Y V Reddy: Role of monetary policy in attaining growth with stability - the Indian experience

Address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Bank of Greece, Athens, 2 April 2007.

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Governor Garganas and Friends,

I am honoured by the kind and persuasive invitation of Governor Garganas to visit Greece and give an address at the central bank. The ties and understanding between Greece and India can be traced to at least well over two millennia. There are references to Megasthenes as Greek Ambassador in the Chandragupta Maurya's Court of Pataliputra in the 4th century B.C. The Monetary Museum of Reserve Bank of India displays coins, which indicate active trade between Mauryan Empire in India and Greece over two thousand years ago. For me personally, it is an exhilarating experience to be in the land with which Socrates, Plato and Aristotle are associated. In fact, enthusiastic grounding in their philosophy, in my youth, helped me not to only get through the civil services examination forty years ago but also prompted me to pursue, in my own way, knowledge and truth. I am grateful to this country for all the wisdom and inspiration, which still guide us.

My address today is on a theme traditionally close to the heart of any central banker but gaining increasing and broader relevance in the context of market integration and globalisation. I will make a brief presentation on the evidence of impressive and accelerating growth in India; reining in inflation and containment of inflation expectations; and assurance of financial stability. Recognising that several factors contribute to this, I would like to highlight the role of monetary policy in this complex process.

1. Evidence of impressive and accelerating growth

The average growth rate of the Indian economy over a period of 25 years since 1980-81 (India’s fiscal year is from 1st April to 31st March) has been about 6.0 per cent, which is quite a significant improvement over the annual growth rate of 3.5 per cent over the previous three decades from 1950-51 to 1979-80. In the more recent period, the Indian economy has entered what one might call a high-growth phase, the growth rate averaging 8.6 per cent per annum in the last three years. In the last two years, the growth rate has averaged 9.1 per cent. While the GDP growth has accelerated, the population growth rate has moderated. The combined effects of these have given impetus to a sharp acceleration in the per capita GDP growth. For example, during the 1970s, the per capita income in India grew by 0.6 per cent, which implicitly meant that a person might not see doubling of his income even once in his lifetime. Since the 1990s, the per capita income has been growing at an average rate of around 4.0 per cent, implying that a person’s income will double in nearly 18 years. A person with a life expectancy of, say, 72 years could thus see his income doubling at least three times in his adult life. If the current GDP growth rate of around 9 per cent is maintained, a person can hope to see the standard of living multiplying by almost five times in his lifetime.

A noteworthy feature of Indian growth process over the last one and a half decades has been its stability. This is evident from the substantially lower coefficient of variation of real GDP growth during the post-reform period as compared to that during the pre-reform period, that is, before the nineties. It is also important to note that India's growth is driven by domestic consumption, contributing on an average to almost two-thirds of the overall demand, while investment and export demand are also accelerating. As consumption is less volatile component of demand, this has also contributed to reducing the volatility of GDP. The economy, which withstood the spike in oil prices in recent years, is displaying moderate deficit in current account after a few years of marginal surplus. Reflecting the growing competitiveness of the economy, merchandise exports have been growing at an annual rate of over 25.0 per cent per annum in the last three years, while net invisibles have continued to be strong on account of workers' remittances and software exports.

The strengthening of economic activity in the recent years has been supported by persistent increase in domestic investment rate from 22.9 per cent of GDP in 2001-02 to 33.8 per cent in 2005-06 coupled with an efficient use of capital. Domestic saving rate has also improved from 23.5 per cent to 32.4 per cent during the same period. This was made possible due to improvements in both public and private corporate saving.

2. Reining in inflation and containment of inflation expectations

The inflation rate accelerated steadily from an annual average of 1.7 per cent during the 1950s to 6.4 per cent during the 1960s and further to 9.0 per cent in the 1970s before easing marginally to 8.0 per cent in the 1980s. India had generally not experienced runaway inflation. On the other hand, the volatility in the inflation rate, as measured by the coefficient of variation, which was fairly high in the 1950s at 4.4, moved in a narrow band of 0.4–1.0 in the subsequent decades, thus reducing the inflation-risk premium. The pick up in inflation rate from 1970s onwards reflected the impact of a sharp rise in money supply growth and also partly supply shocks from crude oil prices and crop failures. Demand pressures, emanating partly from the widening fiscal imbalances, also contributed to inflationary pressures in the 1980s. The second half of the 1990s was marked by a significant turnaround in the inflation outcome reflecting the improved monetary-fiscal interface.

