REVIEW ARTICLE

Money and Finance Through the Looking Glass*

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Monetary economics has seen perhaps more controversies than any other branch of economics since the `twenties. The fall of the gold and gold exchange standard, the decline of classicism leading to the dominance of fiscal economics in the wake of the Great Depression, the Fisherian elegant exposition of the quantity theory of money in terms of the world-renowned equation, MV = PT, followed by the Cambridge version and the Keynesian attempt to provide 'fundamental equations', Milton Friedman's restatement of the quantity theory of money in the `fifties together with the emergence of what has come to be known as 'monetarism', the burst of the Phillip's curve, and the subsequent disproval of it, the emergence of the rational expectations school, new classicism, post- and new as also neo-Keynesian economics - all these to put in a summary form, are a part of the story of what monetary economics is all about. The amount of research efforts that has gone in to prove/disprove the basic premises of monetary economics, depending on one's predilections, is phenomenal. Fortunately, it gave rise to rich, innovative ideas, and influnced the thinking of those who wielded considerable power in policy-making and decision- taking. In the process, it enriched the Keynesian logic and framework and brought about a sharp change in the processes that form part of the operating procedures of central banking.

Dr. C. Rangarajan, the author of the essays of the book under review was a unique central banker. His academic pursuits in money, banking and finance and his long stint as a teacher at the higher schools of learning in India and abroad, provided him with a rich haul of building blocks to mould the edifice of monetary policy making from the early `eighties when he took a proactive position as Deputy Governor until he laid down office as Governor of the Reserve Bank of India at the end of 1997. He was a key member of the Chakravarty Committee to review the working of the monetary system in India in the `eighties. The imprint of this association was clearly visible in his Presidential Address to the Indian Economic Association in 1988, which is the very starting point of the *Essays*. He nurtured young research workers in the Reserve Bank, to keep pace with the latest theoretical developments, and left the windows of his thinking open to new ideas. Being an econometrician by training, he could view both theory and applications as inseparable twins and his policy-oriented examination of the live issues of the day had sound analytical underpinning. If Lord Keynes was a great pamphleteer, Dr. Rangarajan can be truly regarded as an articulate artist extraordinaire of the economics profession. In this review article, a few of Dr. Rangarajan's ideas are highlighted with a view to understanding the mind of the person who dominated monetary policy thinking in India for nearly two decades.

First, and foremost, is the proposition that 'money matters' which runs through the book. For Dr. Rangarajan, credit expansion will *ipso facto* lead to increase in money supply (MS), and therefore the 'credit view' gets subsumed under the 'money matters' argument (see p.23). While in a balance sheet sense, this is very correct, it is important for monetary policy makers to provide adequate credit supplies to match credit demands. Given the indefiniteness of credit demand function, the perception that 'credit view' has not been appropriately tested in the Indian context has gained ground, especially among those who have been tracking the record of the impact of financial innovations on money supply determination. Dr. Rangarajan would contend

that so long as the relationship among money, output and prices is explained, and if that relationship is found to be stable over time, MS is a critical element of monetary management. In a typical policy economics mode *a la* Tinbergen, MS becomes an intermediate target to achieve the ultimate objective(s).

So long as the money demand function is stable and provides a predictable relationship among money, output and prices, it will serve as a sound foundation stone for monetary targeting (p.53, p.64 for example). To him, clearly MS has to be broad money and cannot be narrow money as some economists in the classical tradition e.g. Professor P.R. Brahmananda would argue (see the very first essay). Almost all economists in India have been using broad money concept ever since the early `eighties, even though some writings on money demand still test the function with respect to narrow money. In an important sense, the definitional issue was settled. The Reserve Bank which, till the very early `eighties, used to give the sources of money stock in terms of narrow money (M1) switched over to broad money (M_3) as the reference for data dissemination and monetary analysis.

