Y V Reddy: Current concerns and some perspectives on inflation

Concluding remarks by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Institute for Development Research in Banking Technology (IDRBT), Hyderabad, 27 August 2004.

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Dear Shri Bajpaiji, Shri C. S. Rao garu, Shri Kamesam, Dr. Gulati and friends,

At the outset, I am thankful to the Institute for inviting me to this function and giving the pleasure of being with you all. The programme clearly says that I have to give some concluding remarks. This makes it clear that my presence is essentially ceremonial - hand over the certificates to the bright young people and just give a few remarks, basically perhaps because the Reserve Bank of India (RBI) funds this Institute. I think it is a very wise thing for the Institute for Development Research in Banking Technology (IDRBT) to express thanks to those who fund and cultivate those who matter. I will, however, take the opportunity to make some comments on current concerns on inflation.

Financial regulation

To begin with, there will be a few comments on the addresses delivered today and then some reference to the IDRBT. Shri C. S. Rao, Chairman, Insurance Regulatory and Development Authority (IRDA) emphasised the synergy that is developing between banking and insurance. There are two elements here - one from the macro-side and the other from the operational or the micro-side. India's contractual savings and long-term savings are rather low, which is why we are not able to invest heavily in infrastructure, and that is the macro part where insurance has a critical role. The second part is that much of business in our country is not really covered by insurance. The growth of economic activity requires risk-mitigation and the classic case is agriculture in India. So if we don't have the risk mitigation measures, the capacity for increasing the economic activity gets constrained. We pride ourselves that financial sector reforms in India started early in the reform cycle, but within the financial sector, the insurance reforms came in rather late in the cycle. Hence, there is enormous scope for expansion in that area. Shri Rao's focus on the linking of banks and insurance sector, taking advantage of the penetration that banks already have in the rural areas, is a remarkable approach and admittedly, it is extremely useful to use the technology in this process. We should work further on this and I am sure the banks, especially public sector banks, have great business potential too in bankassurance.

Shri Bajpai, Chairman, Securities and Exchange Board of India (SEBI) has covered in his address both historical perspective and cross-country perspective. As compared to most other countries, the extent of progress that has been made by our securities regulator in terms of technology penetration and safety measures is impressive and currently, absolutely world class. SEBI should be proud of that. As we go along, there is a need to be abreast of the global developments and at the same time integrate it into our own unique socio-economic circumstances.

There are two issues - one is at the operational level and the other is the overall stability issue in regard to the role of the financial regulators - and on both these counts, by and large, we have every reason to be proud of our achievements. We withstood the external and domestic challenges as well as economic and political ones in the last ten years. India emerges from the 1990s, as an island of financial stability in a sea of turbulence among the emerging markets and the credit goes to all who have been participants in this venture of improving the financial system.

On IDRBT

As regards the activities of IDRBT, we are heralding a customer-centric national switch for ATMs. This, I believe, facilitates access to a large number of ATMs of different banks. IDRBT has taken major steps to herald an IT revolution in the financial sector in a brief span of about eight years. Another excellent initiative is the University-Industry collaboration and both the M.Tech. Programme and the PGPBTM Programme are significant contributions. Undoubtedly, the IDRBT will have a proper balance between research, training and IT infrastructure provisioning for the benefit of the financial sector as a whole. India boasts of excellence in the development of computer software, and the entire world's financial sector sources its software from Bangalore, Hyderabad, Pune, etc. Perhaps, there is some merit in our trying to get advantage of this expertise being provided by various centres. IDRBT can play a role by creating a forum in which the software industry and the hardware industry that are setting global standards are able to serve the financial sector domestically also. And whatever we try to do, we have to be very careful about the quality of services and it is hoped that IDRBT will introduce, if it has not already introduced, and also upgrade the mechanisms by which there is an assessment of the quality of services IDRBT is providing.

RBI and technology

Some mention of the RBI's work with regard to technology will be in order in this forum. An important contribution of the RBI to the development of technology is indeed the establishment of this Institute. The major achievement in the last one-year is the Real Time Gross Settlement (RTGS). Between the timetable and making sure that it works right, we gave preference to making sure that it works right which resulted in some delay but by and large we are on track. Within three months of the introduction of the RTGS, the system has been able to settle almost 90% of the inter-bank funds transfer, which were being earlier routed through the net-settlement based inter-bank clearing at Mumbai. The year also witnessed the introduction of what is called the Special Electronic Funds Transfer (SEFT), which provides for transfer of funds in the electronic mode on the same day basis with multiple daily settlements. The RTGS and SEFT are together able to cover about 2500 branches of banks in around 200 cities. No doubt, there is still lot of scope for further improvement.

It is appropriate to mention the items on the RBI's agenda on technology matters. One of course is the expansion of the reach of the RTGS and what is most important is to make sure that it not only increases its reach but also works well. Secondly, the National Electronic Funds Transfer needs to connect almost all branches in the country using the SFMS and the INFINET. The third is enhancing the level of security in the Payment and Settlement System. We should accord the highest priority to security in all IT-related matters, particularly in the financial sector, because they are all inter-related and if security is breached in one place, it is quite possible that this spreads into the other areas. The fourth relates to the conduct of clearing and settlement at the national level through a national settlement system. Introduction of cheque truncation system on a pilot basis in the National Capital Region is an important task. There are also some proposals related to the risk mitigation schemes for deferred net settlements system. In this regard, we are also pursuing the idea of having a semi-autonomous Board for Payments and Settlements. Ultimately, there should be a separate legislation governing the Payments and Settlements System.

