

Globalisation, financial markets and the operation of monetary policy in India

Rakesh Mohan¹

Monetary policy in India underwent significant changes in the 1990s as the Indian economy became increasingly open and financial sector reforms were put in place. In the 1980s, monetary policy was geared towards controlling the quantum, cost and direction of credit flow in the economy. The quantity variables dominated as the transmission channel of monetary policy. Reforms during the 1990s enhanced the sensitivity of price signals from the central bank, making interest rates the increasingly dominant transmission channel of monetary policy in India.

The openness of the economy, as measured by the ratio of merchandise trade (exports plus imports) to GDP, rose from about 18% in 1993-94 to about 26% by 2003-04. Including services trade plus invisibles, external transactions as a proportion of GDP rose from 25% to 40% during the same period. Along with the increase in trade as a percentage of GDP, capital inflows have increased even more sharply: foreign currency assets of the Reserve Bank of India (RBI) rose from USD 15.1 billion in March 1994 to over USD 140 billion by March 15, 2005. These changes have affected liquidity and monetary management. Monetary policy has responded continuously to changes in domestic and international macroeconomic conditions. In this process, the current monetary operating framework has relied more on outright open market operations and daily repo and reverse repo operations than on the use of direct instruments. Overnight interest rates are now gradually emerging as the principal operating target.

With the continuing increase in foreign currency assets accompanied by sterilisation, the balance sheet of the Reserve Bank has undergone changes in its asset and liability structure, which in the current situation is posing a challenge. Against this backdrop, the recent developments in monetary policy in India are reviewed in three parts, particularly focusing on its continuing evolution as the economy becomes more open. Section I briefly outlines the monetary policy framework and how it has evolved recently. Section II focuses on the management of interest rates and exchange rate in the face of sustained capital inflows. The final section flags the dilemmas and policy challenges.

1. Monetary policy framework

The framework of monetary policy in India is signaled by regular semiannual statements: the Annual Monetary and Credit Policy Statement in April/May and the Mid Term Review in October/November. However, monetary measures are taken promptly and effectively, whenever required, to respond to ongoing developments in both the domestic and global markets. The two formal statements serve several purposes. They provide a framework for or supplement to the monetary and other relevant measures that are taken from time to time in response to events affecting macroeconomic assessments, in particular relating to fiscal management as well as seasonal factors. They also set out the logic, intentions and actions related to the structural and prudential aspects of the financial sector. The biannual statements thus enhance transparency, improve communication and contribute to an effective consultation process.

The preamble to the Reserve Bank of India Act sets out the objectives of the Bank as being “to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage”. Although there has not been any explicit legislation for price stability, the twin objectives of monetary

¹ Dr Rakesh Mohan was Deputy Governor of the Reserve Bank of India till October 2004. Currently he is Secretary, Department of Economic Affairs, Ministry of Finance, Government of India.

policy in India are (i) price stability and (ii) provision of adequate credit to productive sectors of the economy. With the increasing openness of the Indian economy, greater emphasis has been given to strengthening the institutional capacity to support growth consistent with stability in the medium term. On balance, price stability has evolved as the dominant objective of monetary policy for sustaining economic growth and ensuring orderly conditions in the financial markets. The underlying philosophy is that it is only in a low and stable inflation environment that economic growth can be sustained. Monetary policy also aims to support growth by ensuring that the credit requirements of various segments are met through an appropriate credit delivery and pricing mechanism and the development of a credit culture that is conducive to market development.

Between the mid 1980s and mid 1990s, India followed a monetary policy framework which could broadly be characterised as a flexible monetary targeting approach. Under this approach, growth in broad money supply (M3) was projected in a manner consistent with expected GDP growth and a tolerable level of inflation. The M3 growth thus worked out was considered a nominal anchor for policy. Reserve money (RM) was used as the operating target and bank reserves as the operating instrument. However, as deregulation increased the role of market forces in the determination of interest rates and the exchange rate, the monetary targeting framework came under stress. By increasing liquidity, capital flows put upward pressure on the money supply. There was also increasing evidence of changes in the underlying transmission mechanism of monetary policy. With pricing decisions left to market forces, interest rates and the exchange rate gained in importance vis à vis quantity variables. Most studies in India showed that money demand functions had been fairly stable. However, it was felt that the financial innovations that had recently emerged in the economy provided some evidence that the dominant effect on the demand for money in the near future need not necessarily be from real income, as it had been in the past. Interest rates do seem to exercise some influence on the decision to hold money. Accordingly, the monetary policy framework was reviewed towards the late 1990s, and the Reserve Bank has switched over to a more broad-based multiple indicator approach since 1998-99. In this approach, policy perspectives are obtained by looking at interest rates or rates of return in different markets (money, capital and government securities markets), high frequency data such as currency, credit extended by banks and financial institutions, fiscal position, trade, capital flows, inflation rate, exchange rate, refinancing and transactions in foreign exchange, and output data. However, for simplicity and greater understanding, the biannual statements still set out the framework in terms of money, output and prices.