The inflation rate declined from an average of 11.0 cent during 1990-95 to 5.3 per cent during the second half of the 1990s. The inflation rates since the second half of the 1990s have been, by and large, benign despite sustained external capital inflows and continued surge in fuel prices, mainly attributable to more focused macroeconomic and monetary management and increasing trade openness. During this period, the average inflation rate has been contained at about 5 per cent, which has been significantly lower than that of around 8 per cent in the previous three-and-a-half decades. During 2005-06, the average headline inflation rate remained at about 4.5 per cent and inflation expectations remained well contained despite continued dominance of somewhat adverse supply-side factors.

In the recent period, the headline inflation, as measured by the Wholesale Price Index (WPI), remained above 6.0 per cent level during January-March 2007, touching 6.46 per cent for the week ended March 10, 2007; however, the average inflation was 5.3 per cent during the period April 2006 to March 10, 2007. It is useful to recognise that, historically, the tolerance level to inflation has been low, relative to many developing countries, especially on account of democratic pressures.

In this context, I quote from a recent book by Sadiq Ahmed of World Bank titled 'India's Long Term Growth Experience', which has analysed the growth experience of India in two phases: from 1950 to 1980 (Phase I) and from 1980 till date (Phase II)[1]:

> "On the whole, the ability to contain India's inflation rate at substantially below the world rate and the rate prevailing in non-oil-exporting developing countries during both phases is a testimony to the sound conduct of monetary policy. This is particularly encouraging because India faced many external shocks and associated adverse effects of imported inflation during phase II when it opened up the economy as opposed to the closed economy environment of phase I."

3. Assurance of financial stability

In the context of financial stability, the increased resilience of the economy to the external and domestic shocks is worth mentioning. India faced a major balance of payments crisis in 1991 triggered by the Gulf-war, which was responded with macroeconomic and structural reforms, both domestic and external; and a stabilisation programme. The reforms led to sustainable growth as the resilience of Indian economy to withstand external shocks improved. This is reflected in the fact that we, in later years, could successfully avoid adverse contagion impact of shocks from the East Asian crisis, the Russian crisis during 1997-98, sanctions-like situation in post-Pokhran (nuclear testing) scenario, and border conflict during May-June 1999. The Indian economy in the 1990s was able to absorb such shocks without any significant impact on the real economy and the financial sector.

The Indian record on the financial stability is especially noteworthy as the decade of the 1990s has been otherwise turbulent for the financial sector in most of the EMEs. Also, the different segments of

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[1] Ahmed Sadiq (2007); "India's Long term Growth Experience", The World Bank, Sage Publications.

domestic financial markets have generally remained stable. From the financial stability perspective, it is necessary to have a financial system in which orderly functioning of financial markets is ensured coupled with sound, competitive and efficient financial institutions nurtured by prudential policies and practices. We have observed that the Indian banks' balance sheets have strengthened considerably, financial markets have deepened and widened and, with the introduction of the real time gross settlements (RTGS) system, the payment system has also become robust.

4. Role of monetary policy

It is reasonable to say that the performance of the Indian economy has been by and large robust and resilient, which is attributable to economic reforms in several areas thus improving efficiency and competitiveness in the system as a whole. The conduct of monetary policy also has some significant role in this outcome, in view of its success in broadly fulfilling its objective – growth with stability, the latter encompassing macroeconomic, price and financial stability. The positive contributions of monetary policy were made possible by reviewing and continuously refining the monetary policy framework, in tune with changing economic environment and context. In this address, I would like to take you through various aspects of our experience in the conduct of monetary policy in an emerging market economy, which is gradually, but significantly, opening up.

