Mr Reddy discusses monetary policy in India

Speech by Y.V. Reddy, Deputy Governor of the Reserve Bank of India, at the Fourth Securities Industry Summit, in Mumbai, India on 26 May 1999.

Chairman and friends,

I thank the organisers for inviting me to deliver the inaugural address at the Fourth Annual Securities Industry Summit. Although the discussions in this Summit will specifically veer around the securities market, monetary policy strongly influences the working of the financial markets. As a central banker, I will, therefore, speak on monetary policy making, which I trust will provide some perspectives to the deliberations at the Summit.

Objectives

In India, monetary policy has always emphasised the objectives of price stability and growth. What this, in effect, has meant in practical policy setting is, formulating a balance between the two objectives depending on the evolving situation but within the broad context of keeping the inflation rate within a reasonable bound.

Apart from these two important goals, there has been a conscious attempt on the part of the Reserve Bank in recent years to maintain orderly conditions in the foreign exchange market, and to curb destabilising and self-fulfilling speculative activities. This has assumed strategic importance for the sustainability of the external sector in the face of growing cross border capital flows into the economy. With the increasing order of domestic and international financial integration, exchange rate expectations do impact on the domestic stance of monetary policy and hence the significance of inflation. In the transitional phase, however, given the exchange market imperfections, the exchange rate objective may occasionally predominate due to emphasis on avoidance of undue volatility. In fact, sometimes, as was the case recently, it could be the most dominant reason for short-term monetary policy adjustments.

In a broader framework, the objectives of monetary policy in India continue to be price stability and growth. These are pursued inter alia through ensuring credit availability, with stability in the external value of the rupee as well as overall financial stability, all being reflective of pursuit of the overall objectives. The relative emphasis among the objectives is governed by the prevailing circumstances.

Targets

The conduct of monetary policy in India has traditionally proceeded with the help of an intermediate target, which the central bank could influence directly and which bears a reasonably close relationship with the ultimate objectives. The particular mode of central bank intervention is the operating instrument. Macro-economic variables, which post useful information about the objectives of monetary policy, although they may not in themselves be amenable to central bank targeting, are ‘indicators’ or ‘information’ variables.

The Reserve Bank of India (RBI) sets indicative broad money (M3) expansion targets in line with the expected rate of growth of GDP and a tolerable level of inflation. Consistent with the targeted level of broad money expansion, is a desired level of reserve money expansion. The order of the reserve money expansion, however, has to be consistent with the likely fiscal and external payments position, since the main sources of reserve money expansion are net RBI credit to government and net foreign exchange assets. The targeted M3 expansion is publicly announced through the Governor’s statement on monetary and credit policy. The broad money target is also supported by a number of other

indicators such as movement in interest rates, exchange rate and availability of credit to productive sectors of the economy.

Monetary target is premised on a stable demand function for money. In the Indian context, a number of earlier studies on the demand for money have demonstrated that it is stable. Dr.Rangarajan demonstrated that money demand equations provide reasonable predictions of average changes in prices over a medium-term horizon of 4-5 years, though not necessarily on a year-to-year basis. In essence, the concern was with the long-run stability of the money demand function in terms of its most proximate determinant, i.e. real GDP, rather than its short-term behaviour. Most recent studies in RBI examined the stability of the money demand equation using a number of alternative procedures. While these tests showed parameter shifts, they did not point to parameter instability. In the 1990s, the monetary targets were set either as point targets or in a narrow range implying scope for missing point targets, but it has to be recognised that a wider range would question the credibility, diluting the very objective of targeting.

The pressures on monetary expansion in the earlier part of targeting exercise emanated from monetisation of fiscal deficit and later on from capital inflows. During the period 1985-92, net RBI credit to Central Government accounted for over 96 per cent of the monetary base, which was reduced to about 65 per cent in the subsequent period during 1993-98, with corresponding increase in net foreign exchange assets of the RBI.

Although the practice of automatic monetisation of the budgetary deficit was done away with, effective from April 1997, it can significantly reduce the pressure on monetisation only if the size of the Central Government’s market borrowing programme is kept within reasonable limits. However, there is a qualitative difference, since the RBI has some flexibility now in respect of the extent of its support to Government borrowing programme.

