Rethinking the Role of Monetary Policy in India: A Critical Analysis

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By

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The ever increasing attention being paid to finance capital and the financialization[i] process itself has rendered the old fashioned monetary policy apparently in effective in accomplishing celebrated twin objectives of containing inflation and fueling economic growth. It is becoming evident that the growth of financial institutions which have not been directly regulated by the Central Banks as in the case of orthodox financial intermediaries, has in fact rendered the weapons of monetary policy almost inoperative, and therefore, it appears that central banks all over the world, especially in developing countries like India, have confined themselves into the role of 'measuring' inflation and taking steps to ease inflationary pressured by the way of putting certain 'classical restrains' on the lending rate of formal financial institutions over which Central Banks still have the regulatory mandates. To validate this, for instance, let us recall the euphoria that were created in the air by the present incumbent at the RBI, Dr.Reghuram Rajan[ii], when he wore the suite of RBI Governor quitting his assignments at the IMF, that he would appoint Committees after committees to look into domains of present monetary policy framework, and adopt policies triggering economic growth. The expectation was that he would deviate from the 'mistakes' which his predecessors had made, and introduce policies that would help the economy to take a new route of growth by way of reducing the cost of money, and thereby encouraging the real sector to invest, and create more gainful employment opportunities. But two years down the line, Reghuram Rajan's tall promises still remain unfulfilled, and it is astonishing that he seems to have put his feet in the same shoes of his predecessors; increasing regulatory rate of interest point wise claiming that inflation would have to be tamed. Thus it is obvious that Central Banks in most of the developing economies especially in countries like India have become the mere institutional arrangements to manage currency issues so that inflation is not accelerated to derail the system, heeding nothing to the growth and development imperatives of the country. In the background of these developments, the present work intends to examine the contours of monetary policy in India and while examining the turnaround in monetary policy the paper also attempts to look into whether the policies have given effect to the real economic intentions of the government viz. augmenting employment, income and stabilizing the price level, and to suggest ways of adapting monetary policy to the real economic requirements of the country.

What is expected of MP theoretically?

Before dwelling into the various aspects of present monetary policy in India, it is important to have a theoretical insight into the significance of monetary policy as a macroeconomic tool[iii]. It has been well understood that Inflation is always a monetary phenomenon at least in developed nations (Friendman, 1956). Now, theoretically speaking, MP forms an important arm of economic policies of any type of government. The strength, spirit and the relevance of MP actually emanates from the undisputable role that money plays in an exchange economy. Every economy is compartmentalized into: the real sector and the monetary sector. A decoupling of these two vital segments of an exchange economy eventually collapses the system, and that is why, taking note of this, many well established economists have called for the proper and effective integration of the real and the monetary sector. The Classical writers, while believing in full employments, found monetary policy as neutral in its influence on real variables, and argued that changes in the stock of money could only decide the direction of the general price level leaving real variables unaffected. Contrary to this view, Keynesian on the other hand stood with the argument that such neutrality of money becomes operational only once the economy is put into the situation of full employment, and so long as the country is ravaged under the problem of unemployment of productive resources, monetary policy could be used to impact real economic variables viz. output and employment. For long, the entire discussion on the role of monetary policy in influencing real economic variables has centered on these two paradigms which are poles apart in their approaches.

In this context it is quite imperative to look into the expected role of monetary policy in countries like India which has been saddened with the problem of unemployment and poverty for a long period of time. In India too official appointees of Central Banks have always had the view that taming inflation within the affordable limit ought to be the primary objective of monetary policy although governments especially finance ministers have always been demanding monetary policy to be pro active in tackling real economic issues. Such has been the gravest and perhaps the toughest stand the highest officers of Central Banks used to take that in some occasions even the governors of RBI expressed their willingness to step down from the post of Governor if Central Government continued the policy of pressuring them to fall in line with dictates of Central Government as far as the monetary policy is concerned[iv].

What might have pursued Central Bank to curiously and vigorously focus on controlling money stock to stabilize the price level without heeding to the real economic requirements of the nation? One reason, perhaps, had been the influence of foreign exchange reserves on the high powered money stock of our country. During the regulated regime of the forex market, there could be compelling circumstances when the fluctuations in the forex reserves owing to volatile Balance of Payments (BoP) exerted unwelcoming pressures on the reserve money stock of the country. To counter this, like any central bank of countries running a regulated exchange rate and a market, the RBI as well would have to resort to 'sterilization' techniques to free the domestic money supply of external disturbances. Barring this technically undeniable factor, another factor that might have been at work is the perpetual policy of Government to run fiscal deficit and its repercussions on the money supply of the country which needs to be looked into in detail.