(a) Dynamics in objectives: growth and stability

The preamble to the Reserve Bank of India Act, 1934 sets out in a way broadly the tone of Reserve Bank's monetary policy objectives: "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". I can do no better than quote one of my distinguished predecessors and current Chairman, Economic Advisory Council to the Prime Minister, Dr. C. Rangarajan on this subject:

> "In a broad sense, the objectives of monetary policy can be no different from the overall objectives of economic policy. The broad objectives of monetary policy in India have been: (1) to maintain a reasonable degree of price stability and (2) to help accelerate the rate of economic growth. The emphasis as between the two objectives has changed from year to year, depending upon the conditions prevailing in that year and in the previous year."

Thus, although, unlike the current trend in many countries, there is no explicit mandate for price stability, the twin objectives of monetary policy in India have evolved as those of maintaining price stability and ensuring adequate flow of credit to the productive sectors of the economy. The latter captures the growth objective by ensuring provision of adequate or appropriate liquidity to support investment and export demand. The relative emphasis placed on price stability and economic growth is modulated according to the circumstances prevailing at a particular point in time and is clearly spelt out, from time to time, in the policy statements of the Reserve Bank. Of late, considerations of macroeconomic and financial stability have assumed an added importance in view of increasing openness of the Indian economy.

(b) Changes in the framework

A monetary targeting framework was in place since mid-1980s and till 1997-98 with broad money (M3) as an intermediate target. The aim was to modulate money supply growth, consistent with two parameters, viz., (a) the expected growth in real income, and (b) a projected or a tolerable rate of inflation. On the basis of these two parameters, the targeted monetary expansion was set. In practice, the monetary targeting framework was used in a flexible manner with feedback from developments in the real sector.

With the changing inter-relationship between money, output and prices in the wake of financial sector reforms and opening up of the economy, a review was warranted. Accordingly, the Reserve Bank formally switched over in 1998-99 to a multiple indicator approach under the guidance and framework evolved by my distinguished predecessor, Dr. Bimal Jalan. As per this approach, interest rates or rates of return in different markets (money, capital and government securities markets), along with data such as on currency in circulation, credit extended by banks and financial institutions, fiscal position, trade balance, capital flows, inflation rate, exchange rate, refinancing and transactions in foreign exchange, which are available with high-frequency, are juxtaposed with the trends in output, with a view to deriving policy perspectives. Keeping in view the intrinsic reporting lags and varying reliability of inflation indicators coupled with the infirmities surrounding the relevant indicators like potential output and unemployment, our efforts have focused on improving the information set, both quantitatively and qualitatively.

(c) Fine-tuning the operating procedure

As regards the operating procedure of monetary policy in India, reliance on direct instruments has been reduced and a policy preference for indirect instruments has become the cornerstone of current monetary policy operations. Liquidity management in the system is carried out through open market operations (OMO) in the form of outright purchases/sales of government securities and daily reverse repo and repo operations under a Liquidity Adjustment Facility (LAF). The LAF has enabled the Reserve Bank to modulate short-term liquidity under varied financial market conditions, including large capital inflows. In addition, it has enabled the Reserve Bank to set, as far as possible, an informal corridor for the short-term interest rates consistent with the policy stance. This has also facilitated a reduction in the levels of statutory pre-emptions without engendering liquidity pressures. These operations are supplemented by providing access to the Reserve Bank’s standing export credit refinance facility, in a limited manner, and liquidity support to the primary dealers.

In this new operating environment, the Reserve Bank has been increasingly relying on a mix of market-based instruments and changes in reserve requirements, when necessary, for the conduct of monetary policy. Changes in fixed reverse repo/repo rates set by the Reserve Bank from time to time for the conduct of its Liquidity Adjustment Facility (LAF), under which the central bank conducts daily auctions for the banks, have emerged as the main instruments for interest rate signalling in the Indian economy.

