SPEECH

THE FUTURE COURSE OF MONETARY POLICY*

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The National Institute of Bank Management (NIBM) needs to be complimented for organising this Seminar on Banking and Monetary Policy issues particularly in the context of the changing environment. Having been associated with the NIBM in its first year of existence I cannot but feel a sense of nostalgia as the institution will soon be celebrating its Silver Jubilee. It gives me great pleasure to be with you at this inaugural function today.

I have had the opportunity of going through the papers prepared for this Seminar and I am encouraged at the increasing interest being taken by Indian economists in monetary economics. It is my belief that one of the drawbacks in the development of the subject in India is the lack of interaction between the academic community and the practitioners of monetary policy. I do hope that fora like this provide an opportunity for meaningful interaction. With a view to stimulating discussion, I propose to share with you some thoughts on the monetary policy scenario as I see it developing by the turn of the century. Let me preface this with a general remark that if academic work on monetary policy is to be relevant, it should take into consideration the preoccupations of the practitioner.

The theory underlying monetary and financial policy for the past half a century is based on the mistaken belief that we can secure a higher level of employment and output by maintaining total money expenditure at an appropriate level. The increasing of aggregate demand to stimulate output has been the most important single cause of extensive misallocation of resources. The continuous injection of additional amounts of money can create a temporary demand but this effective demand can last only if the increase in the quantity of money continues to accelerate. Such an acceleration of money growth can only result in accelerating inflation which results in an inevitable disorganising of economic activity. When the central bank presses the panic button and slows down the monetary growth, there is an inevitable decline in output and employment. It is unfortunate that ever since the late 1930s, economists were able to provide 'scientific' quantitative evidence for a false theory and in the process the valid theoretical underpinnings of a sound monetary policy were rejected in the absence of sufficient quantitative evidence. I am sure that some of the older economists at this Seminar would be able to decipher that I am merely echoing the thoughts of Hayek who in his Nobel Memorial Lecture argued that true but imperfect knowledge is preferable to the pretence of exact knowledge that is likely to be false.

The world-wide inflation since the 1940s occurred precisely because it was believed the world over that financing the Government by creating money was a necessary and lasting effective method of increasing output and employment. The argument in favour of running government deficits was what Hayek calls a 'seductive doctrine' which, governments could not resist. It is here that economists have to bear the blame for having provided a faulty theoretical underpinning for disastrous monetary and financial policies.

In recent years, it is increasingly recognised that debauching the monetary medium can only result in inflation and not growth and a large number of central banks are coming out of the closet to openly declare their position that inflation is public enemy No. 1 and that if a country wishes to attain long-term growth, then inflation must be excoriated from the system. Notwithstanding

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economists holding an eclectic view on the causes of inflation, more and more central banks are recognising that inflation is, and always is, a monetary phenomenon. Accordingly, inflation control is becoming the primary if not only mission of a number of central banks. A consistent, predictable and coherent anti-inflationary monetary policy is the best contribution that a central bank can make in the pursuit of growth of the economy.

In the recent period, the inflation rate in India on a year-on-year basis has come down to around 7 per cent as against twice the level a year ago. While this decline in the inflation rate is welcome, it has also to be viewed against the background of a very significant reduction in world inflation rates which reveals a number of success stories in countries with historically high inflation rates. The inflation rates over the past year for some of these countries were as follows : New Zealand (1.0 per cent), Australia (1.2 per cent), Sweden (1.8 per cent) and Norway (2.5 per cent). In all these countries where there has been a sharp reduction in the inflation rate, monetary policy has had a strong and unswerving anti-inflationary focus. I stress this international setting because in India there is a powerful and articulate segment which argues for a rapid easing of monetary policy to provide a stimulus to growth ostensibly on the ground that this would help the weakest segment of society. Nothing could be farther from truth. If we were to undertake a rapid easing of monetary policy we would be throwing away a one chance in a generation of singeing inflation from the system. The curtailment of inflation is the best anti-poverty programme and as such a strong anti-inflationary monetary policy is supportive of an overall policy expression of societal concerns.

