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DEREGULATION, LIBERALIZATION AND EVOLUTION OF MONETARY POLICY IN INDIA

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Abstract

In a developing country the monetary policy performs the role of not only stabilizing prices but also supporting growth. With deregulation and liberalization, the challenges faced by the monetary authorities have exacerbated. In India too the wave of deregulation and international integration of the financial markets and real sector has rendered the traditional monetary policy approach inappropriate .It has led to the evolution of a broad based and a forward looking monetary policy. The paper discusses the rationale and changes in the monetary policy framework in India namely, from the 'Monetary Targeting approach' to the 'Augmented Multiple Indicators Approach'.

INTRODUCTION

The formulation of monetary policy in all the economies of the world is aimed at minimizing undesirable fluctuations in the output or prices. The successful working of the monetary policy depends on the proper use of its various operating instruments as interest rates or reserve ratios and a proper understanding of the transmission mechanism and its channels in relation to the economy where it is operating. The question that arises in this regard is that -what is it that determines or influences the monetary policy framework in any economy? In this context Mohanty (2010a) remarks that in practice, the nature of framework of the monetary policy is contingent upon two important considerations. First, the level of development of financial markets and institutions; and second, the degree of openness of the economy to trade and capital flows. This statement can be substantiated by the observation that in the recent past, challenges for monetary policy makers have actually exacerbated due to the ongoing wave of financial deregulation, liberalization and globalization in the Indian economy. Global linkages of the Indian economy have highlighted the need for a broad based and forward looking monetary policy, that is, a policy calibrated on the basis multiple indicators and economic forecasts rather than a policy designed to respond only to the current state of the domestic economy, as the economy has become highly sensitive to international economic developments.

In India, the use of monetary policy came to be recognized as significant following the build up of inflationary pressures after 1970s which was the result of expansionary fiscal policies of the government. During the last four decades of operation of the monetary in India, there has been a great change in the monetary policy framework and its operation more so after the introduction of structural policy

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reforms. In this backdrop, this paper traces the developments in the overall framework and process of formulation of the monetary policy that have taken place especially in the post liberalization era.

FINANCIAL LIBERALIZATION, GLOBALIZATION AND CHALLENGES FOR THE MONETARY POLICY

The deregulation and liberalization of the financial markets as well as the real sector in the Indian economy has strengthened the influences of market forces and global factors in influencing key macroeconomic variables, rendering the traditional monetary policy framework inadequate to achieve its objectives. The major factors responsible for this may be identified as under-

i Firstly, the interdependence between economies following free movement of goods and capital between countries has made prediction of macroeconomic performance of the economy complex and reduced the accuracy of growth forecasts for purpose of taking appropriate policy actions. Globalization has brought about considerable fuzziness in reading underlying macroeconomic and financial developments, clouding the monetary authority's gauge of the performance of the economy (Reddy 2007).

ii Secondly, greater integration of domestic financial markets with overseas financial markets has created a need for aligning the local monetary policy with international financial sector developments. This has added a new dimension to the liquidity management functions of the Reserve Bank of India.

iii Thirdly, in the recent past India has been facing the brunt of attracting excessive (and volatile) capital inflows from the portfolio route encouraged by expectations of a robust growth of the Indian economy. These excessive capital inflows in relation to the absorptive capacity of the economy have intensified the macroeconomic dilemma of the impossible trinity, thus, making the formulation of an independent monetary policy less accommodative and outdated. That is, in the present context, the monetary authority needs to simultaneously manage free capital movement, exchange rate stability and domestic liquidity conditions in an effective manner.

iv Lastly, integration of the real as well as the financial sector with other economies of the world has increased price fluctuations arising from external factors as crude oil price fluctuations and commodity price fluctuations transmitted from the trade route .This has mitigated the effectiveness of the traditional approach of controlling inflation through control of money supply alone. Highlighting the significance of these developments, Reddy (2007) remarks that the central banks are often concerned with stability or variability of inflation rather than the level of prices and that inflation processes having become highly unclear, central banks are faced with the need to recognize the importance of inflation perceptions and inflation expectations as distinct from inflation indicators.