With increasing market orientation of the financial structure and international capital flows, monetary policy responds to developments on an ongoing basis. In an administered interest rate and exchange rate regime, the quantity variables dominated and transmitted monetary policy impulses. However, external and financial sector reforms have since enhanced the sensitiveness of quantity variables to their market determined price, i.e. interest rate and exchange rate.

It must be recognised that in recent times, the emphasis has also been on closely monitoring different indicators apart from relying on the intermediate target. For aiming at the intermediate target (viz., broad money) the underlying operating target is reserve money, particularly the banks’ reserves, while the supplementary operating target is the short-term interest rate proxied generally by the overnight call money rates.

Operating Procedures and Instruments

The reforms in the monetary and financial sectors have enabled the RBI to expand the array of instruments at its command. As already mentioned, the operational target of monetary policy continues to be banks’ reserves which is controlled by changes in reserve requirements effected mainly through the instruments of cash reserve ratio (CRR). However, the use of CRR as an instrument of monetary control is sought to be de-emphasised and the liquidity management in the system is increasingly undertaken through open market operations (OMO), both outright and repos.

In view of the overall downward movement in CRR, except on occasions of exchange rate volatility, the excess liquidity in the system is mopped up by outright sales of government securities by RBI. Over the reform period, the market absorption of government securities was facilitated by reforms in the government securities market, which ensured market related rates of interest and thus some of the basic conditions were provided for developing a secondary market.

The short-term liquidity management is also aided by conduct of repos on a regular basis. Usually, the RBI conducts repos for a maturity of up to 14 days, which is the cycle for reserve requirements. Recently, the RBI has been conducting 3-4 day fixed rate repos to absorb very short-term liquidity and to even out money market rates, especially overnight call money rates. The repo rates and the amounts tendered in the repo auctions, apart from reflecting liquidity conditions, provide a floor for the overnight call money rates. In the event of tight liquidity conditions, the RBI' s liquidity support to primary dealers (PDs) enables it to directly intervene in the market, thereby moderating pressures on the overnight call money rates.

The RBI also reactivated the Bank Rate in April 1997 as a reference rate and as a signalling device to reflect the stance of monetary policy. The interest rates on different type accommodation from the RBI including refinance are linked to the Bank Rate. The activation of the Bank Rate endowed the RBI with an additional instrument. It must be noted that the announcement impact of Bank Rate changes has been pronounced on the prime lending rates of commercial banks.

The refinance window of the RBI provides an additional instrument for influencing reserves. Until recently, the RBI provided two types of refinance facilities to banks - export credit refinance and general refinance. While the former facility is formula based and is extended to banks against their outstanding export credit eligible for refinance, the latter facility was provided to enable banks to tide over their temporary liquidity shortages.

The general refinance window has since been replaced by a Collateralised Lending Facility (CLF) within the overall framework of an Interim Liquidity Adjustment Facility (ILAF).

Currently, the liquidity management at the short end is in the form of ILAF. Liquidity is injected by the RBI through CLF to banks, export credit refinance to banks, and liquidity support to PDs. All these facilities are available subject to quantitative limits [formula-based] for specified duration and at the Bank Rate. Additional limits could be availed by banks under Additional Collateralised Lending Facility (ACLF) and by PDs at two percentage points above the Bank Rate. Absorption of liquidity will continue to be through fixed rate repo i.e., at repo rate announced on a day to day basis. These are supplemented by OMO in Government dated securities and Treasury Bills by the RBI. OMO involve decisions by the RBI on a daily basis or even intra-day basis in regard to the quantities and the cut-off yields at which the dated securities and Treasury Bills are operated upon. It may be noted that these operations are in the given framework of the CRR that directly affects liquidity and the Bank Rate. Often, the periodic Treasury bill auctions by RBI, themselves provide opportunities for the RBI to signal its overall stance on the appropriateness of interest rate and liquidity.

Thus, the ILAF provides a mechanism by which liquidity would be injected at various interest rates, and absorbed when necessary at the fixed repo rate, so that the volatility in the money market is minimised and the market operates within a reasonable range.