Efforts initiated in the late 1980s to develop the money market were intensified in view of the critical role it plays in facilitating the conduct of monetary policy and in improving the transmission mechanism. The government securities market has been developed since the early 1990s. Along with the use of an auction-based system, this has enabled price discovery and improved the fungibility and liquidity of the market. Measures have been initiated to integrate the Indian forex market with the global financial system, with increasing freedom given to banks to borrow abroad and fix their own position and gap limits. With increasing market orientation, the monetary policy statements have been focusing on structural and regulatory measures designed to strengthen the financial system and to improve the functioning of various segments of the financial market. These measures, introduced after extensive consultations with experts and market participants, have been directed towards increasing the operational effectiveness of monetary policy, redefining the regulatory role of the Reserve Bank, strengthening the prudential and supervisory norms, improving the credit delivery system and developing the technological and institutional framework of the financial sector. The interaction of technology with deregulation has also contributed to the emergence of a more open, competitive and globalised financial market.

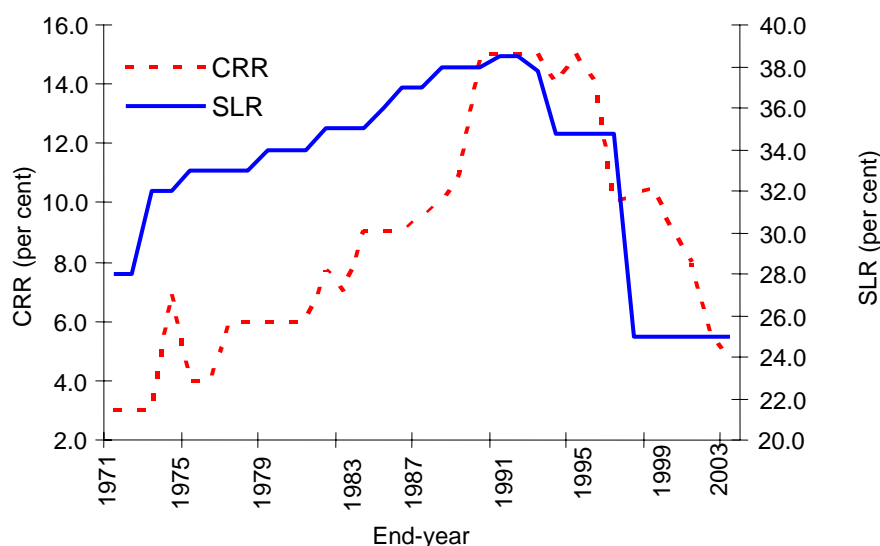
The reform of the monetary and financial sectors has enabled the Reserve Bank to expand the array of instruments at its command and enhanced its ability to respond to shocks. The efficacy of monetary policy has also improved as a result of a conscious effort to progress from direct instruments of monetary control to indirect instruments.

Over the years, the reliance on reserve requirements, particularly the cash reserve ratio (CRR), has been reduced as an instrument of monetary control. The CRR has been brought down, notwithstanding intrayear variations, from a peak of 15% in 1994-95 to 5% currently.² The objective of

² The prescribed CRR reached a low of 4.5 per cent in June 2003 before being revised to 5 per cent in two stages in September/October 2004. This increase in CRR was necessitated, partly for absorbing liquidity in the system, but more

policy is to reduce the CRR to its statutory minimum of 3% over a period of time. During the 1980s, the financial markets were highly segmented and controlled and the interest rates in the government securities market and the credit market were tightly regulated. Credit was extended to the Government by mandating the maintenance of a minimum statutory liquidity ratio (SLR) whereby the commercial banks set aside substantial portions of their liabilities for investment in government securities at below market interest rates. The SLR, which had increased to about 37.5% in the beginning of the 1990s, was brought to its statutory minimum of 25% by October 1997 (Graph 1). The rates of interest on government securities are also determined by the market through an auction process. Though banks continue to hold a substantial part of their portfolio in government securities, more than the statutory minimum, it is more as a result of their risk perception and portfolio choice than of statutory compulsion. The RBI has also made a proposal to the Government to amend the Reserve Bank of India Act and the Banking Regulation Act so as to allow the Reserve Bank greater flexibility to reduce the CRR and SLR below the current statutory minimum, if the monetary situation so warrants.