It is thus evident that deeper linkages of the Indian economy with the rest of the world economy developed as result of an outward oriented growth strategy and the resulting reliance on external demand and overseas investible funds for fuelling growth posed multiple challenges for policy makers in the post liberalization era. These challenges led to the evolution of a relatively broad based monetary policy framework over time in terms of its objectives, transmission channels, operating instruments, its approach and formulation. The following sections of the paper, throw light on these aspects of the monetary policy, with a comprehensive view of the past and present perspectives.

OBJECTIVES OF THE MONETARY POLICY

In a developing economy, the Central Banks through the operation of the monetary policy are ideally entrusted with the responsibility of maintaining price stability and ensuring adequate credit flows to support growth. In the recent past, more so after the global financial crisis, there has been a redefining of the goals of monetary policy to include financial stability on the agenda. With the shift in the growth strategy adopted by India, characterized by the dawn of liberalization including financial liberalization and globalization, monetary policy in India too has assumed a larger role besides the dual objectives of growth and price stability.

Reddy (2010) observes that, in India the mandate for the reserve bank of India is very broad. It was initially interpreted to mean the dual objectives of growth and price stability, the relative emphasis depending on the context but the RBI reinterpreted this a few years ago by adding financial stability to the objectives. He further states that since 2004 price and financial stability were given greater weight because the poor are affected severely and also instantly by instability while the reform induced benefits of growth percolate to them with a time lag.

Another that the monetary authority is entrusted with in India is that of supporting the governments' borrowing program for its fiscal needs which is carried out largely by way of open market operations. As the governments' debt manager the RBI tries to minimize the borrowing costs for the government but this interferes with the monetary policy management in an environment of rising inflation. However, with abolition of monetization of the governments' budget deficits and with the enacting of the Fiscal Responsibility and Budgetary Management Act (FRBM) in 2003, the fiscal obligations of the RBI have eased contributing to elimination of large scale withdrawal of funds from the banking system and have led to improvement in the monetary management ability of the central bank. Moreover, the government has also proposed to create an independent Debt Management Office, (DMO) in the 2007-08 budget which when created, will entirely divest the RBI of the responsibility of managing government borrowings. This will give autonomy to the Reserve Bank in managing its monetary policy independently.

Finally, greater global linkages of the domestic economy has added another challenge to the monetary policy objective of stabilizing output shocks as contagion effects of global business cycles have made the economic growth increasingly susceptible to external shocks and less amenable to stabilization by merely managing the domestic credit flow.

TRANSMISSION MECHANISM AND ITS CHANNELS

The process by which the monetary policy impacts the economy by its various direct and indirect channels is referred as the transmission mechanism. A standard monetary policy transmission mechanism depicting the transmission of policy signals to the real economy may be illustrated as under

Change in monetary policy stance affecting bank reserves and / or short term interest rates	→	Credit Bank interest rates Exchange Rates Asset prices	→	Investment Consumption Exports	→	Output Prices

The various transmission channels of the monetary policy through which output and prices respond to the changes in the monetary policy stance may be identified as-

i. Money supply and credit
ii. Interest rate channel
iii. Exchange rate channel
iv. Asset prices channel
v. Expectations channel