Over the decade 1980-81 to 1990-91, the average rate of growth of M_3 was 17 per cent, real growth was 5.6 per cent and the inflation rate 7 per cent. The inflation rate of the past two years has been well above the trend rate and there are inherent dangers of reflating too early in the name of fostering growth. Monetary economists need to focus attention on a few simple facts which should caution against the irresistible urge to revive the economy by injecting created money in the system. First, the monetary growth in India is much higher than in a large number of countries with high real growth rates and low inflation rates. Secondly, there are a number of indicators which tend to show that monetary policy in India is not unduly tight. The income velocity of M_3 over the past five years has not shown any perceptible variation — hovering around 2.1-2.2. Again, the M_3 broad money multiplier has ranged around 3.1-3.3. If the monetary policy were tight, it would affect the real sector only if the income velocity reaches a level where further tightening of the monetary policy does not result in an increase in the income velocity. It would be reasonable to expect that in the Indian context, a tight monetary policy would merely result in a slight increase in the income velocity and as such there is unlikely to be any adverse effect on output. Thirdly, currency accounts for about one-fourth of broad money. Erudite quantitative studies talk about an irreducible demand for currency and, if the reserve money growth is insufficient, then the deposit growth would be severely affected. The experience of the 1980s does show that there is no such immutable demand for currency and there is sufficient scope for a change in the velocity to meet transaction requirements. Here, once again, one has to take into account a factor which cannot be easily quantified and, therefore, the pertinent issue gets side stepped. In this context, we need to give greater attention to the phenomenon of the activation of idle currency hoards. Any analysis which does not take into account the currency hoarding/dishoarding function would miss an important aspect of the monetary process. The upshot of all this is, once again, that a tight monetary policy is unlikely to have any adverse effect on the real sector; if at all it is the inflation rate which will come down.

I have dwelt at some length on these issues as a backdrop to the emerging issues in financial sector reform and the implications for the future course of monetary policy.

One of the major objectives of the financial sector reform is to reduce the effective tax on the banking system of heavy reserve requirements. Cash reserve requirements have for many years been internationally used as powerful instruments of monetary control and this instrument is seen as a tool for putting an upper limit on deposit growth. But then, there are the fashions of the time. In more recent years, the use of reserve requirements has been on the wane in a number of countries. In a number of countries (viz., Switzerland, New Zealand, Australia and Canada), these requirements have been abolished while in some other countries (viz., USA and Germany), they have been reduced significantly. The central banks of a number of countries have recognised that the process of deregulation and innovation in instruments has resulted in an increasing proportion of deposits being outside the reserve requirement framework and as such effective ratios are lower than the prescribed ratios. In the Indian context, the medium-term plan is to reduce the cash reserve ratio from an effective ratio of about 16.5 per cent in 1992 to 10 per cent by 1997. A feature of cash reserve requirements in India has been that over the 1980s the prescribed reserve ratio was raised sharply and to compensate the banks, higher and higher rates of interest were paid on these cash balances — this is a self-defeating process. Had interest not been paid on cash balances, the same degree of monetary control could have been attained by prescribing the ratio at one-half of the level actually stipulated. Quite clearly, the Gordian Knot has to be cut and the policy now has been to gradually lower the stipulated ratio and simultaneously reduce the interest paid on cash balances; contrary to the general belief, this is quite clearly to the advantage of banks.

While the objectives are quite clear, the time path of the adjustment has to be carefully modulated. To the extent that the central bank relies on the direct approach of a link between reserves and monetary growth, a decline in reserve requirements would result in an attenuation of monetary .control. If loss of monetary control is to be avoided the central bank would need to have much greater interest rate manoeuvrability and the security market needs to be adequately developed. The players in the Indian financial markets must recognise that, by the turn of the century, it is conceivable that in most countries there will be substantially reduced reserve requirements or even a total elimination of reserve requirements without any deleterious effects on monetary control and open market operations and direct lending to banks and financial institutions could become the major instruments of monetary control. As such, the Indian financial system should prepare itself for a major change in the system of monetary control.