Graph 1
Reserve requirements



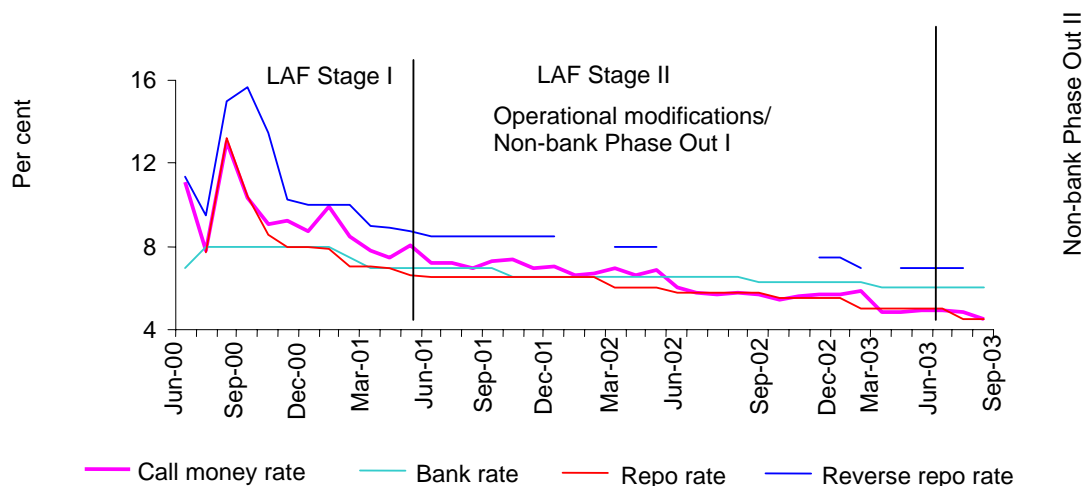
As reliance on direct instruments of monetary policy has declined, liquidity management in the system has been increasingly carried out through open market operations (OMO) in the form of outright purchases/sales of government securities and daily repo and reverse repo operations. The OMO are supplemented by access to the Reserve Bank's standing facilities and direct interest rate signals through changes in the Bank rate/repo rate. A liquidity adjustment facility (LAF) was introduced in June 2000, which has emerged as the principal operating instrument of monetary policy. The LAF enables the RBI to modulate short-term liquidity under varied financial market conditions in order to ensure stable conditions in the overnight (call) money market. The LAF operates through daily repo and reverse repo auctions that set a corridor for the short-term interest rate consistent with policy objectives (Graph 2). Although there is no formal targeting of overnight interest rates, the LAF has enabled the Reserve Bank to de-emphasise targeting of bank reserves and focus increasingly on interest rates. This has also helped in reducing the CRR without engendering liquidity pressure.

A number of reforms have been implemented in the financial sector and monetary policy has evolved with increasing globalisation. However, monetary policy has had to contend with a sustained high fiscal deficit and mounting debt accumulation. The fiscal position of both the Central and State

importantly for signalling the Bank's concern at the unacceptable level of inflation and also to keep the stability in financial market condition.

Governments was under stress throughout the 1980s and 1990s. The combined gross fiscal deficit (GFD) reached a level of 10% in 1990-91, compared with 7.9% 1980-81. There was some evidence of fiscal correction during the first half of the 1990s in terms of a fall in the fiscal deficit and public debt. Subsequently, however the fiscal situation deteriorated with the combined deficit hovering around 10% during the second half of the 1990s. The average combined GFD/GDP, which was 8% during 1981-82 to 1989-90, did improve to 7.4% during 1990-91 to 1996-97, but thereafter deteriorated sharply to 9.0% during 1997-98 and 2004-05. The slippage in the deficit was also reflected in the large growth in government borrowing.

Graph 2
Evolution of the liquidity adjustment facility



In most circumstances, the spillover effect of a high fiscal deficit would be reflected in a large current account deficit and inflation. However, this period was marked by dampened investment demand from the private sector accompanied by high private saving. As a result, the overall saving-investment gap narrowed, and the current account deficit was small; it turned into a modest surplus during 2001-02.

As manager of public debt, the RBI is responsible for ensuring smooth implementation of the Government's market borrowing programme. Reforms have deepened the government securities market. In the context of the continued large market borrowing programme of the Government, the Reserve Bank has on occasion accepted private placement of government securities along with open market operations. This policy meets the twin objectives of managing liquidity in the system and containing volatility in the secondary market. The release of government securities into the market thereafter serves to modulate both liquidity and interest rate volatility. This approach has helped in balancing monetary policy objectives with debt management objectives and in the process has imparted stability to the financial market. Further, the continuing foreign exchange inflows and moderate demand for credit from the corporate sector have enabled the Reserve Bank to maintain relatively low interest rates in spite of a high fiscal deficit.

Since 1997, in addition to maintaining low inflation, monetary policy in India has been concerned with the revival of investment demand. Accordingly, monetary policy has focused on ensuring adequate liquidity and has favoured low and flexible interest rates. This monetary policy stance has been signaled through cuts in the Bank rate, LAF rates and the CRR. The pace and magnitude of easing has, however, been conditioned by the need to ensure macroeconomic and financial stability, particularly in the context of continuing large external capital flows. The successive annual policy statements and mid-term reviews of the RBI have also highlighted the structural and regulatory measures required to strengthen the financial system. These measures have been adopted in order to increase the operational efficacy of monetary policy, redefine the regulatory role of the Reserve Bank, strengthen prudential norms and develop the technological and institutional infrastructure.

