# HOW MONETARY POLICY CAN IMPACT FINANCIAL CRISIS?

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**Abstract:**

Central banks tend to participate in the market to calm and deflect the disasters generating a tangled relationship between monetary policy and financial crises.The money supply and interest rates that are present in the market as a result of central bank policy can affect asset prices and investor confidence.This study investigates the relationship between developing monetary policy options during a financial crisis and shedding light on the choices that lead to optimal balance and prevent development of existing weaknesses.It also emphasizes that, even with experience, there should be no loose ends and that precautions should be made to avoid long-term, systematic problems.The purpose of these monetary policy tools is to balance the needs of inflation control, economic growth, and financial stability. The RBI frequently makes changes to these tools because macroeconomic data and economic conditions are ever-changing.Throughout its recent economic history, India has suffered various financial crises, indicating to reasons, such as bad fiscal management, foreign shocks, or troubles with the banking industry. The vulnerability of India's financial system to both internal and external shocks is shown by crises such as the COVID-19 Crisis of 2020. In order to improve crisis management practices and encourage preventative actions to decrease the likelihood that such disasters will occur again, the RBI and the Indian government have strengthened financial legislation and regulations. Strategies that reduce the damage caused by financial crises are developed in order to comprehend the relationship between monetary policy and these occurrences.

**KEYWORDS:** Monetary policy, Financial crisis, Macroeconomic, Central bank, Economic growth.

## INTRODUCTION

## MONETARY POLICIES

The acts of a central bank or other regulatory body that control the amount and pace of expansion of the money supply, which in turn influences interest rates, are known as monetary policy. Interest rate changes, government bond purchases and sales, and adjustments to the amount of money banks must hold in reserve (bank vault) are all ways to sustain monetary policy. The policy pertaining to shifts in the money supply is referred to as monetary policy. By guiding the flow of funds in the proper channels, supplying institutional facilities for credit in particular economic sectors, and adapting the money supply to the demands of growth, an adequate monetary policy promotes economic growth.

Monetary policy thus supports the nation's economy's robust expansion. In a larger sense, monetary policy encompasses both monetary and non-monetary methods that affect the cost and availability of money, such as physical control, budgetary measures, income policy measures that affect the monetary position, and price or wage management. The actions done by the central banking authority to control the availability and cost of credit are referred to as monetary policy.

The availability of credit, the amount of money in circulation, the cost of borrowing, the values of capital assets, and the overall liquidity of the economy are the five interconnected components that drive monetary and credit policy. Creating the conditions for the efficient mobilization of the supply of actual and potential savings through the encouragement of financial intermediaries and the development of a variety of financial assets, on the one hand, and the efficient investment of these resources through the modification of the credit structure to sub-serve the needs of development, on the other, continue to be one of the core responsibilities of monetary authorities in the context of growth. It is clear that macro- management significantly relies on monetary policy. The Central Bank's (RBI) function has evolved over time from regulating credit to concentrating on keeping inflation stable and, more recently, aiming for inflation to stabilize the economy.

In particular, India's monetary authority has changed over time from being the government's ally to being an independent body. It's intriguing to examine such an evolution, particularly in the context of India. Numerous investigations have already been conducted in India that take into account the transmission and behavior of monetary policy.Because the impacts of monetary policy on the macro-economy have not been entirely evident, the effectiveness of monetary policy has been the subject of an ongoing debate. Monetary policy is important in industrialized nations. Among the goals of monetary policy, inflation holds the top spot. Full employment has given way to inflation management in rich economies, but this is less significant in emerging nations where unemployment is a significant issue impeding long- term growth. But when it comes to the trade-off between inflation and growth, both industrialized and emerging nations agree that there is no trade-off but rather a vicious cycle in which inflation control and growth encourage one another. In affluent nations, monetary policy management is highly valued when considering inflation or exchange rates rather than growth. In contrast to emerging nations, where the central bank must prioritize the development of the financial structure in addition to encouraging growth, industrialized nations' financial systems are also more advanced and overdeveloped. Monetary policy is important in industrialized nations. Among the goals of monetary policy, inflation holds the top spot. Full employment has given way to inflation management in rich economies, but this is less significant in emerging nations where unemployment is a significant issue impeding long-term growth. But when it comes to the trade-off between inflation and growth, both industrialized and emerging nations agree that there is no trade-off but rather a vicious cycle in which inflation control and growth encourage one another. In affluent nations, monetary policy management is highly valued when considering inflation or exchange rates rather than growth. In contrast to emerging nations, where the central bank must prioritize the development of the financial structure in addition to encouraging growth, industrialized nations' financial systems are also more advanced and overdeveloped. To promote economic growth and limit inflationary pressures, monetary policy must be one of regulated expansion. In the short term, this strategy tries to limit the rate of credit expansion, while in the long term, it aspires for a secular expansion of credit. A development program of this kind necessarily releases inflationary pressures; as a result, monetary policy must be restructured to keep these pressures from threatening the economy's ability to grow.Such a strategy has two components:

(a) a positive one, where the central bank promotes savings and credit growth, and (b) a negative one, where it regulates credit expansion to levels determined by available supply. The role of monetary policy in managing interest rates alone is being questioned in light of recent developments like the globalization of the capital market and other financial innovations. In addition to the limited effect that interest rate changes have on demand, the variety of financial markets and instruments also dilutes the effect of monetary policy on interest rates generally. However, as financial innovation has not yet reached the same levels in emerging nations as in industrialized ones, these factors are less significant there. Maintaining the balance of payments, controlling inflation, and promoting economic growth with reasonable price stability are the core objectives of monetary policy. However, in actuality and practice, very few countries are able to achieve a low and constant rate of inflation, which is the most challenging issue for emerging nations. However, as more and more nations attain low rates of inflation, it should be possible to target even lower rates. It is also thought to be a significant accomplishment of recent years because aiming for a zero rate of inflation is no longer regarded as inconceivable. In summary, therefore, it is not hyperbole to state that monetary policy is a government economic policy. In order to accomplish specific state goals, the central bank of a nation employs monetary policy to directly or indirectly affect the amount of money through the use of general tools like bank rates, open market operations, and variable reserve ratios, as well as specific tools like margin requirements, moral persuasion, minimum interest rates, etc. The policies pertaining to currency and coinage issuance, monetary standards, statutory reserves for currency

International Journal of Scientific Research in Engineering and Management (IJSREM)
Volume: 09 Issue: 04 | April - 2025 SJIF Rating: 8.586 ISSN: 2582-3930

issuance, exchange rate rules, and foreign exchange transactions are more elements that make up monetary policy.

**Essential areas that should be addressed by monetary policies are** :

1. **Economic Growth -** Growth in the economy is the primary goal of monetary policy.

By regulating interest rates and their effect on investment in the economy, monetary policy affects economic growth. Investment in the economy accelerates when the Reserve Bank of India adopts an easy credit policy, that is, by maintaining low interest rates, and this increased investment promotes economic growth.

2. **Price Stability -** One of the main goals of monetary policy is thought to be price stability. Price instability results from both inflation and deflation, which are detrimental to the economy. The primary goals of monetary policy are to prevent such a scenario and maintain prices at a steady level in order to lessen wealth and income disparities.

3. **Exchange Rate Stability**: The goal of monetary policy is to keep the exchange rate relatively stable and steer clear of frequent fluctuations. In order to affect the demand for foreign exchange and preserve exchange rate stability, the Reserve Bank of India modifies its foreign exchange reserves.

3. **Balance of Payment Equilibrium -**The imbalance of payments is a problem for developing nations like India. The balance of payments has two components: the surplus and the deficit. While the latter indicates a lack of money, the former represents an excess of money in the economy. Through its monetary policy, the Reserve Bank of India works to keep the balance of payments in balance.

## MONETARY INSTRUMENTS

### 1. Repo Rate

These loans are often for brief periods of time. The repo rate, to put it simply, is the interest rate at which the RBI loans funds to commercial banks in exchange for government assets. Commercial banks borrow money from the RBI during financial crises, and the interest rate at which they do so by selling their bonds and securities is known as the repo rate. It is one of the RBI's most effective instruments for managing the nation's money supply, liquidity, and inflation rate. The RBI raises the repo rate when the economy requires less money supply, which makes it harder for banks to borrow money and, conversely, to pump money into the economy; when the central bank lowers the repo rate, banks are encouraged to borrow money.

