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CREDIT REQUIREMENT IN INDIA : A STUDY ABOUT MONETARY POLICY

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KEYWORDS :

How far is the short run monetary policy viable in impacting the interest for bank credit and consequently the pace of economic action in India and other Emerging Market Economies (Emes) is an interesting question. In such economies just as of late, monetary and financial sector reforms have resulted in deregulation of financial markets, decontrol of interest rates, more amazing cross-nation capital versatility and market dead set trade rates. Trade policy reforms have expedited evacuation of series of tariffs and quantitative restrictions on trade, resulting in an open current account. An expansive number of cross nation capital control structures have been demolished and both remote immediate investment and portfolio investment have at times touched unparalleled levels (see Pandit and Siddharthan, 2009). Stock markets have developed in size, profundity and arrive at. The market for government securities has also come to be more vibrant.

For researchers in the field of economic policy, the later reforms in markets for money, finance and global finance, make these economies almost a research facility case for analyzing the effectiveness of monetary policy in the post change period. For economies with improved financial markets there are several studies which inspect the effect of monetary policy initiatives using the credit channel of transmission. Some of these studies are, Bernanke and Gertler (1995), Kashyap, Stein and Wilcox (1993) and Friedman and Kuttner (1993). Vera (2002) examines these issues for Venezuela and Pandit et al (2006) look at the bank lending channel of transmission mechanism for India.

In the present study we focus on how, around different factors, change in a monetary policy variable as the policy rate in India and six different Emes, will impact the firms' interest for non-sustenance bank credit, which in the short run reflects the pace of potential economic movement in the industrial sector (see Davidson and Weintraub 1973, and Arestis 1988). Use of month to month information in thepresent study makes it possible to catch short run response of the industrial sector to changes in policy rate. As an instrument of monetary policy, we select the policy rate variable because any change in this rate is relied upon to impact acquiring cum discount rates, capital flows and rates of trade .On top of this, a change in policy rate has a proclamation impact on the market. Monetary policy adjusting through change in the policy rate in the short run, might have a noticeably fast affect on proposed pace and bearing of economic action of an economic substance like firm, for which a proximate measure is firms' interest for bank credit.

IMPORTANCE OF MONETARY POLICY

In the theoretical literature on development economics and macro economics, there are two important streams of thought about the role of monetary policy, which may be tackled at the outset. First, in the development economics literature it is suggested that investment activities in an under developed country are subject to greater degree of uncertainty than in a financially developed country.

Changes in policy rates which are always small and incremental may not be important enough as determinantsof investment. It might be factors like availability of credit, expected rates of return which will be predominant as determinants of investment. Our response to this concern is that our study is related to a period in which there have been extensive reforms in the financial sectors of the EMEs .When there is fall in policy rates for example, market rates of interest also fall and as a result, discount rates go down. This increases the present value of cash flows from investment besides reducing the borrowing cost. Further, the central banks of the EMEs have to a large extent fine tuned the use of policy tools and besides quantity signals, price signals are also effective. The overall scenario in EMEs is more liberalized in the post reform period. As a result, the domestic financial markets are better integrated within the home economy and also with international financial markets. The next challenge in the theory is about the irrelevance of monetary policy. Here we refer to applicability of rational expectations hypothesis of the New Classical Macroeconomics and the degree of capital mobility across economies. Rational expectations as a hypothesis is theoretically important but in applied macro policy especially in the context of EMEs, the implicit assumption of rational expectations hypothesis like wage price flexibility does not hold valid. Another implicit assumption associated with New Classical Macro Economics of which rational hypothesis provides the base, is that of competitive markets.

This implies a perpetual tendency toward full employment under equilibrium conditions. Markets in EMEs can not to be said to be competitive in an Arrow-Debreu sense nor is full employment the inevitable equilibrium outcome in such markets. An important assumption of rational expectations hypothesis is the availability of information especially about economic policy changes. For EMEs this assumption is also violated and workers as economic agents may not have full information.

With respect to significance of monetary policy in an open economy it has been contended in Pandit (2005, 2006) that monetary policy is truth be told more important in economies like India for various reasons. Nonetheless, several developments in the later past seem to have fuelled the level headed discussion with respect to the superfluity of monetary policy. The most essential around these are the deregulation of the domestic financial sector; the opening up of economies and the pattern towards globalisation. Around open economies, capital development as immediate and portfolio investments, coupled with market resolved trade rates, makes control of money supply or what is called monetary focusing on a by and large diverse and challenging ball amusement. Similarly, domestic interest rates in open Emes have a tendency to get adjusted with outside rates and take after the secured interest equality conditions (See Dua and Pandit, 2002). Worldwide financial reconciliation of obligation, value and credit markets could be seen putting the national bank stuck a predicament. It could be contended that national banks in the marketdriven economies of a globalised planet can not, one or the other alter the amount i.e. the supply of money and credit, nor would it be able to alter the cost i.e. the rate of interest.

Consequently, a question check is, no doubt put on the significance of monetary policy. The perspective that monetary policy is immaterial in a globalised planet is seriously imperfect. It continues to be important in pursuing the short and medium term targets of value stability, trade stability and all the more vitally, financial stability. A national bank require not settle rates of interest however using an exceptionally short rate such as the repo rate in India, as an instrument, the national bank can send customized signals to the money and credit markets. This might drive the money market towards creating the corresponding spectrum of interest rates.

Similarly, while money supply is not totally controllable by a national bank, the monetary power has to choose the timing and size of sterilisation and authorize it to ensure optimal liquidity and a rate of development of money supply which is not well outside the focused on reach. Similarly, if the domestic coin is under pressure, just national bank intercession can achieve systematic conditions in the outside

trade market. At times there is policy instigated non mediation in the outside trade market for understanding the short term goals of monetary policy.

It must be conceded, in any case, that national banks no more extended preside over the so-called charge economies characterised by altered trade rates, capital controls and administered rates of interest. Alongside the money market, credit markets, obligation and stock markets are extending and developing and are also at the present time getting integrated across the planet. For a national bank, the science of successful monetary policy is presently distinctive, in which less of fiat and a greater amount of right assessment of market signals is essential. The national bank does not must be guided by market signals alone, since that would suggest end of "policy". Keeping the targets and numerous indicators of monetary policy in perspective, the monetary power has to respond to signals from the genuine sector as well as from obligation, value, money and cash markets—both domestic and outside. Taking after economic reforms in Emes, these markets are more vibrant and at times even unstable. This makes the act of successful monetary policy all the more requesting.

For advancing countries and Emes, the part of monetary policy is all the more critical. First, in such countries, yield is usually concentrated in a smaller run of goods and services and financial markets are not exceptionally profound. This makes diversification of risk exceptionally troublesome. To counter the de-stabilising shocks, countervailing monetary policy is all the more essential. Second, the operation of market forces in some spheres of an improving economy may be frail, non-optimal or even non-existent. This makes the case for monetary policy guided lending essential. Third, by virtue of pay indexation and other structural rigidities in both labour and goods markets, control of expansion through contractionary policy may not be easy. Fiscal distortions like high fiscal deficits, in an advancing economy, might result in swelling which could be successfully handled with a judicious blend of fiscal cum monetary policies.