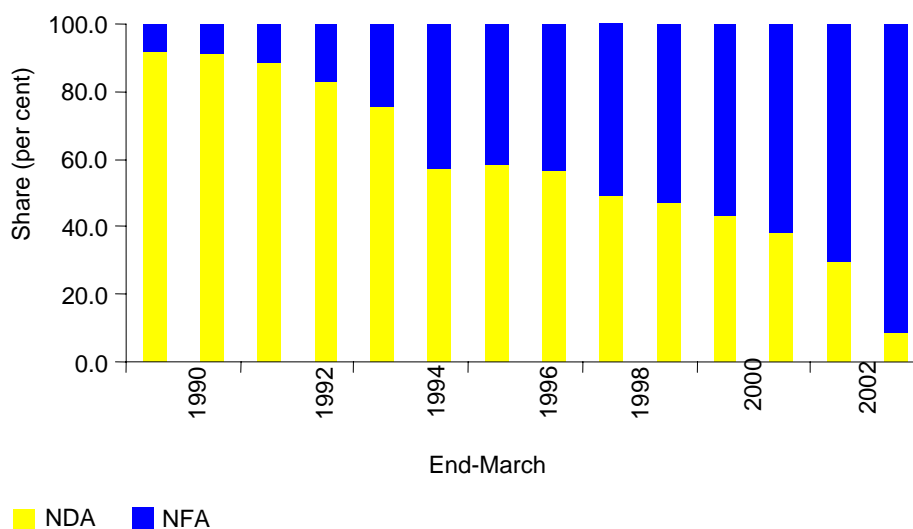
2. Management of capital inflows

Following the adoption of structural reforms and external liberalisation in the early 1990s, the Indian economy experienced surges of capital inflows; an indicator of the consequences of globalisation. Net capital inflows increased from an average of USD 5.8 billion (INR 82 billion, or 2.2% of GDP) per annum during the second half of the 1980s to USD 9.1 billion (INR 354 billion, or 2.2% of GDP) per annum in the second half of the 1990s and to an average of USD 15.7 billion (INR 735 billion, or 3.1% of GDP) in 2002-03 2003-04. While the capital inflows eased the external financing constraint, they also posed dilemmas for the conduct of monetary policy. With overall surpluses in the balance of payments emerging as the dominant factor driving money supply, monetary policy action was needed to ensure that the pursuit of the final target of growth with price stability was not endangered.

The principal instrument for managing capital inflows in India has been sterilisation. In order to neutralise the expansionary impact of rising net foreign exchange assets (NFA) in the monetary base, the Reserve Bank resorted to open market sales of government securities from its portfolio. In this context, the operationalisation of the Market Stabilisation Scheme (MSS) has given an additional instrument for liquidity management. MSS is an arrangement between the Government of India and RBI to mop up the excess liquidity generated on account of the accretion to the foreign exchange assets of RBI to neutralise the monetary impact of capital flows. Under the scheme, RBI issues Treasury Bills/dated government securities by way of auctions and the cost of sterilization is borne by the Government. The ceiling on the outstanding obligations of the Government by way of issuance of such bills/securities under MSS was initially placed at Rs.60,000 crore in March 2004 but is subject to revision through mutual consultation and the ceiling is presently at Rs.80,000 crore. The bills/securities issued under MSS are matched by an equivalent cash balance held by the Government in a separate identifiable cash account maintained and operated by RBI and such balances would be appropriated only for the purpose of redemption and/or buy-back of the Treasury Bills and/or dated securities issued under the MSS. As on March 18, 2005, Rs.64,211 crore was mobilised under MSS. As a result, there has been offsetting movement between the NFA and net domestic assets (NDA) of the Bank (Graph 3). This could be gauged from the fact that the share of NFA in reserve money (RM) has risen from under 10% in March 1991 to over 123% now (as at March 25, 2005). Similarly, the NFA to currency ratio rose from about 15.0% to over 165.2% during the same period. Because of sterilisation operations, the growth in RM could be contained within the desired trajectory in order to avoid excessive money creation. Consequently, the average annual growth in RM in the recent 10 year period between 1994-95 and 2003-04 fell to 12.3%, from 16.8% in the preceding 10 years between 1980-81 and 1989-90. The growth of broad money supply was also lower, at 16.5% as against 17.2% during the comparable period. Thus, domestic money supply has remained by and large unaffected by the external inflows and consequent build-up of foreign exchange reserves.