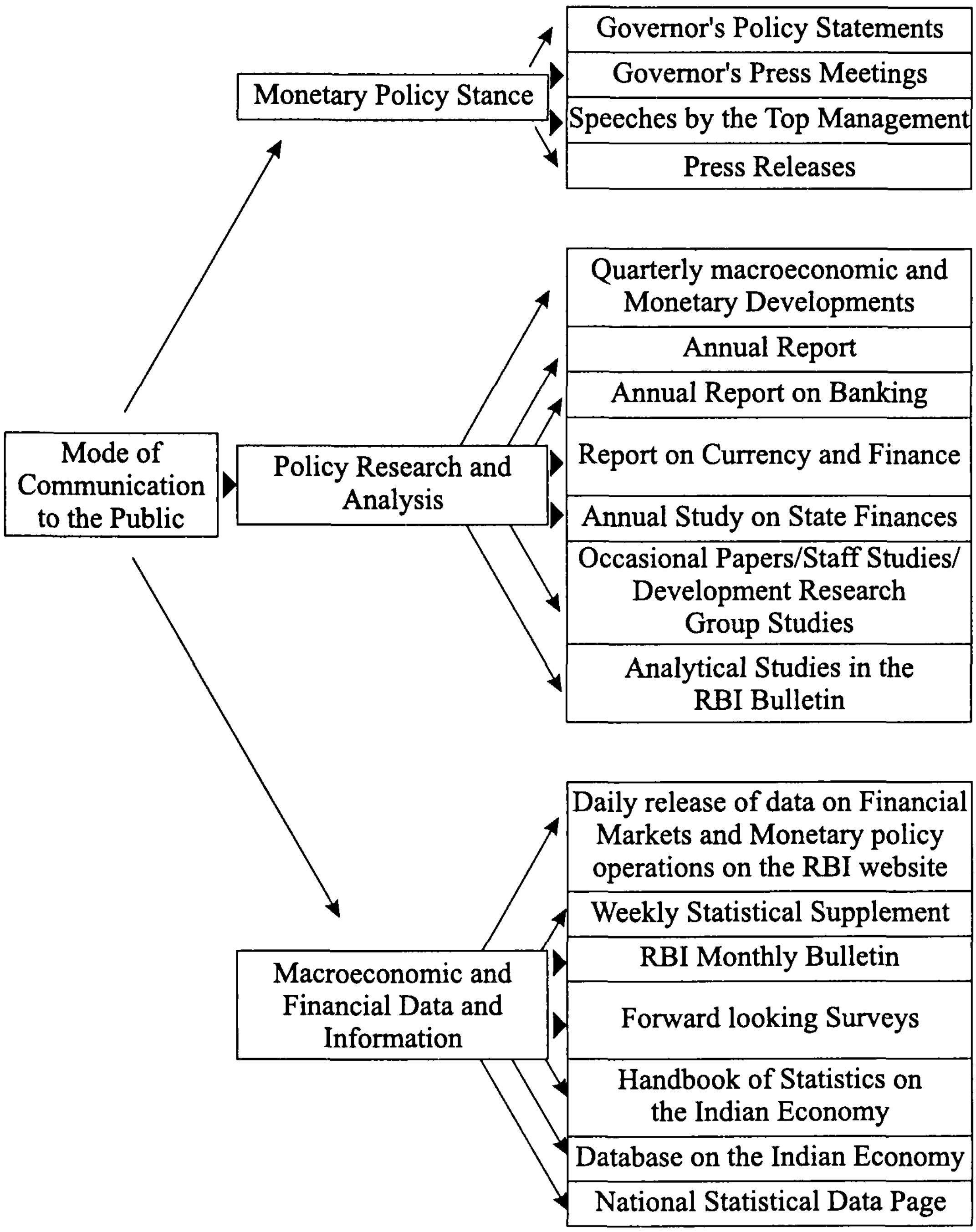
In India, following the ongoing structural transformation since 1990s, the nature of transmission mechanism has been changing over time in terms of the channels by which monetary policy signals are expected to be transmitted for effective and timely response of the economy in terms of its macroeconomic performance.