Closely linked to the issue of the cash reserve requirement is the statutory liquidity ratio which has been prescribed at a level as high as 38.5 per cent. As a result of various changes, the effective ratio is now already 36.0 per cent and it is intended to reduce the ratio to 25 per cent over the next three years. For a successful implementation of this medium-term policy intent, it would be necessary to have a well-developed securities market. While artificially low interest rates on Government securities have been the bane of the securities market, in the recent period, there has been a convergence of interest rates in the system. It is not often recognised that the interest rates on Government securities are now close to the realm of substitutability: the maximum rate on securities is 13 per cent while the average lending rate on advances is around 15.5 per cent. Given the risk perception, by the end of the decade, it is quite conceivable that the banks' choice of asset holdings will be determined not by statutory prescription but by the risk reward perception on securities and bank lending. Quite clearly banks will need to strengthen their risk evaluation capabilities to take a considered decision on their asset portfolio.

Quite often it is argued that commercial lending rates are too high and should be brought down sharply. While the nominal rates for commercial loans are high, the problem is that these lending rates can be brought down only if deposit rates are reduced. To maintain the competitiveness of banks, it is necessary to ensure that real deposit rates must be kept positive. Using a twelve-month average of the inflation rate, it is observed that since 1990, the real deposit rates have ranged from a peak of 2.7 per cent and a low of -0.8 per cent and at present the rate is around 0.5 per cent. While the present real commercial lending rate is high (around 6.5 per cent), a reduction in deposit rates is a prerequisite for a reduction in lending rates. Until reserve requirements are lowered substantially and the element of interest rate concessionality reduced, there would inevitably be a cost wedge between deposit and lending rates.

At the present time, the Reserve Bank's refinance operations are not effective as instruments of monetary control as the bulk of such refinance is sector-specific and based on an automatic formula. Obviously, in a well developed financial market such a system of refinance would be an anachronism and would quite clearly need to be altered. In the kind of financial system which is emerging, sector-specific refinance facilities will necessarily become a smaller segment and the bulk of refinance would be general refinance at market-related refinance rates of interest and auctions for central bank funds could become the predominant form of Reserve Bank intervention in the market.

Quite often, monetary policy and exchange rate policy are discussed as separate and distinct segments of overall financial policy. These two segments are inevitably intertwined and as a market-based system develops, it would no longer be meaningful to view these as separate segments of policy. If these two segments are not made consistent one or the other segment of policy could be greatly attenuated.

The banking industry is going through an important reform with the introduction of capital adequacy and income recognition norms and provisioning requirements. With the greater transparency of balance sheets, the Government has already provided an amount of Rs. 5,700 crore in 1993-94 for the recapitalisation of banks. While it is often argued that overall financial policies and the environment are responsible for the losses of banks, it is important to recognise that in the same environment some banks have performed better than others. While detailed bank-wise plans need to be worked out to ensure that after recapitalisation, the weaker banks do not relapse into the earlier problems, it would be necessary to work out strategies of damage containment; this would include the working out of policies of asset shedding where necessary as also control on liability growth. Banks would need to recognise that the financial system will become progressively competitive and it would be difficult for inherently weak units to be protected in such an environment.

Before I conclude, I must stress that I have tried to set out the kind of changes which are likely to take place in the next few years. Direct controls will become less important and interest rates would be the key instrument through which monetary policy would be transmitted *via* the money and securities markets. These are admittedly unsettled issues at the frontiers of monetary policy and I am sure that distinguished participants at this Seminar would provide invaluable contributions to the debate on the future course of monetary policy. I wish your deliberations all success.

Nominal and Real Lending and Deposit Rates of Scheduled Commercial Banks

(Per cent per annum)

Effective Date	Average Inflation Rate on the basis of previous twelve months	Nominal Lending Rate for limits of over Rs.2 lakh. (minimum)	Nominal Deposit Rate (maximum)	Real Lending Rate	Real Deposit Rate
(1)	(2)	(3)	(4)	(5)	(6)
October 10, 1990	8.3	16.0	11.0	7.7	2.7
April 13, 1991	10.3	17.0	12.0	6.7	1.7
July 4, 1991	10.9	18.5	13.0	7.6	2.1
October 9, 1991	12.7	20.0	13.0	7.3	0.3
March 2, 1992	13.7	19.0	13.0	5.3	(—)0.7
October 9, 1992	12.8	18.0	12.0	5.2	(—)0.8
March 1, 1993	10.5	17.0	11.0	6.5	0.5