Graph 3

Shift in domestic and foreign assets of the RBI



The conduct of discretionary monetary policy in the face of surges in capital flows has engaged considerable attention in the literature. A key issue is whether or not monetary policy is rendered ineffective by capital flows. Does the monetary stance (say, a tightening effected through reduction of NDA) get completely offset by the expansion of NFA on account of capital inflows? An examination of the offset coefficient - the response of NFA to (exogenous) changes in NDA - provides some clues. An offset coefficient close to unity would imply that the efforts to tighten monetary policy induce equal offsetting foreign inflows, leaving no scope for independent monetary policy. In contrast, an offset coefficient of zero would imply that the monetary authority has complete control over the money supply and, therefore, discretion in the conduct of monetary policy. Empirical studies show that the Reserve Bank has been able to offset the expansionary effect of foreign capital flows on domestic money supply, consistent with its macroeconomic objectives.³ While sterilised intervention appears to have been conducted successfully so far, there is also the critical issue of the exchange rate regime and the related issues of the quasi-fiscal costs of intervention and the level of domestic interest rates. Monetary policy has to contend with the reality that the speed of change in capital flows can be much greater than that in the current account, even if the capital account is not fully convertible.

India's current exchange rate policy has focused on managing volatility without a fixed rate target. The underlying demand and supply conditions are allowed to determine exchange rate movements over a period in an orderly manner. Recent international research on viable exchange rate strategies has lent considerable support to the exchange rate policy followed by India. In this context, the overall approach to the management of foreign exchange reserves has reflected the changing composition of the balance of payments, and has endeavoured to reflect the "liquidity risks" associated with different types of flows and other requirements. The policy of reserve management is thus judiciously built upon a host of identifiable factors and other contingencies. Such factors, include, inter alia: the size of the current account deficit; the size of short-term liabilities (including current payment obligations on long-term loans); the possible variability in portfolio investment and other types of capital flows; the unanticipated pressures on the balance of payments arising out of external shocks; and movement in the repatriable foreign currency deposits of non resident Indians (NRIs).

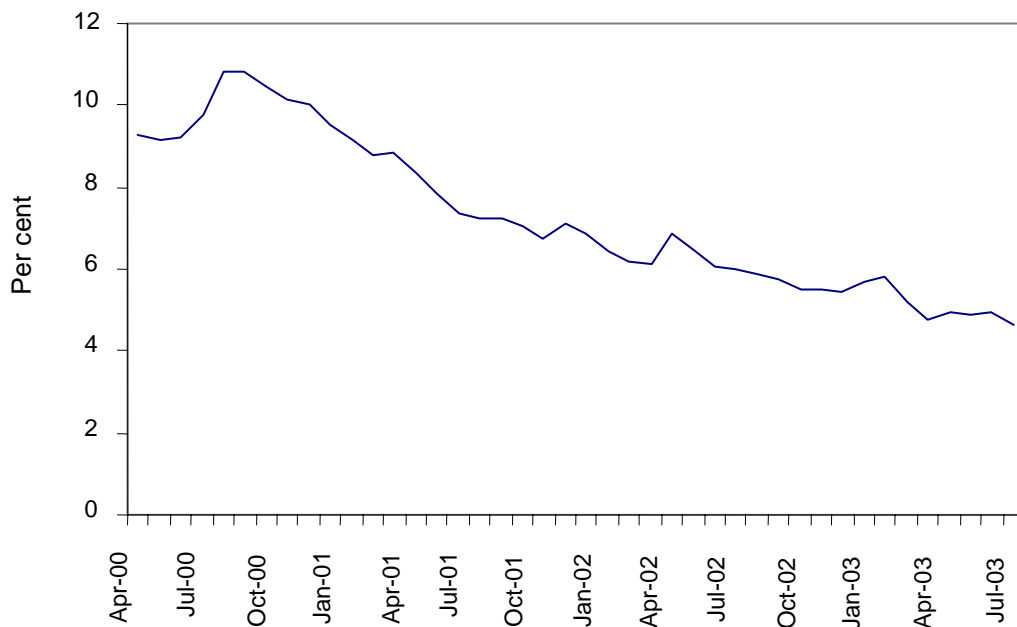
The substantial growth in reserves in the recent period has generated a welcome debate regarding the costs and benefits of holding reserves. In any cost-benefit analysis on this topic, it is essential to keep in view the objectives of holding reserves in emerging markets, which cover, inter alia: (a) maintaining confidence in monetary and exchange rate policies; (b) enhancing the capacity to intervene in forex markets; (c) limiting external vulnerability so as to absorb shocks during times of crisis; (d) providing confidence to the markets that external obligations can always be met; and (e) reducing volatility in foreign exchange markets. Sharp exchange rate movements can be highly disequilibrating and costly for the economy during periods of uncertainty or adverse expectations, whether based on problems that are real or imagined. For developing countries, these economic costs are likely to be substantially higher than the net financial cost of holding reserves. In this context, it is important to note that in India, in the last few years, almost the whole addition to reserves has been made without increasing the overall level of external debt. The increase in reserves largely reflects higher remittances, quicker repatriation of export proceeds and non debt inflows. Even after taking into account foreign currency denominated NRI flows (where interest rates are linked to Libor), the financial cost of additional reserve accumulation in India in the recent period is quite low, and is likely to be more than offset by the return on the additional reserves.