The stability of money demand does not, however, mean, as Dr. Rangarajan shows, that there has to be contemporaneousness in the money-output-prices relationship or in the money-prices relationship, given the evolution on the output front. Dr. Rangarajan in fact comes out with a three to five-year averaging method, to illustrate the positive relationship between MS expansion and price increase (p.10, p.64). The 5-year time horizon is merely an indicative or illustrative way of substantiating the point. The averaging could well be for a shorter or longer period or it could even be a moving average.

Monetary targeting, in the face of financial innovations and the consequential adverse effect on the stability of money demand, has been echoed in the *Essays.* But so long as money demand is stable, how could one completely ignore monetary targeting is the issue that Dr. Rangarajan would take upto with his critics. For policy formulation, he would, however, be prepared to take a close look at a number of other variables *viz.*, real sector developments, credit, fiscal deficit, prices, balance of payments position while retaining the monetary targeting framework. (He calls it 'menu' or 'checklist' approach. See p.64).

The alternative to monetary targeting would be, as Dr. Rangarajan has pointed out, interest rate or exchange rate targeting, as is done in many industrialised countries. While exchange rate targeting binds you to stricter conditions such as *low* inflation rate in line with the partner countries' inflation rate and a defined anchor, interest rate targeting is relatively easy, provided, as Dr. Rangarajan observes, the financial markets are well integrated (p.64) and interest rates by and large move in a moderate range. While logically this argument is appealing, one needs to closely examine the question of having an intermediate target in the event of uncertainty emerging in the stability in money demand in near future in an environment of continued market segmentation. Although there is increasing evidence of integration of money and foreign exchange markets, segmentation exists in most markets owing to lack of depth in the market and absence of well developed secondary market operations.

Dr. Rangarajan's faith in monetary targeting should be seen not as a simple calculus of real money demand determination on the basis of elasticity of demand with respect to projected

income growth, but as one that has a 'feedback' rule (p.11). The 'feed-back' here would effectively imply ranges of estimates, and revisions in estimations of MS growth, based on availability of recent data on the evolving output situation.

Dr. Rangarajan is clearly aware of the pitfalls in monetary modelling when there are severe constraints to optimal deployment of instruments to get at the 'intermediate target'. The Kutty Memorial lecture on the autonomy of central banking (Essay 3) provided the opportunity to reduce, if not eliminate the severe constraint as well as to devise a more meaningful and forward-looking monetary-fiscal policy coordination. This lecture is not, therefore, a plea for 'autonomy' in the narrow sense but an advocacy for improved maneuverability in monetary policy actions. Out would go automatic monetisation that has grown out of the system of issue of *ad hoc* treasury bills. The autonomy that Dr. Rangarajan considered meaningful was headroom to efficient conduct of monetary policy.

This maneuverability is crucial since it provides a larger space - the NDC (net domestic credit) as a whole for the play of monetary policy. With NFA (net foreign assets) being no longer exogenously given, at least since 1993-94, the central bank will have larger area of responsibility in the conduct of its policy.

Dr. Rangarajan has been a sceptic of the validity of the Phillips curve in developing countries, even before he joined the Reserve Bank (see his contribution on the subject to the International Economic Association's Conference held in Pune in 1980; see also p.61). He sees inflation control as vital, and as the best anti-poverty programme. He would also regard inflation control as a means to optimise growth (see p. 73).

It is against this backdrop that one needs to view Dr. Rangarajan's contribution to financial sector reforms. Since growth maximisation by definition depends upon productivity factor, efficiency in the financial sector is critical for investments to be productive. Issues of financial prudence, which would provide the foundation for financial soundness, came to the fore during Dr. Rangarajan's period of Governorship of the Reserve Bank. The mechanisms brought about in respect of asset classification, capital adequacy ratio and income recognition, and supervision of banking entities and non-bank financial companies are well documented in the *Essays* and in various Reserve Bank publications during the said period. It was also during his tenure as Governor that India moved towards external current account convertibility through acceptance of Article VIII obligations of the International Monetary Fund and considerable relaxations on external capital account. To facilitate implementation of prudential norms, care was taken to reduce reserve requirements, develop Government securities and money markets and improve the rural credit delivery system.

