

FOREWORD

The structural reforms process was initiated in India in the early 1990s in order to place the economy on a higher growth path on a sustainable basis. These reforms encompassed almost all sectors of the Indian economy and, among others, necessitated changes in the monetary policy framework. This Report undertakes a detailed assessment of key issues related to Monetary Policy. The Report is in many ways a continuation of the analysis attempted in the previous two Reports. The Report on Currency and Finance, 2001-02 undertook a comprehensive assessment of a decade of economic reforms in India, whereas the Report for the year 2002-03 focused on management of the external sector in an open economic framework.

The conduct of monetary policy has been changing in response to the process of financial liberalisation. The increasing volume of cross-border trade in goods and services along with that of financial flows have enhanced inter-dependence in monetary policy formulation across countries. Sharp swings in capital flows and volatile exchange rate movements have emerged as key concerns in monetary management in the emerging market economies. Accordingly, all central banks are paying greater attention to financial stability considerations in their overall design of monetary policy formulation. Financial innovations have also induced significant transformation in the operating procedures of monetary management. Concomitantly, there is now a growing recognition of the need to impart to central banks a greater degree of independence, especially from the budgetary compulsions of the Governments, in order to stabilise inflationary expectations for ensuring price stability.

In India, the conduct of monetary policy during the 1990s has been shaped by wide-ranging structural reforms during this period. This necessitated significant changes in the monetary policy framework in terms of objectives, instruments and targets. The changes had to be dovetailed with a simultaneous process of evolution of financial markets in consonance with the aim of enhancing allocative efficiency through the process of price discovery. At the heart of monetary reforms lay the containment of the fiscal dominance of monetary policy. In contrast, with the opening up of the economy, monetary management had to contend increasingly with challenges emanating from the large volume and sudden switches in capital flows and episodes of volatility in the financial markets. In this milieu, while price stability and credit availability remained twin objectives of monetary policy, financial stability has gradually emerged as a key consideration in the conduct of monetary policy.

Against this backdrop, the Report is focused on the theme of "Monetary Policy" and focuses on the developments since the early 1990s. The Report begins by addressing the changes in the monetary policy framework in terms of objectives, intermediate targets and operating procedures of monetary policy. This is followed by a discussion on monetary management in an open economy, especially in view of the multiple external shocks impacting the economy during the period of reform. The Report then attempts an assessment of the effectiveness of monetary policy in achieving its key objectives, *viz.*, inflation and credit availability. Issues relating to the monetary transmission mechanism are also addressed in the context of the financial sector reforms and the concomitant shifts in the operating procedures of monetary policy. Finally, the Report examines issues related to financial stability. An overall assessment of the conduct of monetary policy in India indicates that the Reserve Bank has been successful in maintaining price and financial stability, even in an environment characterised by repeated shocks, both domestic and external. Efforts to improve credit delivery mechanism have also started yielding dividend in recent years.

The Report has been prepared in the Department of Economic Analysis and Policy (DEAP) under the overall guidance, supervision and editing by Dr. Narendra Jadhav, Principal Adviser and Chief Economist.

The Report was drafted by a core team of economists led by Muneesh Kapur. The core team comprised Indranil Bhattacharyya, Binod B. Bhoi, Saibal Ghosh, Rajeev Jain, A. Karunakaran, Arun Vishnu Kumar, S. M. Lokare, Rekha Misra, M. Ramaiah, Satyananda Sahoo, Indranil Sen Gupta, S. Suraj, and Amar Nath Yadav.

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Almost every officer of the Department was associated in the preparation of Chapter II of the Report, dealing with recent economic developments.

I hope that the analyses presented in this Report would not only encourage further research in monetary economics, but also lead to constructive debate in the country, thereby contributing to the future conduct of monetary policy.

I take this opportunity to place on record my deep appreciation of the outstanding professional skills in the Reserve Bank of India, in the design and in the conduct of monetary policy by all officers in the Reserve Bank of India and in preparation of the Report by officers of the Department of Economic Analysis and Policy. I would also like to express my appreciation to Governor Reddy for giving me the opportunity to oversee the final stages of completion and publication of the Report, even though I demitted the office of Deputy Governor a few weeks ago.

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Department of Economic Affairs,
Ministry of Finance,
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Deputy Governor, RBI (until October 31, 2004)

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