Notwithstanding sustained sterilised intervention, there has been an all-around reduction in interest rates in recent years to historically low levels. For example, the overnight call money rate fell from 13.06% in August 2000 to 4.86% in March 2005. The 91 day and 364 day Treasury bill rates fell from 10.47% and 10.91% to 5.37% and 5.61%, respectively. Secondary market yields on government securities with one year, 10 year and 20 year residual maturities declined from 10.82%, 11.47% and 11.61% to 5.67%, 6.66% and 7.08% respectively between August 2000 and March 2005. The interest rates on AAA rated corporate bonds also fell, from 12.1% in August 2000 to 7.14% in March 2005

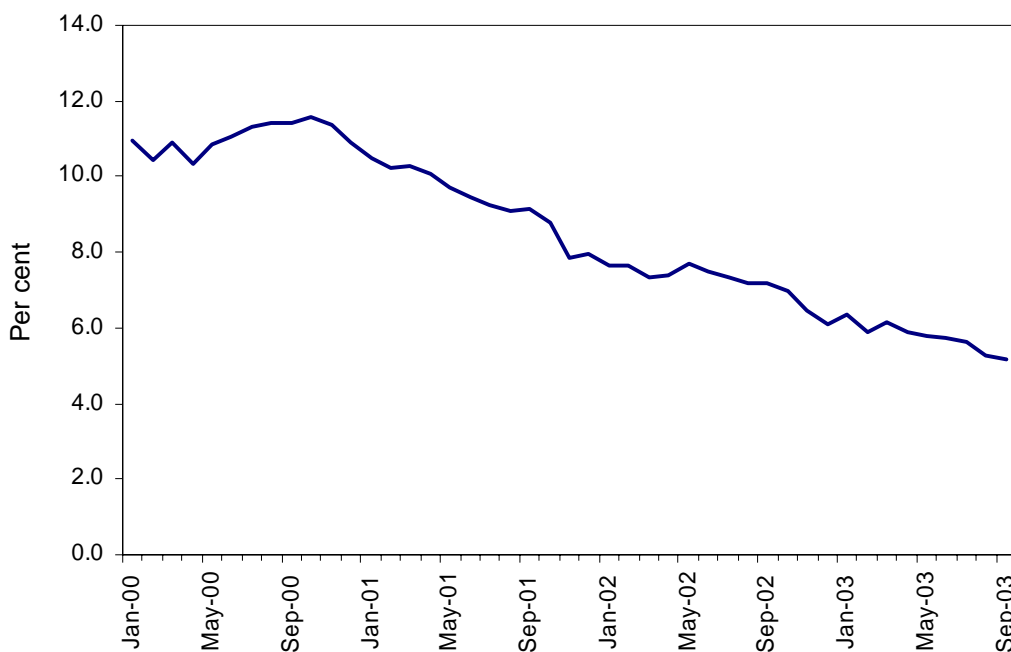
³ For India, the offset coefficient was estimated to be mildly negative (-0.3) over the period April 1993 to March 1997 suggesting that monetary policy (including sterilisation operations) was sufficiently independent of external factors to pursue domestic goals. Granger causality tests for the period April 1994 to March 2003 indicated a unidirectional causality from changes in NFA to NDA. Thus, capital inflows were not induced by domestic monetary conditions. Moreover, the sterilisation coefficient - the response of change in NDA to that in NFA - was (-)0.83. This implies that an increase of INR 100 in NFA attracted a policy response of sterilisation that drained away NDA worth INR 83 from the system.

(Graphs 4 to 7). The average cost of government borrowing declined from about 11% during 2000-01 to 5.96% in 2004-05 (up to December 15, 2004). Thus, contrary to conventional thinking, sterilised intervention has not resulted in an increase in interest rates.