The Reserve Bank has also actively encouraged the development of the collateralised segment of money market to facilitate safe and smooth clearing of the short-term liquidity mismatches amongst market participants. Two types of collateralised markets have emerged – first, a repo market and second, a market for collateralised borrowing and lending obligations (CBLOs). The latter is a unique product similar to a tri-partite repo. Clearing Corporation of India Ltd. (CCIL) acts as a central counterparty and facilitates collateralised lending and borrowing amongst market participants.

The liquidity management was further refined in 2004 with the introduction of a market stabilisation scheme (MSS) under which the Reserve Bank was allowed to issue government securities as part of liquidity sterilisation operations in the wake of large capital inflows and surplus liquidity conditions. While these issuances do not provide budgetary support, interest costs are borne by the fisc; as far as Government securities market is concerned, these securities are also traded in the secondary market, on par with the other government stock.

In brief, currently in its monetary operations, the Reserve Bank uses multiple instruments to ensure that appropriate liquidity is maintained in the system, consistent with interest rate policy and the objective of price stability, so that all legitimate requirements of credit are met. Towards this end, the Bank pursues, *inter alia,* a policy of active management of liquidity through open market operations (OMO) including Liquidity Adjustment Facility (LAF), Market Stabilization Scheme (MSS) and cash reserve ratio (CRR), and deploys the policy instruments at its disposal, flexibly, as warranted by the situation.

(d) Gains in operational autonomy

The mid-1950s witnessed the beginning of serious erosion of autonomy in the monetary policy function due to the emergence of the system of *ad hoc* Treasury Bills and automatic monetisation. Under this system, it was agreed that the Reserve Bank would replenish Government’s cash balances by creation of *ad hoc* Treasury Bills issued in the Bank’s favour whenever such balances with the Reserve Bank fell below the stipulated minimum. Thus, the *ad hoc* Treasury Bills, which were meant to meet temporary mismatches between receipts and payments of the Government, became cumulative and eventually emerged as a significant source of monetary financing of the Government expenditure.

The relationship between the Reserve Bank of India and the Government took a significant turn in September 1994 when a supplemental agreement was entered into with the Government which limited, initially, the net issuance of ad hoc treasury Bills. This initiative culminated in the abolition of the *ad hoc* Treasury Bills in April 1997 and the system was replaced by a provision for extending limited ways and means advances. The phasing out of automatic monetisation of budget deficit has, thus, strengthened the monetary policy framework, imparting flexibility and operational autonomy.

With the enactment of the Fiscal Responsibility and Budget Management Act in 2003, the Reserve Bank has withdrawn from participating in the primary issues of Central Government securities with effect from April 2006. There could be exceptions only on the grounds of national security or national calamity or such other exceptional circumstances.

The recent legislative amendments enable a flexible use of the CRR for monetary management, without being constrained by a statutory floor or ceiling on the level of the CRR. The amendments also enable the lowering of the Statutory Liquidity Ratio (SLR) to the levels below the previous statutory minimum of 25 per cent of net demand and time liabilities of banks – which would further improve the scope for flexible liquidity management.

(e) Strengthening the transmission channels

In a market-oriented economy, policy signals are transmitted through an integrated and efficient money, government securities and foreign exchange markets combined with a robust payments and settlement system. The Reserve Bank has therefore, been engaged in developing, widening and deepening of various markets and institutions. The medium-term framework is to keep developing the financial markets, preserving the integrity of financial markets and thereby, improving the transmission of monetary policy impulses. In the area of money market, several measures were taken to refine the overnight and the notice money market, the term money, commercial paper and certificate of deposit markets, besides the repo market. A screen-based, negotiated, quote-driven system for dealings in the call/notice and term-money markets (NDS-CALL) has also been recently launched.

Well functioning market for government securities is necessary, both for effective public debt management and monetary management, while serving the broader interest of development of financial markets in general, and debt markets, in particular. Accordingly, a number of initiatives have been taken over the years to develop both the primary and secondary markets for Government securities. The need for further development assumed greater significance in the context of the imperative prohibition of Reserve Bank from participating in the primary issuance of Central Government securities with effect from April 2006 as per the provisions of the Fiscal Responsibility and Budget Management Act. An Internal Technical Group on Central Government Securities Market (July 2005) was constituted to, *inter alia*, suggest measures for enhancing the depth and liquidity of the secondary market, in the new environment. The Group envisaged that steps were needed to be taken over the medium term to develop the Government securities market in terms of instruments/processes/participants. The recommendations are being acted upon in a phased manner.