### 2. Reverse Repo Rate

The rate at which a nation's central bank borrows funds from its commercial banks is known as the reverse repo rate. It is the interest rate at which RBI takes out short-term loans from other banks. The RBI accomplishes this by offering banks government bonds and securities in exchange for a promise to repurchase them later. RBI raises the reverse repo rate in an effort to reduce the economy's money supply, which lowers commercial bank liquidity and raises interest rates.

### 3. Cash Reserve Ratio (CRR)

According to the cash reserve ratio, a certain percentage of all deposits had to be kept in current accounts with the RBI; commercial banks were not allowed to use that amount for any type of economic or business activity. The cash reserve ratio (CRR), one component of the RBI's monetary policy, is used to regulate the country's money supply, inflation rate, and liquidity. When CRR rises, bank liquidity falls, and vice versa. The RBI increases the CRR to drain the loan-able funds that banks have available, which slows down investment and reduces the amount of money in the economy, both of which help to lower inflation when efforts are made to reduce the amount of money in the economy during times of high inflation.

**4. Statutory Liquidity Ratio (SLR)**

The minimal percentage of deposits that a commercial bank must keep in liquid cash, gold, or other securities is known as the Statutory Liquidity Ratio, or SLR. In essence, it is the amount of reserves that banks must maintain before extending credit to clients. The RBI sets the SLR as a way to regulate the expansion of credit in India.
The SLR is used by the government to control inflation and promote economic expansion. While lowering the statutory liquidity rate will spur economic growth, raising the SLR will reduce inflation.

**5. Bank Rate**

The rate at which the RBI lends money to commercial banks is known as the bank rate. The interest rate that the RBI charges for lending money to the banking sector is called the bank rate, sometimes referred to as the discount rate. Money can be supplied by direct loan, discounting, or purchasing money market instruments such as treasury and commercial notes. When there is inflation, the central bank raises the bank rate, which makes it more expensive for commercial banks to borrow money. This lowers the amount of credit that banks extend to each other, which in turn reduces the amount of money in circulation.

The impact of a change in the bank rate in practice is determined by a number of factors, including the degree to which commercial banks rely on the Reserve Bank for funding, the availability of funds with banks from other sources, the degree to which changes in the bank rate directly affect other interest rates, and the significance of a change in the bank rate as a gauge of monetary policy stance.These monetary policy measures are designed to balance the need for inflation control, economic growth, and financial stability. The RBI continuously adjusts these tools based on evolving economic conditions and macroeconomic indicators.

## FINANCIAL CRISIS

Financial crises are a sign of strain on the banks, other financial intermediaries, and the financial system as a whole. They typically lead to the failure of institutions that are crucial to the system and significant downturns in the national economy. It can be referred to as a period of financial market volatility characterized by serious issues with insolvency and liquidity among market participants, necessitating government action to limit such effects.

## CAUSES OF FINANCIAL CRISIS

A financial crisis arises from any imbalances in the domestic economy that are connected to the global money and capital flows, the real economy, the financial sector, the macro economy, or asset pricing. A financial crisis is brought on by rising interest rates, stock market drops, increased uncertainty, drops in aggregate price levels, bank panics, and a reduction in investor and depositor confidence. High external debt, currency devaluation, and current account swings have become key contributors to financial crises in the context of open international capital mobility. Significant technological or financial advancements can also trigger a crisis. On the other hand , For monetary policy to be effective, there must be financial stability.
From monetary policy to banking and ultimately to the actual economy, there is a crucial web of connections. Monetary policy cannot accomplish its economic aims and objectives without financial stability. Financial

instability limits the amount of credit available to households and businesses by interfering with financial intermediation and market functioning. This can therefore result in lower aggregate demand, which would further strain the financial system. The distinction between monetary and financial policy does not imply that monetary policy has no effect on financial stability or that financial policy has no effect on inflation and resource use. The real economy's activity, asset prices, balance sheets, and the rate of company defaults and corresponding credit losses on loans to those firms are all impacted by monetary policy.