In the initial years, inflation in India was structural caused by undesirable fluctuations in the agricultural output due to crop failures and the role of monetary policy was limited to regulation of credit with the purpose of ensuring credit flows to the agricultural sector and limiting the chances of speculation by using the instrument of selective credit control. Later, in the 1980s, due to expansionary fiscal policies inflation assumed a cyclical nature as well and role of monetary factors in influencing prices became prominent. Therefore, after mid 1980s, the monetary policy, with the aim of targeting inflation, came to be primarily based on the control of money supply to transmit monetary policy signals. The reason for relatively greater reliance on the quantum channel was that during this period lending activity in the economy was confined to the commercial banks and there existed a predictable relation between the money supply, output and prices. As the structure of the Indian economy changed, the working of the transmission mechanism was altered. The Third Working Group on Money Supply (RBI 1998) found that over time output response to monetary policy operating through the interest rate channel became stronger in case of India and more persistent than the response through credit channel and so the interest rate gained importance vis-à-vis quantity variables. This change was brought about due to the developments in the financial markets and a more open economy. During this time period, the monetary policy signals came to be transmitted relatively more strongly through the changes not only in interest rates but also exchange rates and other asset prices. This significant shift in the relative effectiveness of transmission channels, led to a formal shift in the monetary policy framework after the year 1997-98 namely, from the Monetary Targeting approach to the Multiple Indicators approach.

It will be interesting to note that a fifth channel, namely the expectations channel too has emerged out to be significant in the recent past. Mohan (2006) opines in this regard that the expectations channel has assumed prominence in the conduct of forward looking monetary policy in view of its influence on the traditional four channels and also because, the beliefs of economic agents central banks policies can affect the variables that ultimately impact the macro economy. He states that the 'open Mouth Operations' by the central banks, that is, an announcement of future central bank policy, influences expectations in financial markets and can lead to desirable changes in output and inflation.

Based on this rationale and in order to influence expectations of the market participants in the desired manner ,RBI has in the recent past, adopted a practice of sharing information regarding policy measures, the reasons behind those policy measures and also analysis of the macroeconomic performance of the economy. Consequently, RBI communicates the stance and the rationale of the monetary policy through a variety of documents and other sources as through its website. This contributes to influencing or stabilizing expectations of market participants in a highly volatile international economic environment. These several channels through which the dissemination of information takes place has been depicted in Figure-1(Mohanty 2010b, p10).

Figure-1: Information Dissemination and Policy Communication



OPERATING INSTRUMENTS AND LIQUIDITY MANAGEMENT

The RBI has been using both direct and indirect instruments in its conduct of the monetary policy. With deregulation, the reliance of the monetary policy on administered interest rates and selective credit controls has become obsolete while the instruments as reserve ratios, repo rate and open market operations have gained importance in recent past in order to synchronize the monetary policy's working with the changes in the transmission mechanism and its underlying channels.

Initially, in the pre monetary targeting period (i.e. before mid 1980s) characterized by the administered interest rate regime, the RBI set limits on the secondary expansion of money through instruments such as CRR and SLR .During the Monetary Targeting period (i.e. mid 1980s to1997-98), the broad money (M3) growth provided the nominal anchor while the reserve money was used as the operating target. Later, the process of financial liberalization and deregulation of interest rates enhanced the role of market forces in determining interest rates and also exchange rates. Accordingly, RBI placed greater emphasis on the money market as a focal point for the conduct of monetary policy. This vision got a concrete shape following the Narasimham Committee recommendations (Government of India 1998) when the RBI introduced the Liquidity Adjustment Facility (LAF) in June 2000 to manage market liquidity on a daily basis and also to transmit interest rate signals. Under LAF, the RBI manages liquidity through repo rates and reverse repo rates which sets the corridor for overnight market interest rates.

The management of liquidity in India got further complicated due to persistent and volatile capital inflows in excess of the absorptive capacity of the economy in the 2000s.This added another dimension to the liquidity management operations of the RBI. Initially, the liquidity impact of large capital flows was sterilized through open market operations and resort to the LAF operations but, with a limited stock of government securities in the reserve bank's portfolio additional instruments in the package of RBI's policy instruments were required. This led to the introduction of the Market Stabilization Scheme (MSS) in April 2004.Under the scheme, short term government securities are issued for sterilization of excess liquidity following absorption of excessive capital flows by RBI. Thus, the introduction of MSS enabled the independent use of monetary policy instruments as CRR and LAF according to the needs of the domestic economy.