Graph 4
364 day Treasury bill yield

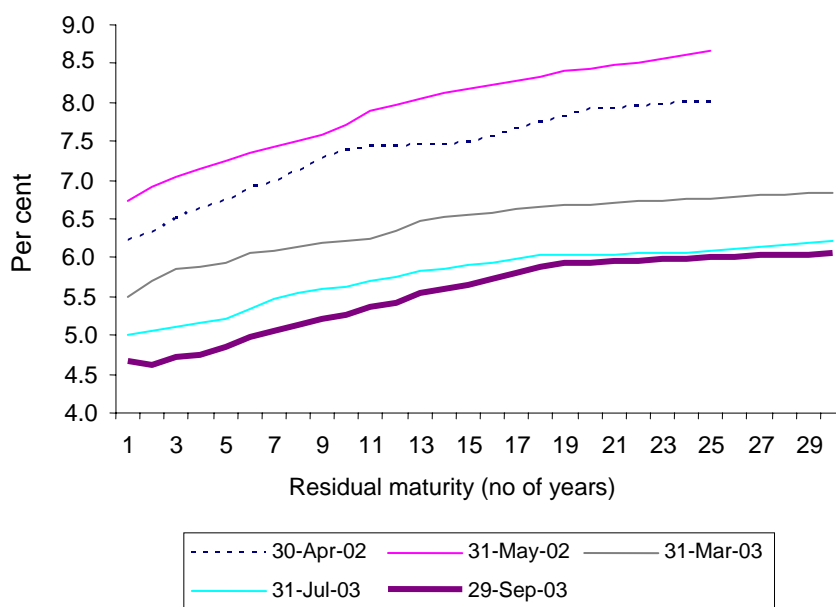


Graph 5
Yield to maturity of 10-year government securities



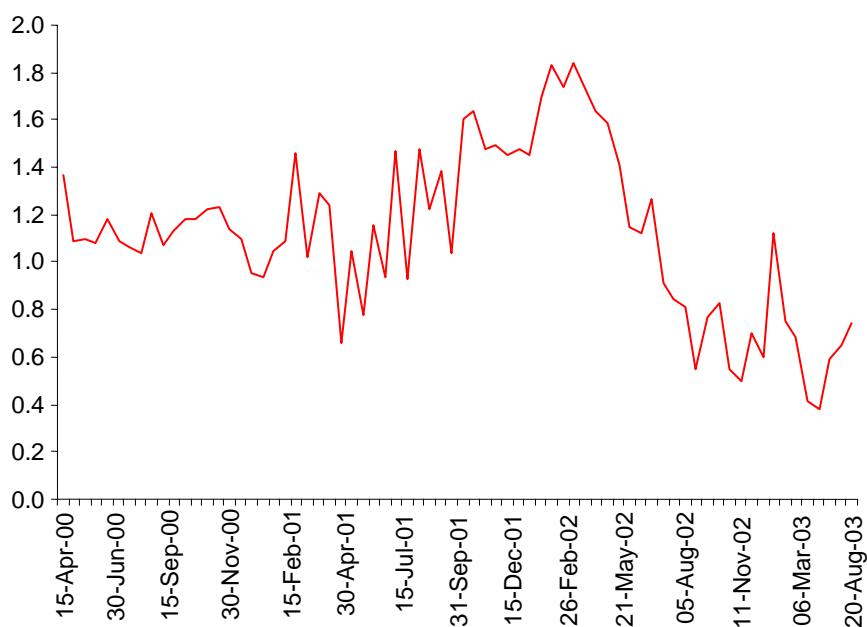
Graph 6

Yield curves for central government dated securities



Graph 7

Spread between AAA-rated corporate bond yield and yields on government securities (five-year)



3. Dilemmas and policy challenges

The current situation is characterised by large capital inflows, resulting in the rise of reserves to over USD 90 billion. The inflows are continuing to increase and are currently coming through foreign institutional investment. The RBI has been managing the monetary situation through a variety of measures including partial sterilisation through direct OMO and daily repo operations and reduction in non-resident deposit rates to remove arbitrage opportunities. The broad principle guiding exchange rate management has been the careful monitoring and management of exchange rates without a fixed target or a pre-announced target or a band. Thus, there is flexibility in the exchange rate together with ability to intervene, if and when necessary. Reflecting the large inflows of capital, the exchange rate of the rupee appreciated by about 4.8% between April and October 2003 from INR 47.50 to INR 45.32 against the US dollar. The surfeit of liquidity has enabled the Government to finance its borrowing at progressively lower rates. Since the demand for credit by the corporate sector has been low over the last two years, crowding out by the government sector has not occurred. Furthermore, many corporates are showing a preference to borrow in US dollars to take advantage of the low international rates as compared to the higher rupee lending rates by banks and expectations of exchange rate appreciation. This has also resulted in a lot of unhedged exposure, which might entail significant but unavoidable risks to some corporate balance sheets, possibly impacting the quality of banks' assets in some cases. Monetary policy is, therefore, currently focusing on consolidating the success achieved in recent years in reining in inflation expectations, ensuring liquidity is available to industry sectors which are showing signs of a pickup and a revival of investment demand, sensitising banks to the impact on their balance sheets of a possible change in monetary conditions due to a credit pickup, and being prepared for some moderation in capital flows if the stance of monetary policies of industrial countries moves from an easy or neutral to a relatively tighter regime.

The ultimate success of monetary policy could be judged in terms of inflation performance and the central bank's ability to maintain stable conditions in the financial market. The pursuit of price stability was central to the process of financial sector reforms initiated during the 1990s. Although inflation is not targeted per se, monetary policy was formulated with the stated objective of curbing inflationary expectations. The Indian inflation record over the past five decades can be considered satisfactory as compared with many developing economies, and performance improved significantly during the second half of the 1990s. The average headline inflation rate has come down to about slightly below 5.0% over the last five years as compared to the long period average of 7-8%. Apart from domestic factors, the decline in inflation coincided with the current phase of disinflation characterising the global business cycle. The guiding principle for inflation management continues to be that in the medium to long run, price increases largely reflect monetary expansion. In the short run, however, inflation could be affected by non-monetary factors, especially on the supply side. Consequent to the reduction in the inflation rate, inflation expectations have also come down. While the openness of the economy to international trade has partly contributed to the low inflation, more recently increases in oil and non-oil commodity prices have posed upside risks to inflation. Further, there are dangers of asset price inflation being transmitted through large capital inflows. Thus, notwithstanding sustained efforts over time to help build confidence in price stability, market sentiment can shift suddenly if prices increase noticeably. Hence, monitoring of international inflation and interest rates has become an integral part of monetary policy making.