The villainous role of Budget and the entry of Monetary Targeting

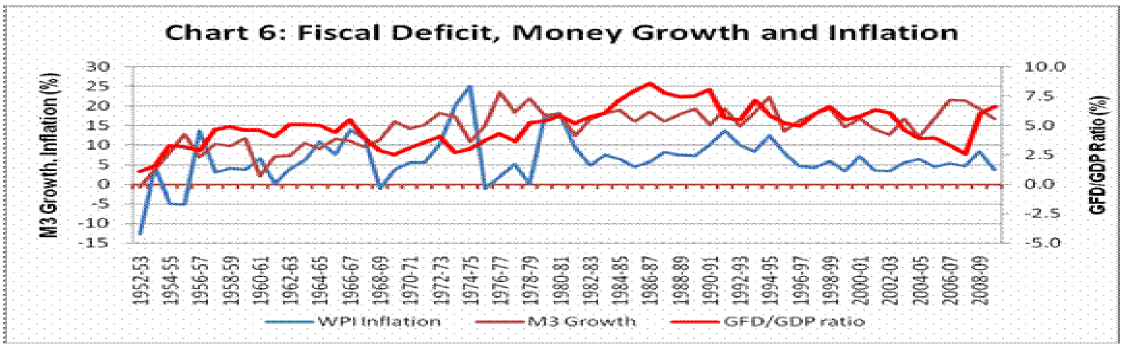
Having said all that Central Bank should look beyond merely monitoring the rate of growth of money supply in a country like India, one must be contended with the fact that uncontrolled monetary expansion in the pursuit of rejuvenating the real sector by injecting liquidity may create and exacerbate severe instabilities in the monetary system, resulting in the eventual derailment of the economy. We have experiences of countries facing complete inexplicable financial anarchy like Iraq where people used to move to market with basket of money only to return home with pocket of goods when galloping inflation crept into that nation following the invasion of US led western troops. Even now, before us, there is the Sudan money market, where money has eventually become just papers devoid of commensurate value. Undoubtedly, one cannot expect such things to happen in a developing country like India.

Knowing these things that once things get out of control it is difficult to bring back financial normalcy, Central Bank in India has been very cautious in dealing with issues pertaining to money supply. But certain factors external to Central Bank like the fiscal deficit that creeps into the budget of the central government has appeared to be an influencing determinant of money supply in India. Several steps to reduce fiscal deficit aside, still the problem persists unabated thanks to the failure on the part of the central government to mobilize revenue both direct and indirect, and to axe the unproductive expenditure of the government. The fiscal deficit unless bridged by the government borrowing would lead to minting additional currency, that is increasing the High Powered Money (Gupta, 2010), and when it is put to the system, multiplied via credit creation process, would further trigger of growth in broad measure of money supply, which is labeled as M^3[v]. In fact this fear had ruled the monetary policy makers in India for quite some time, and of course, one cannot find fault with them in assessing the impact of high fiscal deficit in that way. It was with the intention of diluting the pressure of fiscal agencies on the determination of money supply in India that a committee headed by Prof.Sukhmoy Chakravarty, later came to be known as the Chakravarty Committee, was appointed to look into all gimmicks of this unholy tie up between the fiscal deficit and high powered money growth. This committee, after having gone into the details of this mechanism, had made a historic recommendation in the monetary history of the country that a target rate of growth of money expansion needed to be set up after consultation between the RBI and the GOI which would bind both organizations in a common effort of containing the rate of growth of money supply in India. This entire process of fixing the target rate of growth of M^3 has later come to be known as the 'Monetary Targeting' (MT, hereafter). To put in other words, the MT was one of the first step to free the Central Bank and the money supply from the unnecessary exertion of the fiscal deficit, or it could be well said that MT broke the connection between the fiscal deficit and the money supply partially putting an end to the coercion that GOI could place on the RBI.