To provide a roadmap to attain these goals, the RBI has decided to start the preparation of a new vision document on technology. The new vision document will encompass the consolidation of progress made and also show the way forward. As soon as the preliminary draft is prepared, we will be able to submit it to a group of multi-disciplinary professionals, both from the user-side and the technology-side and it will invite your advice and guidance. This vision document will be put in the public domain in the draft stage itself.

On the current macroeconomic situation

In view of the widespread interest in the current inflationary environment, I will make a brief presentation on the current macro-economic situation with particular reference to inflation.

If you recall, a few weeks ago I had made a brief statement on the concerns relating to inflation. At that stage, it was submitted that there were both global and domestic factors working, predominantly global but some domestic factors - which are driving the current inflation. I had also mentioned about both the supply and demand factors and that the rise in headline inflation was predominantly a result of supply-shock. In terms of policy response it was indicated that (a) we are monitoring the developments carefully; and (b) we respond to the development on an ongoing basis with a view to ensuring price stability.

This is as good a statement today as it was a few weeks ago. But there are certain developments since then, and it is my duty to place them before you.

First, a number of fiscal actions have been taken in particular relating to oil. The impact, you may not find the impact of these actions today or tomorrow, but it is very clear that there is a determined fiscal response which has been initiated and which will be continued as necessary. This should help contain inflationary expectations.

Second, there is a new development in Indian situation. It is that the corporate houses have taken upon themselves the importance of maintaining certain amount of price stability. The industry and trade have taken initiatives in terms of looking at what may be called the broader interest. In terms of pricing power, there are occasions when the corporate sector may not use the full pricing power in the short-run to gain immediate advantage keeping in view a longer term perspective. This realisation is evident among our corporates and I am sure it is happening among the larger trading community also. These attitudes and actions do contribute to moderating inflationary outcomes and, more importantly, expectations.

Third, we had a series of discussions in the recent past with the financial industry associations and the leading bankers. We had extremely fruitful discussions and the major advice that came forward from the banking community and the financial sector is to try and reduce volatility. All of them agreed that it is in the interest of everybody that we minimise volatility in the financial markets and in public policy minimise knee-jerk reactions, while focussing on price stability and the underlying inflation.

Fourth, in the domestic circumstance, there is a truckers' strike and there are fears of strike adding to inflation. It must be recognised that there may be some increase in the numbers relating to headline inflation for those few weeks. I would, however, describe the truckers' strike to be in the nature of a "temporary supply disruption in certain localities" rather than something that should influence the inflationary expectations or the approach to price stability. It is this distinction that is required when we are analysing the type of policy responses.

Fifth, as far as the financial markets are concerned, the money markets have been reasonably stable and the forex markets have also been stable. In the government securities market, however, there have been certain concerns. The RBI is aware of the situation and the market participants have made several suggestions to minimise volatility or adverse impact, and these are being examined at the operational level. We in RBI are trying to see that there are no avoidable uncertainties in policy, while mitigating undue pressures on the functioning of markets without undermining market efficiency.

Positives getting more positive

But in all this, while it is true that we should be concerned about the current rise in headline inflation, we should not forget the positive side, and in my view, the positive side seems to be getting a bit more positive in the last two-to-three weeks. How is that so?

First and foremost, there is virtually a national consensus that high inflation is not good and that it should be brought down. Whether it is political leadership, whether it is economic agents, whether it is bankers, whether it is regulators - among everybody there is a national consensus that it is not good to have persistent highs in prices and that everybody should consider the common long-term interests in maintaining price stability. So, there is a national consensus on the issue and several actions have followed from all sections wherever it was warranted and there have been no knee-jerk reactions.

Second, there is good news, in the sense that generally in India democratic pressures ensure that the inflation doesn't go above the two-digit mark. But now, we find that inflation tolerance has come down. The society, the economic agents and the market participants are now reacting to a lower headline inflation, which is a good thing because if we want a sustained strong growth, it is necessary to rein in inflationary expectations. It is necessary to ensure price stability and what is the best way to ensure price stability? Everybody should work towards the same goal including the RBI and that is possible when there is a consensus in this regard. There is a virtual national consensus today that tolerance to inflation has come down and that definitely people are unhappy if it is higher and so it must be brought below that level as soon as possible. This indeed is good news because the economic agents are now factoring in this consensus as a possible factor governing future policies and expectations relating to price stability.

Third, the changing scenario on interest rates is also good news. For long, we had planned systems and we had administered interest rates with some amount of comfort for everyone. In the last five to six years, we had reduction in the interest rates. As the interest rates went down and down over the recent years, we were not fully sensitive to the fact that there is something known as interest rate cycles. So, for the first time, the market participants have got a feel of this interest rate cycle. No doubt, the RBI has been mentioning this in its analysis, but for many it looked like the usual central bank analysis and caution - like a grandfather always cautioning to be careful while crossing the road.