The encouraging inflation performance has been reflected in falling interest rates. The monetary policy stance has been signaled through cuts in the Bank rate, the LAF rate and the CRR. The reduction in inflation and interest rates has occurred along with strong GDP growth, which averaged 6.2% a year over the last 10 years. In 2003, favourable monsoon rains and sustained industrial growth boosted the macroeconomic outlook. Even without the monsoon performance, the favourable macroeconomic outlook reflects the strong corporate results recorded during the last two years, due to lower costs and greater efficiency. As a result, even the current low domestic interest rates have been associated with strong capital inflows, particularly from NRIs. However, the fall in interest rates has only translated into falling yields in the financial markets. The full impact of the monetary policy stance on economic activity has been constrained by the structural rigidities in the financial system, especially on account of downward inflexibility in the interest rate structure and operating costs of financial intermediaries. In the credit market, lending rates for prime corporates and activities like housing have declined significantly, but noticeable reductions are yet to take place in other sectors. Monetary authorities face the dilemma of surplus liquidity in financial markets together with inadequate credit demand for financing sustained growth in the real sector.

Although the Indian financial markets have become increasingly integrated with the international markets, segmentation and inefficiencies in the market have given rise to risk-free arbitrage opportunities in certain types of deposits. The Reserve Bank, for instance, had to act on three occasions in 2003 to reduce the interest rates on non-resident external (NRE) deposit accounts and have aligned such deposit rates to US dollar Libor. The non-resident foreign currency (FCNRB) deposit rates are already linked to Libor/swap rates of respective currencies and maturities. In addition, overseas corporate bodies (OCBs) were no longer recognised as a distinct eligible class of investors in India. Certain restrictions were also placed on the operations of offshore banking units (OBUs). In addition, the Government of India prepaid foreign currency loans of about USD 3.0 billion to the Asian Development Bank and the World Bank by buying foreign exchange from the Reserve Bank. Similarly, the RBI made available USD 5.2 billion from its reserves to the State Bank of India (SBI) to redeem the entire stock of Resurgent India Bonds (RIBs) raised earlier to bolster India's foreign exchange reserves. Notwithstanding these recent initiatives to reduce foreign currency assets, the exchange rate vis-à-vis the US dollar has shown an appreciating trend in part because of the dollar's weakness vis-à-vis other major currencies and continued strong capital inflows on expectations of a positive economic outlook.

Economic theory suggests that when the nominal exchange rate is used as a nominal anchor, monetary policy goals are subservient to exchange rate policy. If the exchange rate is flexible, monetary policy is conducted by influencing the money supply and interest rates. In an open economy, the exchange rate and interest rate objectives became intertwined as real and monetary shocks are transmitted across national boundaries, making the conduct of monetary policy more challenging.

The Reserve Bank has so far been able to balance its objectives of exchange rate and monetary policy objectives by choosing an intermediate exchange rate regime coupled with sterilised intervention. Sterilisation imparts necessary flexibility to monetary policy to serve the domestic objective of low and stable prices and low and flexible interest rates. The reform process has impacted the Reserve Bank's balance sheet in terms of its asset composition and also created changes in the sources of revenue and expenditure. A scenario of continued capital inflows is likely to pose certain constraints in the operation of the current monetary policy stance.

Looking ahead, further refinements in operating procedures have to be carried forward, both for day-to-day liquidity management and for equitable delivery of credit. This becomes necessary in the context of the low interest rate stance and the need to maintain adequate liquidity in financial markets, while narrowing operating spreads in policy rates as well as market-related rates. With the progressive integration of different segments in the financial market, it should be possible in the medium term to fine-tune monetary policy operations to manage market conditions through a narrow interest rate corridor. With capital flows expected to remain strong, a key issue in the future would be greater innovation in the use of available instruments to deal with the expected strong capital flows. The RBI is conscious of the need to monitor international developments closely and carefully and fine-tune its policies and use of instruments to effectively counter emerging situations. In this regard, it is recognised that sterilisation is a first stage response for ongoing liquidity management until more durable policies can be put in place to absorb capital flows for the expansion of productive capacity. Furthermore, sterilisation has built-in costs and limitations. The growing internationalisation of monetary policy arising from the cross-border integration of financial markets also emerges as an important issue. In this context the exercise of discretion in the conduct of domestic monetary policy becomes challenging.