Financial policy influences how financial markets function, which in turn influences how monetary policy is transmitted. It also influences financial conditions through risk premiums, which, when everything else is equal, influence inflation and resource use. This implies that financial policy should be carried with regard for monetary policy and that monetary policy should be handled with account for financial policy. Therefore,however, it may make sense to characteristic the purpose of financial stability to the central bank, if the central bank is granted control of the supervisory and regulatory instruments that are effective for achieving and maintaining financial stability.

## LITERATURE REVIEW

- **Impact of monetary policy on Price stability and financial stability in India (2019), pariyani Vanisha**
- The author defines in this Indian economy there do exist complications regarding the relationship between monetary policy and financial stability. there were two major targets which were set to met through this system . these were making sure that the price stability is not affected which is also leading to financial stability being secured. although reserve bank of India did implied macro prudential restrictions to manage emerging threats without sacrificing the growth having maintaining a healthy financial system its main target.
- **Three essays in monetary economics(2005), Virmani, Vineet**
- The author examines monetary policy actions connection with inflation outcomes showcasing factors such as interest rates and money supply being influenced by central bank policies. It may also focus on achieving price stability by effectively analyzing different monetary policies. It also explores how financial market is impacted by these financial reforms.
- **The Role of Monetary Policy During the Financial Crises (2024), Research gate**
- This study signifies the vital role of monetary policy, from the Great Depression to the COVID-19 pandemic managing financial crises. Throughout different economic downturns, the historical perspective regarding monetary policies used with the aim of effective intervention for monetary policies as essential tools for crisis mitigation. By comparing both events, the research establishes constant trend in policy responses and highlights challenging lessons from past crises.

## METHODOLOGY

The details of the approach used for the current investigation are provided in this chapter. Following a discussion of the study's importance, it lists the goals, theories, and parameters of the investigation. It provides information on sample selection and data collecting. The study's a lot approaches to analysis have been carefully analyzed. It discusses the findings of the research and additionally how it will benefit society as a whole. The research focus on two aspects :-

- To understand the relationship between monetary policies and financial crisis.
- To understand constant trend in policy responses.
- To know the decision making process of policymakers.

**FINDINGS**

As with price stability, one of the primary goals of economic policies should be financial stability. To safeguard financial stability, a supervisory body for the financial system should be developed. These indicators should be regularly tracked, early warning should be given in the event of a deviation, and immediate preventive action should be done. Whenever financial instruments and monetary policy tools interact, monetary policy and financial system supervisory entities need to function together. The claim that monetary policy is a government economic policy is not exaggeration. The central bank of a country uses monetary policy to directly or indirectly influence the amount of money in order to achieve certain state objectives. It does this by using both general tools, such as bank rates, open market operations, and variable reserve ratios, and specific tools, such as margin requirements, moral persuasion, minimum interest rates, etc. Additional components of monetary policy include exchange rate regulations, foreign exchange transactions, statutory reserves for currency issuance, monetary standards, and policies related to currency and coinage issuance. The functioning of financial markets is influenced by financial policy, which in turn affects the transmission of monetary policy. Additionally, it affects financial circumstances through risk premiums, which affect inflation and resource utilization when all other factors are equal. This suggests that monetary policy should be handled with consideration for financial policy and that financial policy should be carried out with consideration for monetary policy. Therefore, if the central bank is given authority over the regulatory and supervisory tools that are useful for attaining and preserving financial stability, it could make sense to attribute the goal of financial stability to the central bank. The financial systems of industrialized nations are also more developed and sophisticated than those of emerging nations, where the central bank must prioritize both growth promotion and the development of the financial structure. In developed countries, monetary policy has a significant role. Inflation is the primary objective of monetary policy. In wealthy economies, full employment has made way for inflation control; in emerging countries, where unemployment is a major problem preventing long-term growth, this is less important. However, both developed and developing countries concur that there is no trade-off between inflation and growth, but rather a vicious cycle wherein growth and inflation management support one another. Over time, India's monetary authority has evolved from an ally of the government to an autonomous entity. Examining such an evolution is fascinating, especially when considering India. In India, numerous studies that consider the behavior and transmission of monetary policy have previously been carried out. The effectiveness of monetary policy has been a topic of continuous discussion because its effects on the macro- economy have not been fully apparent. In developed countries, monetary policy has a significant role. Inflation is the primary objective of monetary policy. In wealthy economies, full employment has made way for inflation control; in emerging countries, where unemployment is a major problem preventing long-term growth, this is less important. Policymakers ought to acknowledge that monetary policy is more effective at times of crisis. This suggests that central banks have a powerful instrument at their disposal to affect market conditions and stabilize the financial system. According to the research, the stability of unstable financial markets may be significantly impacted by prompt and decisive action during times of crisis. Because financial markets are more susceptible to monetary policy during crises, policymakers may need to bring about macro prudential measures to preserve financial stability. Both authorities are free to operate independently and make their own decisions up to the administration-set target level of financial instability. However, if the target level has been exceeded, monetary policy and the financial supervisory authority should coordinate their efforts. In the unlikely event that a conflict emerges because of tool overlap, a committee at the highest level made up of expertise from both the financial and monetary entities should be appointed. The correlation between monetary policy actions and inflation outcomes reveals how central bank policies affect characteristics like interest rates and the money supply. It might also concentrate on attaining price stability through a thorough analysis of various monetary strategies. It also looks at how these financial reforms affect the financial market. The connection between monetary policy and financial stability is not without its problems. With this approach, two significant objectives were intended to be achieved. These included ensuring that price stability would not be impacted, which also helped to maintain financial stability. While protecting a sound