But the reality of the reform process is that there will be interest rate cycles even within an overall stable situation and consistent with overall macro-stability. That cycle is being experienced by the market participants for the first time, with the result that the market participants are now able to input these uncertainties more consciously and factor the type of risk they have to face in their conduct of business. So from the central bank's point of view, it is our endeavour to facilitate - it is not our endeavour to say we told you so - the new environment by working together to see that the appropriate systems to withstand interest rate cycles are more consciously built. In a meeting with bankers a couple of days ago, we have more or less come round to the view that the system should be made to get accustomed to the interest rate cycles.

Fourth, the prospects for real sector are looking better. In the current fiscal, in terms of the numbers, the investment activity is picking up whether one talks of capital goods imports, or one talks of capital goods production. The off-take in the non-food credit in this fiscal has been very impressive. These developments mean that the output should in the normal course grow. So, the output is likely to grow in the next few months and that is in many ways the time-frame which we have to look at in regard to the price levels. One should recognise that ultimately inflation is the result of interplay between the supply side such as productivity, quantum of output and investment activities, and the demand side. So, I would consider the supply side domestically being more positive.

Fifth, as a positive, our exports are growing impressively. We are usually worried that the oil bill is going up but the exports are also going up and so, at least the impact on balance of payments is not as much as we would have apprehended. Hence, we are less uncomfortable in facing the oil price hikes.

Analytics for policy response

In this background, it will be useful to look at the analytics that should govern the policy response.

As between the international and domestic factors that influence the current tendency for a rise in the headline inflation in our country, the international factors continue to be dominant. The international factors relate primarily to oil but also, to some extent, other commodities and financial markets, including interest rates and exchange rates. At the same time, there have been positive developments on the domestic front. These relate to improved outlook on monsoon and pick up in the investment activity. Clearly, therefore, the dominance of international factors in the current price rise and the importance of stability governing domestic economy continue to warrant a measured response to ensure price stability and contain inflationary expectations.

As between supply and demand factors, the evidence clearly continues to be that the increase in inflation is largely on account of supply shock. As regards demand factors, the growth in broad money as well as the reserve money has moderated. There is evidence of gradual unwinding of overhang of liquidity. There may be some transient impact of the truckers' strike on inflation but this need not be treated as a lasting supply shock. In any case, there is no clear evidence that there has been any aggravation on the demand side. On balance, therefore, while the situation has to be watched carefully in terms of the balance between supply and demand factors, the current situation seems to be not much different than what it was diagnosed to be some time ago, viz., significantly a supply side shock.

As regards inflationary expectations, there is a new dimension to the understanding of inflation itself. There is recently a sophisticated debate on the issue of appropriate index of inflation. Analysts have pointed out that the wholesale price index (WPI) of India is similar to producers' price index in other countries and that in other countries, the headline inflation is usually the consumer price index (CPI). More important, internationally, empirical evidence shows that wholesale price or producers' index tends to be more volatile. It may be necessary to capture these nuances and their relationship with policy response in the context of inflationary expectations.

It will be interesting to recall the experience of rise in headline inflation and divergence between WPI and CPI in our country. Over the last five years average WPI inflation, on a weekly basis, was 4.6 per cent and CPI inflation was lower at 3.9 per cent, on a monthly basis. In the recent years, the year-on-year WPI inflation rate was higher in the range of 6.0-9.0 per cent during most parts of 2000-01. Again, inflation remained high in the range of 6.0-7.0 per cent for sometime during 2003-04. As these inflationary episodes were considered to be largely caused by supply side factors, the inflation rate reversed itself quickly once the supply situation stabilised. While the headline inflation responds to both supply shocks and demand pressures, the nature of response could be quite different. The response of inflation to supply shocks is quick but transient. The response to demand shocks on the other hand, is more subtle but persistent. As indicated in the annual monetary and credit policy Statement for the year 2001-02, a factor which complicates the conduct of monetary policy during certain periods is the difficulty in correct assessment of the potential inflationary pressures based on the available data for the current period. While there are uncertainties, it is perhaps useful to look at the recent inflation history for an assessment of inflationary expectations.

The monetary policy stance in other countries is also trying to respond to the oil price shock. In many countries there has been a shift in monetary policy stance from easy to a more neutral one. In most countries, there is very little evidence of cognisable monetary policy response to the oil price hike *per se*. In view of the linkages between domestic and international economy, the monetary policy responses of other countries, particularly the developed ones, have also to be carefully watched.

Most important, there is a reassurance that in the context of current rise in inflation all are on the same side, viz., on the side of price stability. The fiscal authorities, monetary policy, the financial markets and corporates are committed to the objective of price stability and minimising volatility. In this background, therefore, RBI will continue its dialogue with market participants to fine tune its response to minimise volatility while emphasising the importance of Reserve Bank's credibility in maintaining price stability consistent with the compulsions of the growth dynamics in our country at this juncture.

Thank you.