One important issue that came to the fore in most discussions in the first half of the 'nineties related to the introduction of interest rate flexibility as part of financial liberalisation. Here Dr. Rangarajan's caution in gradual liberalisation of interest rates is noteworthy. Analytically speaking, one could defend the cautious approach on the ground that complete interest rate deregulation, in the absence of well developed financial markets and regulatory framework, and in the absence of subdued inflationary tendencies could lead to systemic problems (p.85, p.86 and p.115). This is an important insight that one gains on sequencing of

reforms from the Indian experience, and as Dr. Rangarajan has put it, 'cautious sequencing of reforms' coupled with 'consistent and mutually reinforcing character of the measures taken' would give a boost to financial sector efficiency.

The external sector management issues centre on, according to Dr. Rangarajan, the sustainable level of current account deficit (CAD) relative to GDP. In his view, a 2 per cent CAD ratio, sharp containment of debt creating flows, especially relating to short-term, market related exchange rates, and gradual relaxation of capital account correlated with improvement in financial position of banks, are the necessary ingredients of external sector management (Essays 19 to 21). It must be recognised that when faced with exchange market pressures in 1995-96, he did not hesitate to adopt unconventional methods.

It must be noted that it was during his Governorship, net foreign exchange asset accretion by the banking system became for the first time in *effective* sense, a major source of expansion of money supply. The idea of sterilisation owing to sharp capital inflows became a part of the monetary history of India ever since then. Most importantly, the idea of the need to accumulate foreign exchange reserves to give boost to confidence in policy making and to markets, was sown during his Governorship. This approach has paid good dividends, as one can see in retrospect, given the markets viewing the level of reserves as one of the important components of 'economic fundamentals'.

While many monetary economists often show their preference for dominance of markets over the state, Dr. Rangarajan clearly believes that 'the debate between the state and the pure market is a sterile one and no serious thinker has ever disputed the role of state intervention'. In his view, there is a strong case for state intervention in social and physical infrastructure, whereas in other sectors, state can gradually make the way for markets if markets are able to function in an efficient manner. Complementarity of state and market, with state minimalism is perhaps the key to improving the economic performance of the country. The historical experiences show that while market failures exist, they can be regulated or rather, reregulated, whereas state failures cannot be rectified except through a strong social and political action which can often turn out to be costly.

The *Essays* also contain a section on science and technology issues related to the financial sector. The use of technology in Indian banking industry has got delayed because of labour resistance and unwillingness of bank managements to be forward-looking. Dr. Rangarajan played an important role in bringing about awareness in banks about the need to improving the financial sector efficiency through IT adaptations and upgradations. It, however, took long time for banks to accept this proposition. It is *now* time that banks focus on adaptations of right technologies in quick time, as Dr. Rangarajan reminds us. Fortunately, all the banks have now been investing large amounts in new technologies and providing training to their employees, and the labour has now come to accept the IT as an essential part for the banking industry to grow.

Finally, the *Essays* is extraordinary in several respects. First, it contains analytics of monetary and financial economics to help us understand the rationale of policy actions. Secondly, the *Essays* show that while policies need to be based on the available data and the circumstances of the living present, they would have to be forward looking. Thirdly, the volume

shows that while there are some sound fundamental principles, they need to be applied with flexibility, irrespective of the dynamic inconsistency problem that such applications may entail. Fourthly, the *Essays* have a great educative content for the enlightened public which through articulation of its opinion could influence the processes and the essence of policy thinking in future. It would therefore be no exaggeration to say that when the definitive monetary history of the past two decades is written, Dr. Rangarajan's *Essays* will be considered as the *locus classicus* on the subject.

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* **This is a review article of the book, *Indian Economy : Essays on Money and Finance,* by C. Rangarajan, UBS Publishers' Distribution, New Delhi, 1998. The *Essays* are essentially the author's lectures' and addresses delivered during the period 1988 to 1997, when he was holding the positions of Deputy Governor (upto 1991) and Governor (1992-97) of the Reserve Bank of India.**

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