International Journal of Scientific Research in Engineering and Management (IJSREM)
Volume: 09 Issue: 04 | April - 2025 SJIF Rating: 8.586 ISSN: 2582-3930

financial system was the primary goal, the Reserve Bank of India did imply macro prudential limitations to handle new risks while safeguarding growth. Price stability is seen as one of the primary objectives of monetary policy.

Both inflation and deflation are harmful to the economy and lead to price instability. Eliminating such a situation and keeping prices stable are the major objectives of monetary policy in order to reduce wealth and income inequality. Monetary policy aims to prevent frequent fluctuations and maintain a comparatively stable exchange rate. The Reserve Bank of India adjusts its foreign exchange reserves to have an impact on the demand for foreign currency and maintain exchange rate stability. Therefore, we may state that while price stability is of the highest priority, monetary policy also has to include growth. For monetary policy to be effective, there must be financial stability. From monetary policy to banking and ultimately to the actual economy, there is a crucial web of connections. For monetary policy to achieve its economic goals and objectives, financial stability is a necessary. This is because financial instability impairs market functioning and intermediary relationships, which limits the amount of credit available to individuals and companies. This, in turn, reduces aggregate demand, causing strain on the weekend financial system. We tried to focus on the research of bank competition in India because it seems like an essential subject in a nation like India that has gone through several stages of financial sector changes since 1991. Even so, analyzing cross-national data reveals that many emerging economies also underwent financial sector changes in the early 1990s. Examining and contrasting the effects of competition on multiple components of the financial system in emerging economies could be another crucial research agenda, as the empirical literature has well documented that the countless liberalization measures led to powerful bank competition in many of these economies.

## CONCLUSION

The report also recommends that while deciding on monetary policy, policymakers should consider how crises affect the stock and bond markets. The enhanced efficacy of monetary policy in times of crisis should be appreciated by policymakers. This implies that when it comes to influencing market conditions and stabilizing the financial system, central banks possess a potent tool. According to the research, during times of crisis, immediate and decisive action may dramatically impact the stabilization of unstable financial markets. Policymakers may need to enact macro prudential policies to maintain financial stability since financial markets are more sensitive to monetary policy during crises.

The impact of current monetary policy on financial stability has been significantly affected by prior monetary policy actions. For example, in a macroeconomic environment like the one we are currently in, using monetary policy to reduce inflation is likely to encourage financial instability. If policy rates have been restricted for an extended period, causing financial vulnerabilities to develop and then raising them is more likely to transform them and cause an economic depression than to prevent one. These results suggest that immediate action is crucial for deflate financial booms in general and keep the country from going into a dangerous financial "red zone."

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