

# I

## THEME OF THE REPORT

1.1 The process of financial and external liberalisation during the last couple of decades worldwide has impacted upon the conduct of monetary policy in a significant manner. Increasing trade openness, higher volume and sharp swings in capital flows as well as greater volatility in exchange rates are some of the key stylised facts of the 1990s. As a result, economic developments abroad have an increasingly high degree of influence on domestic output and prices. Simultaneously, risks of contagion have increased manifold, posing threats to macroeconomic and financial stability. Consequently, these developments have necessitated refinements in objectives, strategies and tactics of monetary policy, even though central banks have had a noteworthy success in terms of their inflation objective.

1.2 In India, structural reforms were initiated in the early 1990s. These reforms encompassed all sectors of the economy and involved reorientation towards a market-based economy to foster greater efficiency and growth. Concomitantly, these reforms also impacted upon the monetary policy framework. The opening up of the economy posed a number of challenges to monetary management. Nonetheless, the period has witnessed significant gains in terms of reduction in inflation as well as in containing inflation expectations. Efforts to improve credit availability have also paid rich dividends. Finally, financial stability was maintained in India, even when many other developing and emerging market economies witnessed episodes of financial instability. This Report undertakes a detailed discussion of all these issues. While the focus of the Report is on the evolution of monetary policy in India and the challenges facing it, different Chapters present these developments against the recent theoretical developments in the field of monetary economics and the accumulated cross-country empirical evidence.

1.3 As a prelude to the substantive theme based discussions, Chapter II of the Report titled "Recent Economic Developments" provides an analytical account of macroeconomic developments in the Indian economy during the year 2004-05 so far.

1.4 In the theme-based discussions, Chapter III titled "Monetary Policy Framework: An Analytical Overview" covers issues relating to objectives,

intermediate targets and operating procedures of monetary policy. It explores the rationale for price stability objective of monetary policy and discusses the trade-offs between inflation and growth that a central bank faces. The role of institutional developments - central bank independence and fiscal rules - in contributing to monetary stability is also addressed. It is followed by a discussion on strategies and tactics of monetary policy, with a focus on key changes during the 1980s and 1990s in the intermediate targets, instruments and operating procedures to meet the evolving challenges. Issues in liquidity management to ensure stable conditions in money markets are also covered. The Chapter also revisits issues related to stability of money demand.

1.5 Chapter IV of the Report – "Monetary Policy in an Open Economy" - focuses on the challenges that external openness imposes upon the conduct of monetary policy. The Chapter presents stylised facts on key aspects of globalisation and its implications on the conduct of monetary policy. During the 1990s, capital flows to emerging markets have exhibited a highly volatile behaviour – witnessing a sharp rise in the quantum till the Asian crisis followed by massive reversals in the aftermath of the Asian crisis and a recovery in recent period. Implications of the volatility in capital flows and its impact on exchange rate and monetary management are addressed. It examines factors that have led emerging economies in the recent years to become net exporters of capital to the mature economies. A cross-country survey of policy responses to manage capital flows is presented to draw policy lessons for India. In view of the threat posed by existing global macroeconomic imbalances, a key feature is the recognition that increased financial openness requires monetary policy to pursue orderly conditions in financial markets. An attempt is made to measure synchronicity of business cycles in India with its trading partners to examine temporal changes in co-movement. The need to manage the quantum of capital flows and its associated volatility and to innovate constantly in terms of instruments, as borne out by the Indian experience, is also highlighted.

1.6 Chapter V entitled "Monetary Policy and Inflation" undertakes an assessment of monetary policy in achieving its primary objective, viz., inflation. It examines the global inflation record of the last half-

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century. This is followed by an assessment of various factors that led to the initial build-up of inflation during the 1960s and 1970s and its subsequent containment in the 1980s and 1990s. The experience with inflation targeting framework is critically analysed and its relevance for an emerging economy like India is assessed. The need for fiscal prudence in maintaining price stability is highlighted. Issues such as the conduct of monetary policy in a low inflation environment, exchange-rate pass-through to domestic prices and the impact of oil shocks on economic activity are also addressed. The Chapter also attempts to model inflation process in India and provides estimates of the degree of pass-through of exchange rate to domestic inflation.

1.7 Bank credit is an important source of finance for growth, especially in developing and emerging economies. At the same time, bank credit is an important channel of monetary transmission. Furthermore, excessive increases in credit aggregates are believed to contain lead information on future financial vulnerability. These set of issues are discussed in Chapter VI entitled "Bank Credit". With a shift away from directed credit towards a market-oriented system of credit allocation, high information and transaction costs can have an adverse effect on credit availability for key sectors of the economy. In this context, the Chapter dwells upon the various measures taken by the Reserve Bank to improve the credit delivery mechanism in the Indian financial sector. An assessment of these efforts in augmenting the flow of credit to various sectors of the economy in the post-reforms period is undertaken. The issue of banks' preference for investment in Government securities, despite reductions in statutory preemptions, is also addressed.

1.8 Monetary policy is known to operate with long and variable lags. Chapter VII - "Monetary Transmission Mechanism" - undertakes a discussion of issues related to monetary transmission. A brief theoretical overview of various channels through which monetary policy influences output and prices is followed by a cross-country empirical evidence on transmission lags and pass-through from policy rates to market rates. The Chapter also covers various policy efforts initiated in India with a view to impart flexibility to the interest rate structure as well as movements in real interest rates. Finally, the Chapter undertakes empirical exercises to explore the monetary transmission channels in India including estimates of interest rate pass-through.

1.9 Given the increasing concerns on financial instability, Chapter VIII focussed on "Financial Stability" undertakes a discussion of key issues in regard to financial stability. The Chapter starts with a discussion as to why price stability is not sufficient for financial stability. The role of monetary policy *per se* in contributing to financial stability – in particular, responding to asset price misalignments – is critically analysed. Given the limitations of the traditional monetary instruments in achieving financial stability, the Chapter discusses other policies - regulation, supervision, payments and settlement systems, accounting and governance norms and lender of last resort facility – that are needed to curb excessive volatility in the financial markets and to maintain financial stability through building strong institutions. The Indian approach to ensuring financial stability is highlighted.

1.10 The final Chapter of the Report - "Assessment of Monetary Policy" - presents an overall assessment on the key issues and challenges in the conduct of monetary policy, with special reference to India.