The corporate debt market in India is relatively under-developed but has a large potential to raise resources particularly for infrastructure projects, housing sector and for the corporates themselves. Development of various market segments including mortgage-backed securities, bond insurance institutions for credit enhancement and greater access to real time gross settlement (RTGS) with state-of- the-art technology would provide a strong impetus for growth of corporate bond markets in India. Pursuant to the announcement made in the Union Budget, 2005-06, a High Level Expert Committee on Corporate Bonds and Securitisation (Chairman: Dr. R.H. Patil) was appointed to examine legal, regulatory, tax and market design issues in the development of the corporate bond market. The recommendations of the Committee included enhancing the issuer as well as investor base, simplification of listing and disclosure norms, rationalisation of stamp duty and withholding tax, consolidation of debt, improving trading systems through introduction of an electronic order matching system, efficient clearing and settlement systems, a comprehensive reporting mechanism, developing market conventions and self-regulation and development of the securitised debt market. Actions have been initiated to implement the recommendations of the Committee.

The Indian foreign exchange market has been widened and deepened with the transition to a market-determined exchange rate system in March 1993 and the subsequent liberalisation of restrictions on various external transactions leading up to current account convertibility under Article VIII of the Articles of Agreement of the International Monetary Fund in 1994. As a part of the continuing efforts aimed at liberalising and developing the foreign exchange market in India, an Internal Technical Group on Foreign Exchange Markets was appointed to undertake a comprehensive review of measures initiated by the Reserve Bank so far and identify areas for further liberalization of restrictions along with a medium-term framework. The Committee on Fuller Capital Account Convertibility (CFCAC) chaired by Mr. S.S. Tarapore has also made recommendations for development of financial markets including the foreign exchange market. Several measures have been taken to further liberalise the extant regulations and thereby improve the structure, integration and efficiency of the markets.

(f) Payment and Settlement Systems

The Reserve Bank has also initiated a number of steps – institutional, procedural and operational for making the payment systems safe, secure and efficient. A Board named the Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) has been set up as a Committee of the Central Board of the Reserve Bank of India, with the Governor as its Chairman and all the four Deputy Governors and two external Central Board Directors as its members. The BPSS lays down the policies and standards relating to the regulation and supervision of both the existing and the evolving payment and settlement systems.

For efficiency enhancements and risk reduction, usage of the Real Time Gross Settlement (RTGS) System and other electronic payment mechanisms are being encouraged in a big way. Almost 40 per cent of the 70,000 plus bank branches in the country are now RTGS enabled. Sometime back, the Reserve Bank examined India’s position with regard to compliance with the Core Principles of Systemically Important Payment Systems. It was found that we were largely compliant with all Core Principles except the first one, i.e., "well founded legal basis". The Reserve Bank, with the concurrence of the Government of India, has drafted a Payment and Settlement Systems Bill and this Bill is under consideration of the Parliament. This Bill, when enacted, will not only authorise the Reserve Bank to lay down the policies relating to regulation and supervision of the payment systems, but also provide legal recognition to 'netting' and 'settlement finality'.

Given the critical requirements of information technology and in its endeavour to sustain the progress and provide direction to the IT initiatives of the financial sector, the Reserve Bank has set out a Vision Document which provides a bird’s eye view of the plans for IT development in the medium term, with the required focus on corporate governance.

(g) Strengthening institutional setting

Monetary policy formulation is carried out by the Reserve Bank in a consultative manner. The Monetary Policy Department of the Bank organises discussions between the top management of the Bank and the select commercial banks as also with the industry associations, bodies representating markets and the significant industry groups. It also holds monthly meetings with select major banks and financial institutions, which provide a consultative platform for issues concerning monetary, credit, regulatory and supervisory policies of the Bank. Decisions on day-to-day money market operations, including management of liquidity, are taken by a Financial Markets Committee (FMC), which includes senior officials of the Bank responsible for monetary policy and related operations in money, government securities and foreign exchange markets. The Deputy Governor, Executive Director(s) and heads of four departments in charge of monetary policy and related market operations meet every morning as financial markets open for trading. They also meet more than once during a day, if such a need arises.