MONETARY POLICY FORMULATION

Successful monetary management crucially depends on the proper choice of an intermediate target by the central bank in order to influence the output and prices .Four broad classes of monetary policy approaches followed by central banks of different countries may be distinguished as under-

i. Monetary Targeting Approach -using monetary aggregate as an explicit intermediate target.

ii. Exchange Rate Targeting approach- using exchange rate as an explicit intermediate target.

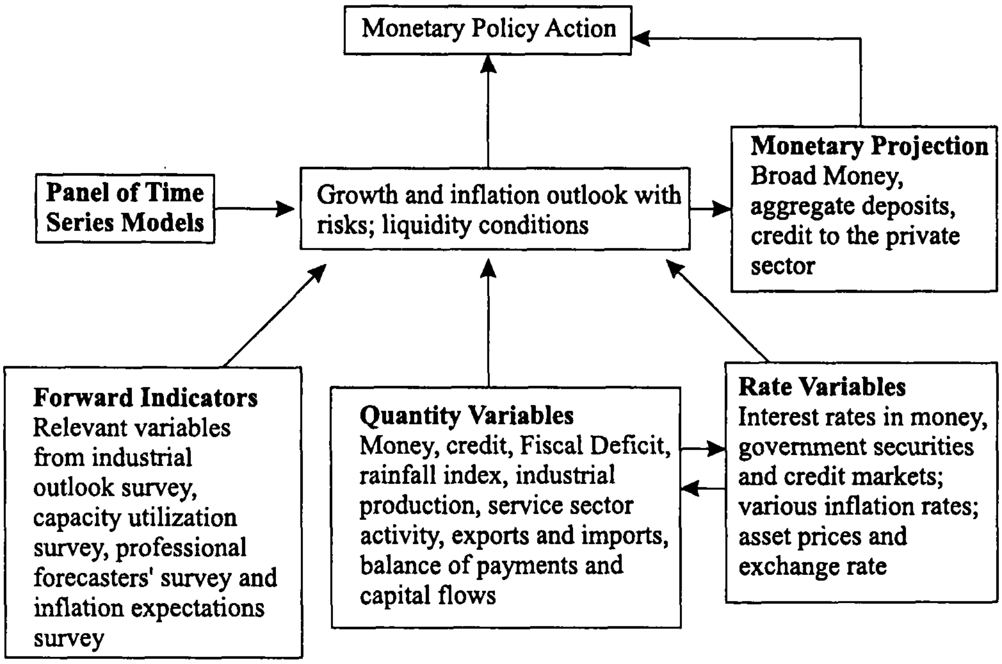
iii. Multiple Indicators Approach- based on a wide range of monetary and financial indicators.

iv. Inflation Targeting Approach- characterized by an explicit final policy goal rather than having any intermediate target.

As discussed earlier ,in India in 1970s inflation surged on account of monetary expansion generated by large scale monetization of fiscal deficit .Following this, the RBI adopted a Monetary Targeting approach or framework on the lines of recommendation of the Chakravarty Committee (RBI 1985).Under this approach, the annual growth in broad money (M3) was formally adopted as an intermediate target .This was based on the empirical evidence supporting reasonable stability in demand function for money which implies that, the demand for money was predominantly influenced by real income. Monetary management under this approach involved working out the M3 growth consistent with the projected GDP growth and a tolerable level of inflation. Over time the money demand function became unstable and uncertain due to increased market orientation of the financial system as also greater capital inflows. This made the use of monetary targeting approach obsolete in terms of maintaining desired levels of output and prices through control of broad money alone. As a result the RBI switched over to the Multiple Indicators Approach and formally adopted it in April 1998.According to Report on Currency and Finance (RBI 2005), under this approach interest rates or rates of return in different markets (money , capital and government securities) along with data on currency, credit extended by banks and financial institutions, fiscal position, trade, capital flows, exchange rate and foreign exchange transactions , available on a high frequency basis , are considered side by side with output data for drawing policy perspectives.

