

The evolving contours of India's monetary policy

Monetary policy must keep step with changing concerns — from funding plans to taming fiscal deficit and infusing financial stability



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Monetary policy remains an important tool of economic policy, both in developed and developing economies. As the institutional environment, both domestic and global, changes, the tasks of monetary policy also change. The monetary and financial system is far more complex today than in the past. Financial intermediation has reached a high level of sophistication, which has itself become a source of concern.

The menu of financial products has expanded enormously. The need for a central bank in India was debated for long. Finally, the Reserve Bank of India was set up as a central monetary authority in 1935. Like all central banks in developing economies, the RBI has been playing both a developmental and a regulatory role. In its developmental role, the RBI focussed on creating an appropriate financial infrastructure in the country.

Trends in monetary policy

The evolution of India's monetary policy reflects the changing concerns over the last seven decades. In the first three decades after Independence, the primary concern of the government was to get plans implemented. All policy instruments, including monetary policy, were tuned towards that goal. Allocation of credit consistent with plan priorities became a major concern.

In terms of monetary policy, planners talked of non-inflationary deficit financing. For example, the First Plan document said: "Judicious credit creation somewhat in anticipation of the increase in production and availability of genuine savings has also a part to play."

Prime Minister Jawaharlal Nehru's letter to the RBI Governor Rama Rau, while accepting his resignation, was clear. It indicated that government was the dominant partner and the role of Reserve Bank was to abide by the larger concerns of the government. So long as inflation was moderate, this approach did not matter.

During the 1950s, the average annual inflation in the wholesale price was only 1.8 per cent. In the 1960s, it was 6.2 per cent. But in the 1970s, inflation touched unacceptable levels, turning double-digit, and the growth of money supply had to be reined in. The 1980s saw a continuous exchange between the RBI and Ministry of Finance on the control of inflation, and the need to contain fiscal deficit and, more particularly, its monetisation. Though this period recorded an



RBI Governors past and present (L-R): Manmohan Singh, YV Reddy, Raghuram Rajan and Shaktikanta Das; Below: RBI Deputy Governor DR Mehta (left) with GH Singhania, ASSOCHAM President, at a meeting in New Delhi on September 13, 1994

average annual growth rate of a little over 5 per cent, the growth path was uneven. The average inflation rate was close to 7 per cent. The annual M3 growth rate was 17 per cent.

The Chakravarty Committee, which was appointed to look into the working of the monetary system, submitted its report in 1985; it emphasised the need for regulation of money supply, and wanted money supply growth to be consistent with real growth and an acceptable level of inflation.

It also emphasised the need for close coordination between monetary policy and fiscal policy, because money supply growth was driven by reserve money and the most important factor determining the creation of reserve money was the RBI credit to government.

Even though the government accepted the recommendations in principle, the latter part of the 1980s still saw a higher fiscal deficit and higher money supply growth. All these landed us in the crisis of 1991.

The early 1990s saw, as a part of the liberalisation programme, far-reaching changes in the central bank's functioning. With ad-hoc treasury bills no longer issued, the automatic monetisation of fiscal deficit ended.

By moving to a market-determined rate of interest, government securities became marketable and enabled the emergence of open-market operations as an instrument of credit control. The dismantling of the administered structure of interest rate helped the rate of interest to emerge as a policy tool.

Price stability and growth have always remained the major objectives of monetary policy. The uncertainty has been over which takes precedence and under what circumstance. Post-1997, the RBI specifically talked of a multiple indicator approach. But the issues connected with multiple objectives remained as before.

Exchange rate management

Post-1996, the RBI had to contend with certain new problems because of the change not only in the monetary policy environment but also the exchange rate regime. In February 1993, India moved to a market-determined exchange rate regime, with intervention by the RBI when needed. Between 1996 and today, India had to deal with at least three major global exchange market disturbances.

The first was the East Asian Crisis, the second the 2008-09 global financial crisis and the subsequent taper tantrums in 2013, and, finally, the current situation.

The RBI managed all these situations with commendable skill. But one broad lesson is that it is no longer possible to deal with an external situation without acting on the domestic market. Protecting the exchange value of the rupee also demands action on the domestic money market. Another lesson is that we cannot ignore what is happening to the real effective exchange rate. Inflation differentials ultimately determine the exchange rate.

Excessive capital inflows and outflows have a monetary bearing, and the means of dealing

with these situations had provoked conflicts between the RBI and government.

Financial stability

Financial stability had emerged as an important objective of monetary policy. The RBI, in this regard, had to play a dual role— monetary policy authority, and regulator of banking and non-banking systems. While India escaped the impact of the 2008 global financial crisis because of the restrictions, long in place, on foreign investment by banks, the rise in non-performing

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assets (NPAs) in the banking system became a concern since 2010.

Inflation targeting

In the evolution of monetary policy, a major change came in 2016 when the RBI Act was amended. The new monetary policy framework requires RBI to maintain consumer price inflation at 4 per cent with a margin of plus- or minus 2 per cent. It is, in a sense, flexible inflation targeting, which fits well with the needs of our country. It is the right blend of the objectives of price stability and economic growth.

However, several aspects of the mandate remain fuzzy and can be open to multiple interpretations. For example, how long can the RBI stay beyond the comfort zone without undercutting the spirit of the mandate?

How much importance should the RBI attach to the mid value of 4 per cent? Which is more relevant and central— stability at 4 per cent or being in the comfort zone? Interpretations may vary according to circumstances. But the spirit of the arrangement is that, over a period of time, the system needs to be close to 4 per cent. We must recognise that 4 per cent inflation itself is well above what developed economies consider appropriate. This has implications for the exchange rate. As we move ahead, the RBI and government must recognise the important role each plays in the governance of the economy. It is in the best interest of the government to cede certain areas to the central bank, allowing it to act according to its best judgement. It is necessary to move away from a scenario of 'fiscal dominance'.