Had excess money supply due to high but manageable fiscal deficit been problematic for the Indian economy? Well, an answer to this question requires much analytical exercise. But viewing from straightforward commonsensical stand, the plain picture before us might compel us to argue that during the time till the MT came to the picture at least, the money supply had not put any pressure on India's growth and development. During this testing time in the post independent India, she had made path breaking accomplishments building many temples of heavy industrialization, the benefits of which we are reaping today. Although growth had not been that much crazy during this period, development did take place which undoubtedly drove the economy to high growth path in the later period including the post liberalization period. It needs to be noted here that during this period, the impact on price level could be absorbed to a greater extent without badly affecting the real income of the people.

Several studies analyze the nexus between deficit and inflation. The course of nexus can be of two types: Deficit induced inflation and Inflation induced deficit (Rangarajan & Mohanty, 1998). Boost in money growth may be the outcome of high fiscal deficit. On the other hand, the existence of high inflation could also lead to high fiscal deficit thanks to the high cost economy. Generally it has been documented that high fiscal deficit is detrimental to the economic growth. This is primarily due to the fact that fiscal deficit is financed by money supply creation having untoward effect on the growth prospects of the economy in future. But if fiscal deficit is the result of investment by the government on productive sectors, in the long run, through supply side effect, fiscal deficit can turn out to be a blessing for the nation. However, it needs to be noted that fiscal deficit in pre-reform period did not reduce GDP as much as it happened in the post-reform period. For instance, a study obvious shows that one percent increase in FD reduced GDP by .41 percent in the reform period of 1992-2011 whereas it did reduce GDP only .014 percent in the pre-reform period 1970-1991 (Monhanty, 2014). Moving further data reveal that fiscal deficit, measured as GFD/GDP ratio and WPI inflation, have not exhibited any noticeable relation in India both in the reform and pre-reform period, whereas fiscal deficit and money growth have (Figure No.2).

Figure 2 Fiscal Deficits, Money Growth and Inflation



Source: RBI publications

The External Effect and BOP Crisis

One bad consequence of persistent fiscal deficit and its repercussions on the quantum of domestic money supply was felt on the external part of the economy in the form of spiraling prices of exports, making India's trade competitiveness poor relative to other similar nations. The escalating import bill coupled with plummeting export earnings wiped out India's foreign exchange reserves which worsened the BOP position. This severe BOP crisis was the impending reason which forced the country to knock the doors of IMF and World Bank for conditional or tied aids. Following the prescriptions of these donor institutions at the behest of the US led group, India had to abide by the policy of keeping fiscal deficit low, and FRBM[vi] act had to be passed to make low fiscal deficit mandatory. Thanks to all these steps, today Central Bank of the country has been in a safe position as it has been relieved of the pressures of GOI's fiscal deficit in determining the quantum of H[vii] money to be issued. This in fact has become a blessing in disguise for the RBI as there has been voice in the air in favor of allowing autonomy for the RBI. The relief from GOI fiscal deficit at least partially can be reckoned as a practical step towards the autonomy of the CB.

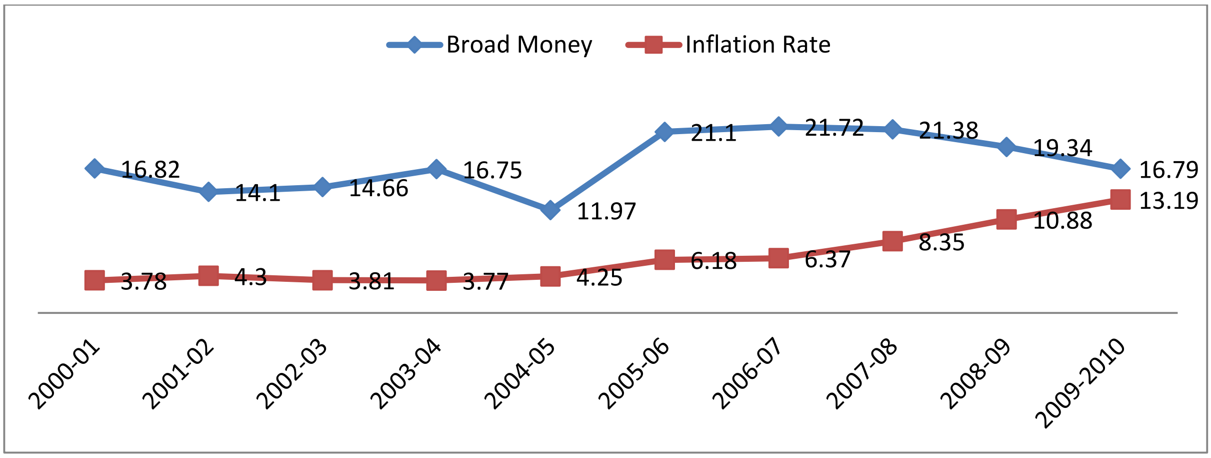
Now, we have a CB free of policy intervention from the part of GOI to a greater extent; a CB to decide only on the money supply growth. The question now is: Does CB appears to be so essential to decide only the cost of money, and thereby taking decision pertaining to the rate of growth of money supply. The way of functioning of CB for quite some time tempt not to disbelief that CB has deviated from its objective of accomplishing certain growth parameters. A cut in interest rate can do wonders unless liquidity trap operates and the operation of liquidity trap itself is a remote possibility. But, our CB has been reluctant to run a cut in policy interest rate so as to give a right signal to the real sector to boost its investment. The seemingly unjustifiable reluctance on the part of the CB in executing a slash in policy interest rates so as to rejuvenate the real sector has cost the economy a lot.