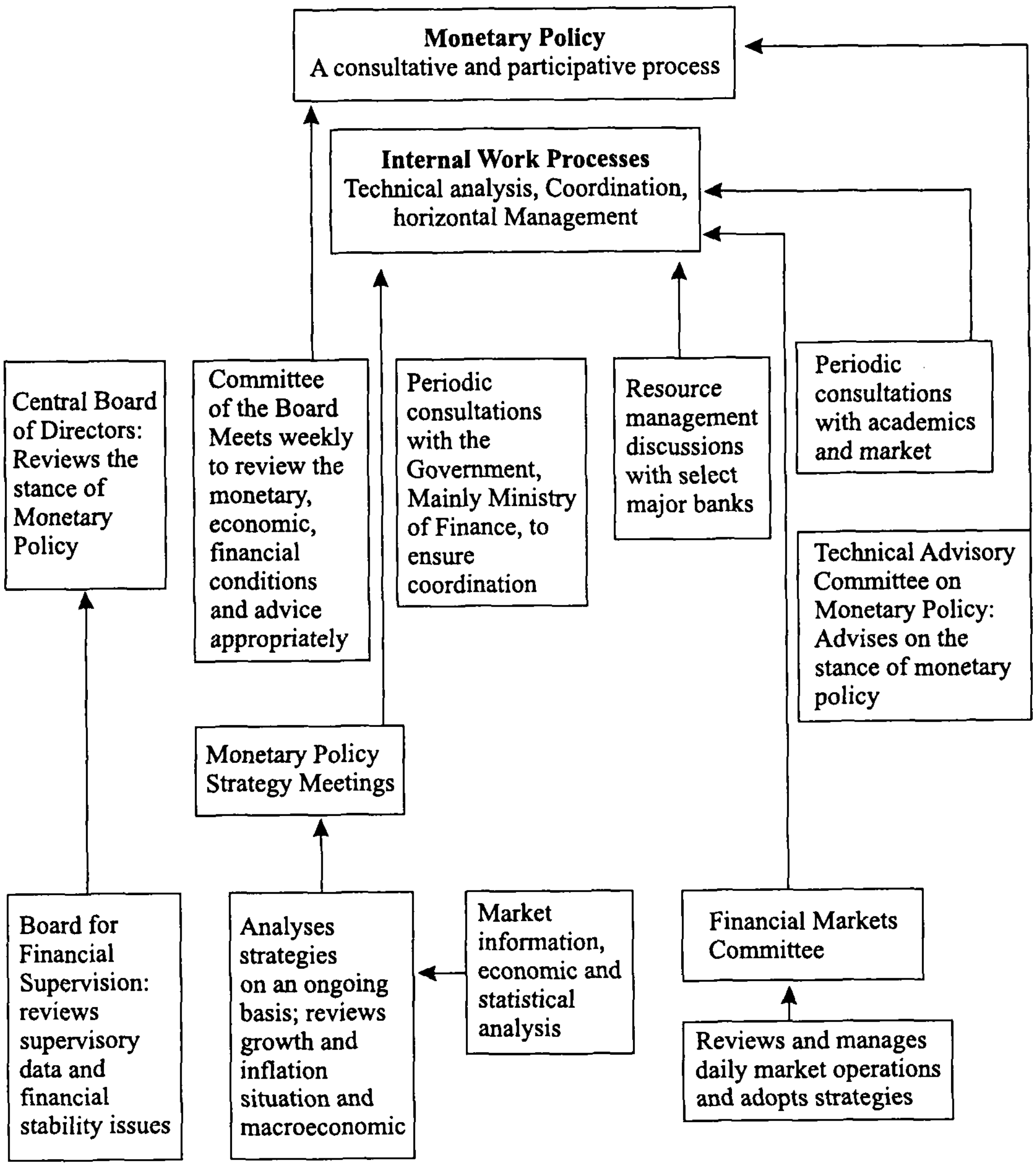
In order to make the monetary policy farsighted, the Multiple Indicators approach has evolved further. The Multiple Indicators Approach has been augmented by use of forward looking indicators and a panel of time series models (Mohanty 2010a). These forward looking indicators are drawn from the Reserve Bank's Industrial Outlook Survey, Capacity Utilization Survey, Professional forecasters' Survey and Inflation Expectations Survey. The assessment from these indicators and models feed into the projection of growth and inflation for the purpose of monetary policy action. This framework of monetary policy is termed as the 'Augmented Multiple Indicators Approach' and is illustrated in Figure-2 (Mohanty 2010a, p531).

