unemployment rate in India in 2021 was 5.98%, down 2.02% from the previous year. The unemployment rate in India for 2020 was 8.00%, up 2.73% from the previous year. The unemployment rate in India for 2019 was 5.27%, down 0.06% from 2018.In 2018, India's unemployment rate dropped by 0.03% from the previous year to 5.33%.

RESULTS

To give a sneak peek at the findings, it was discovered that there is solid evidence that monetary policy consistently has negative effects on a nation's competitiveness, which is represented in a fall in the unemployment rate. The study comes to the conclusion that both short- and long-term monetary policy affects growth. The appraisal of monetary policy and its effects on the Indian economy are the main topics of this study.As a dependent variable, the study uses the gross domestic product (GDP), whereas the independent variables are the repo rate, reverse repo rate, unemployment, foreign direct investment, and inflation. Using these variables, we discovered that a country's economy completely depends on these elements. In 2008, the global financial crisis shook the Indian economy. The policy rates of the central banks were cut to historic lows. Despite a fiscal deficit, the economy expanded in 2010–11 and subsequent years. The two political giants, the BJP and the Congress, have a significant impact on the economic as well as political turmoil. We saw the economy change while both political parties were in power. The GDP calculation used different inputs. Demonetization, which took place in the nation in 2016, has had an effect on the Indian economy. After 2014, India's fiscal deficit increased each subsequent year.

CONCLUSION

All the many elements that affect the health of the Indian economy are combined to form India's GDP. The GDP of India gives us a comprehensive assessment on the performance of the Indian economy. The "Cost Factor" or "Real Price" techniques are the two methods for calculating the Indian GDP. The main cause of India's GDP development following and up until the 1990s was the economy's opening up. Markets were

opened up, and the government used private capital as leverage. More money has since flooded the markets. Monetary policy laws can be either active or passive. The passive rule, which maintains a constant flow of capital, is similar to Milton Friedman's money growth rule. The second, referred to as the rule of price stability, is that in reaction to increases in overall supply or demand, the money supply should be adjusted to keep prices steady. The idea of active regulation is to keep inflation and the price level under control. Our monetary policy is dominated by this Indian law. Healthy advancement is a development that is stable.

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