As a corollary to this, one must understand the fact that in India inflation has unequivocally been regarded as a structural catastrophe rather than a demand induced one. Despite many studies stressing the structural nature of inflation, the policy makers have been giving deaf ear to this, and they appear to have been treating inflation as demand side problem and suggesting much tried out monetary solutions. Theoretically, inflation is demand side tragedy in so called full employed western countries, whereas in countries like India it continues to be supply side, more emphatically, a structural one. Hence, it is not understandable why RBI has been stressing more on controlling liquidity in the name of taming inflation without facilitating the implementation of strategies (using longsighted supply side solutions) to arrest inflation.

The MSP role in inflation

Studies have shown that inflation in India has hardly been influenced by the CB's policy variables; rather, it has well been proved through econometric models that inflation has been set and reset in accordance with the announcement of Minimum Support Price (MSP) which is of course has been a political maneuvering in a country like India. Obviously, it has been revealed that changes in MSP is key to explain around 5 percent variance in CPI inflation in India, and perhaps on account of this that inflation in India has sarcastically been called MSP inflation (Bhalla, 2014). That is inflation of today could be explained by the MSP announced in the previous year, which underlines the much held position that inflation in India has been a structural one, or more obviously, a politically motivated thing. Moving further it is obvious that inflation in India has not been much caused by changes in money supply. Most interesting thing is that such a trend is visible in the reform period too. A glance at the figure provided below stands testimony to this (Figure No.2).

Figure 2 Broad Money and Inflation Rate



Source: RBI publications

Concluding Observations

The foregoing discussion on the monetary policy of the RBI in the context of the macroeconomic environment clearly emphasizes the need to reorient the monetary policy to materialize the real economic objectives of the country. The time has ripened enough to change the course of action of RBI with regard to the implementation of monetary policy tools. What the regulator requires is a package of policies in line with the strategies of government to take the economy to a new track of growth. Short term monetary tools can no longer be considered as a permanent solution to address the problem of inflation. What we really require is supply side adjustments smoothed by monetary policy support. Money should oil the system, stimulate the economy, and finally it should stabilize the economy as well. Since the Indian economy has been witnessing the emergence of specialized banking and non-banking financial intermediaries, the role of RBI itself has become more complicated. It calls for segregating the role of RBI as a regulator from that of the custodian of monetary policy tools.

End Notes

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[i] Financialization connotes a situation where social relations are increasingly expressed in terms of money. Or in other words a situation where every exchange is made with the medium of financial device.
[ii] Mr.Rajan, who assumed office of the Governor of RBI amidst the crisis increased the repo rate by 25 basis points or 25 percent to 7.50 percent surprising the business community in India
[iii] However, we do not intend to give a complete theoretical outline of the monetary policy which any standard book on monetary economics would do.
[iv] I G Patel in his book on his role as an economist in various positions referred to such occasions.
[v] M3 is considered as the broad measure of money supply in India which inter alia comprises of currency, demand liabilities, fixed liabilities and post office savings.
[vi] FRBM stands for Fiscal Responsibility and Budget Management Act, a legislative initiative to bring in fiscal discipline, and thereby to reduce fiscal deficit
[vii] H money refers to High Powered Money which is acting as the monetary base.

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