Figure-2: The Augmented Multiple Indicators Approach



Besides the abovementioned changes in the framework of the monetary policy, Mohanty (2010b) further throws light on the recent and significant developments in the process of monetary policy formulation. He states that, the process of monetary policy in India had traditionally been largely internal with only end product of action being made public but this process has now become more consultative, Participative and articulate with external orientation. A comprehensive view of this participative process has been illustrated in Figure-3 (Mohanty 2010b, p8).

Figure-3: Processes of Monetary Policy Formulation



CONCLUDING REMARKS

In the pre reform era the impact of the monetary policy on the output and prices was essentially guided by the way commercial banks responded to the monetary policy stance. The focus of the monetary policy was on managing variations in the money supply (M3) which was adopted as the intermediate target to fulfill the final objectives of the monetary policy. This policy regime worked in an economy which was until then globally alienated and the financial sector was narrowly confined to the commercial banking system. This has been termed as the Monetary Targeting approach. But, the liberalization of the financial sector and globalization of the economy increased the susceptibility of the economy to external shocks by way of transmission of overseas business cycles; imported price fluctuations and volatility of capital flows. The emergence of a globally integrated economy necessitated and thereby brought about a change in the various dimensions of the monetary policy framework namely, its objectives, transmission channels, operating instruments, its approach and process of formulation in order to make its action effective in minimizing undesirable fluctuations in the economy.

In the current times, the reserve bank is entrusted with not only its traditional objectives of stabilizing prices and regulating credit flows but also with the responsibility of maintaining financial sector stability . In this context, a significant development has been the fading away of the fiscal dominance of the monetary policy, with the doing away of monetization in April 1997.The enactment of the FRBM Act, 2003, has also eased pressures on the RBI to support the government borrowing programme. This has helped in independent execution of the monetary policy. There has also been a diversification in the array of operating instruments used by policy makers to transmit appropriate signals to the real sector .The introduction of the LAF has greatly improved the reserve banks liquidity management capability .The monetary policy approach too has evolved according to the needs of a deregulated and liberalized economy with the 'Monetary Targeting approach' being replaced by the 'Multiple Indicators Approach' and with further refinement in the form of an 'Augmented Multiple Indicators Approach'. These changes in the monetary policy framework in India have made the operation of monetary policy based on multiple indicators rather only money supply and also made it forward looking in order to adequately and timely respond to the domestic as well as overseas fluctuations.

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END NOTE

[1]The impossible trinity refers to the constraints imposed by capital flows on macroeconomic policy. The famous trilemma from the Mundell-Fleming model states that countries cannot simultaneously fix their exchange rate, have open capital account and pursue an independent monetary policy.

[2]Automatic Monetization of deficits through ad hoc Treasury Bills was abolished in India and a system of Ways and Means Advances (WMA) was introduced in 1997.

[3]The FRBM Act laid down targets for reducing the governments' revenue deficits to zero and the fiscal deficit to 3% of GDP by the year 2008-09 in a phased manner beginning 2004-05.