At present, there is no formal corridor for market interest rates, but the Bank Rate often has provided an upper bound and the fixed repo rate provided the lower bound. In a sense, an informal corridor exists for short-term interest rates and the introduction of ILAF has facilitated the evolution of this corridor.

The experience with the movements in the interest rates and exchange rate in the last two years has increasingly reflected the integration among various market segments. The interest rates of major market instruments [91-day and 364-day Treasury Bills, Commercial Paper and Certificate of Deposit] in recent period show some correlation with reasonable speed of adjustment, which augers well for some element of targeting of interest rates in the conduct of monetary policy.

Dilemmas

Monetary management poses dilemmas not only at the analytical level but also at the operational level. In fact, some of these dilemmas have been articulated in the recent policy statements of Governor Bimal Jalan.

First, the basic dilemma arises out of the trade off between growth and inflation. Although a consensus has emerged on the basis of empirical evidence that in the long run there is no trade off between employment and inflation, it is the inconclusive evidence in the short-run that poses a challenge for monetary management. Given the deleterious effects of inflation on distribution of income, there is an imperative need in developing countries to keep the inflation rate as low as possible. In the last year's Economic Survey, it was stated that "As world inflation rates are currently of the order of 0 to 3 percent, 4 to 6 percent inflation rate could be regarded as an acceptable level for India at present." This order of inflation has been, it may be noted, built into the monetary operating framework of the RBI.

Secondly, even a moderate inflation rate poses a dilemma in an open economy. If the domestic inflation rate of an economy, however low it may be, is higher than the average inflation rate of its trading partners, it puts pressure on the exchange rate. In this context, the question of simultaneous balance of the internal and external sectors becomes a major issue.

Thirdly, in a dynamic setting, when the financial markets are continually evolving, and payment systems and technology are changing, one may not find a clear cut evidence of stability in the money demand, which is taken as a basis for intermediate targeting; and in such circumstances, one needs to look also at other relevant indicators. It is not that such dilemmas are specific to us and by and large, countries follow a menu approach or a 'check list' to track a number of relevant variables.

Fourthly, the dilemma that the central bank faces as a manager of public debt and the monetary authority is well known. While the former may require keeping its cost low, the latter may demand a reduction in the extent of government debt that it holds, considering the impact it has on aggregate expenditures and thus on demand. The market-borrowing programme of the government is determined by the fiscal parameters, but the size of the government debt impacts on the interest rates in the economy and it should be clearly recognised that there is a limit to the extent of market borrowing that the central bank can support. These dilemmas can be resolved through proper fiscal monetary co-ordination.

Fifthly, the conflict between roles of the regulator/supervisor and as a conductor of the monetary policy has often been discussed. This is illustrated by the case of a central bank, as a monetary authority, which may require to reduce the liquidity in the system by raising the rate of interest. But, such a rise in the rate of interest could be detrimental to the interests of the weak banks. Similarly, while tightening prudential norms, the central bank has to take into account its impact on banking systems' capacity to intermediate credit.

Finally, in an open economy, the potential conflict between the interest rate and exchange rate objectives could arise when short-term and volatile capital flows occur. For example, the bouts of volatility in exchange rate experienced by us recently necessitated that market conditions are rendered less liquid even if it meant that the interest rates are kept high. This policy has implications for promoting domestic output growth in that the interest rates may for this purpose, be required to be kept at moderate levels. But the larger objectives of evading the likely potential disruption of domestic activities arising out of an exchange rate crisis should also be kept in view.

Conclusion

As part of financial sector reforms, a number of steps have been taken to enhance the effectiveness of monetary policy, and these include, improvement in the payments and settlement systems, development of secondary market in government securities with a diversification of investor base,

reduction in non-performing assets, introduction of ALM guidelines, and reduction in the overall transactions costs. In particular, the recent initiatives of RBI to develop money market and debt markets should contribute to improving the transmission mechanisms of monetary policy.

All the reforms in the monetary and financial sectors may not have the desired results without credible fiscal adjustment. Notwithstanding the discontinuation of automatic monetisation of fiscal deficit, the responsibility for management of a large government borrowing programme does circumscribe the manoeuvrability of monetary policy.