Besides FMC meetings, Monetary Policy Strategy Meetings take place once every month. The strategy meetings take a near-term view of the monetary policy and consider key projections and parameters that can affect the stance of the monetary policy. In addition, a Technical Advisory Committee on Money, Foreign Exchange and Government Securities Markets comprising academicians and financial market experts, including those from depositories and credit rating agencies, provides support to the consultative process. The Committee meets once a quarter and discusses proposals on instruments and institutional practices relating to financial markets.

In pursuance of the objective of strengthening the consultative process in monetary policy, a Technical Advisory Committee (TAC) on Monetary Policy has been set up with four external members drawn from the areas of monetary economics, central banking, financial markets and public finance. The TAC meets ahead of the annual policy and reviews of annual policy. The TAC reviews macroeconomic and monetary developments and advises on the stance of monetary policy.

(h) Emphasising communication

Faced with multiple tasks and a complex mandate, clear communication on the part of the Reserve Bank of India assumes special significance in the area of monetary policy. We emphasise three kinds of communications, viz., (a) analysis of the economy, (b) policy measures, and (c) reasons behind such policy measures. In fact, by international standards, the Reserve Bank of India has a fairly extensive and transparent communication system. The bi-annual policy statements traditionally communicated the Reserve Bank's stance of monetary in the immediate future of six months to one year. Since July 2005, a system of publishing quarterly reviews in addition to the bi-annual statements has been put in place. Speeches by the top executives of the Bank also form an important part of communication process of the Reserve Bank. We have taken a middle path of sharing our analysis, in addition to information, with the market participants, to enable them to develop their own perceptions. In doing so, we have the benefit of the process of two-way communication, of information as well as perceptions, between the market participants and the RBI. The two-way process is also enabled by several formal structured meetings with industry associations, through standing advisory committees, and informal / *ad hoc* committees and technical/working groups.

(i) Aligning with international best practices

The Reserve Bank has adopted a multi-pronged strategy based on international best practices with suitable adaptations to promote development and stability of institutions, markets and the financial infrastructure. Benchmarking our financial sector to international standards and best practices has been very useful to us. In this context, our effort to assess the status and implementation of international standards and codes of various standard setting bodies including the IMF was one of the cornerstones of the recent initiatives which helped us to understand our relative position *vis-a-vis* international standards. The approach to implementation of financial standards and codes was based on the efficiency-enhancing elements of the standards and codes, and on the need to consider them as part of the process of institutional development in the country, while not ignoring their relevance to domestic as well as external financial stability. The process enabled an objective, independent and 'external' assessment of the domestic economy. Such a participative and consultative approach with emphasis on gradualism was advocated to secure a convergence of viewpoints and, hence, to evolve a favorable environment for bringing about necessary changes with harmony.

Government of India, in consultation with the Reserve Bank, have again constituted in September 2006 a Committee on Financial Sector Assessment to undertake a self assessment of financial stability and to further update the status and implementation of various standards and codes.

5. Concluding observations

To conclude, we have a good story to tell the world on our performance relating to the role of monetary policy in attaining growth with stability. However, there are still challenges in maintaining the momentum and more importantly make the growth meaningful to the millions of poor and unemployed. I can do no more than fully endorse, what Dr. C. Rangarajan, one of my predecessors and currently Chairman of the Economic Advisory Council to the Prime Minister, recently highlighted. He referred to six most important challenges warranting priority attention. These are stepping up agricultural growth, infrastructure development, fiscal consolidation, building social infrastructure particularly primary education and basic health, managing globalisation and good governance. The conduct of monetary policy will continue to provide support to these areas by creating an appropriate atmosphere of macro-economic stability, especially price and financial stability; which will, undoubtedly, facilitate accelerated growth.