SPEECH

AUTONOMY AND MONETARY POLICY OF THE RESERVE BANK OF INDIA

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The Economics Teachers' Association needs to be commended for its activities and I am deeply honoured that members have given up this Sunday morning in pursuance of the objectives of the Association.

2. The word "autonomy" conjures up considerable excitement in the context of any institution. The world is becoming a much more open place and when one talks of autonomy of institutions we also need to talk about accountability. In the context of Central Banks, autonomy has become the fashion of the times. But as students of economics we must look more seriously at the core of this autonomy. In the Indian context we have in the Tenth M.G. Kutty Memorial Lecture (1993) on *Autonomy of Central Banks* by Dr. C. Rangarajan, Governor, Reserve Bank of India, a presentation which will go down as the *locus classicus* on the subject. With this document already available to this audience, I thought that in this brief presentation I should attempt to only provide some background on the concept of autonomy in terms of the efficient functioning of monetary policy.

3. Central Banks, the world over, are meant to be entrusted with the responsibility of ensuring stability of the currency in both domestic and international markets and, therefore, it is appropriate that the autonomy of a Central Bank should be assessed with reference to the degree of freedom that a Central Bank has in the operation of its monetary policy. What I would, therefore, like to place before you is how monetary policy has been conducted in the past and the changes in recent policy initiatives.

4. Until the overall reform process was initiated in 1991, the basic approach of monetary policy was to try and neutralise the expansionary impact of the fiscal expansion. Putting it in a rather simplified manner, what was being done was that with a given fiscal deficit the banking system would absorb a sizeable part of the debt at low interest rates under the statutory liquidity ratio (SLR), while the Reserve Bank picked up the uncovered gap through the mechanism of *ad hoc* Treasury Bills which were issued to instantly meet the Government's requirements. Since such a system inevitably generates large primary money creation, the Reserve Bank had been actively using the powerful monetary control instrument of the cash reserve ratio (CRR) to prevent the primary money expansion from resulting in a secondary expansion with inevitable inflationary consequences. While such policy responses would be quite feasible if the fiscal deficit were corrected over time, it has deleterious effects when the fiscal deficits become chronic as repeated escalation of the reserve requirements become necessary. During the period of the foreign exchange crisis of 1990-91, the large fiscal deficit and the sharp acceleration of inflationary pressures, the reserve requirements had to be sharply increased to a level where the total reserve requirements (both SLR and CRR taken together) were raised on an *incremental* basis to an unprecedented 63.5 per cent. While these measures, alongwith other important measures, did help contain the strong inflationary pressures, it was recognised that the time had come to totally reorient monetary policy measures from direct controls to indirect controls.

5. Let me now explain the essence of indirect monetary control. As part of the reform process, it was clear that continually increasing reserve

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requirements and providing artificially low remuneration on these reserves implied a heavy tax on the banking system which then requires a system of heavy cross-subsidisation. Illustratively, in 1991, the ceiling on the Government securities rate was 11.5 per cent while the minimum lending rate of banks for advances of over Rs.2 lakh was as high as 20.0 per cent. There was, thus a need to bring these rates into better alignment. Today the ceiling on the Government securities rate is 13.5 per cent while the minimum lending rate of banks is 15.0 per cent. Thus, on the interest rate front, there has been a major correction of the earlier distortion.

6. Again, there has been a backing off from excessive use of reserve requirements and from incremental reserve requirements of 63.5 per cent the ratio has been brought down to 39.0 per cent; further reductions in the SLR are slated as part of the overall financial sector reform.

7. The system of indirect control requires a major change in the system of financing the Government in that the Central Bank does not first pick up the Government debt and then try to reduce the monetisation of this debt by other direct methods of monetary control. It is here that the embryo of the financial sector reform process has been conceived. In the more recent period, the Government is increasingly financing its large deficits by recourse to market borrowing at close to commercial rates rather than borrowing from the Reserve Bank and to that extent, the first round monetisation has been lower than it otherwise would be.

8. When the Government finances itself increasingly from the market, it is not as if the Reserve Bank would not hold Government paper. What the Reserve Bank would do in this situation is to determine the optimal level of reserve money creation and then tailor its open market operations to attain that objective. In such a situation, the Reserve Bank would be better placed to implement an effective monetary policy.

9. A key feature of the system of indirect control is that the Central Bank would purchase government paper in the primary market at the auctions only at the margin and the rate should essentially be determined by the other market agents[1]. For all practical purposes it would be appropriate to conclude that the Indian experience of 1992-93 and 1993-94 on auctions of Central Government dated securities and 364 Day Treasury Bills shows that this basic requirement of indirect control has been met as purchases by the Reserve Bank have been marginal at the dated securities auction and the Reserve Bank has been a net seller of securities during the past two years. The short-term financing of the Central Government is admittedly still a problem in that the short-term instrument is used to financing what is essentially a longer-term requirement and that such financing is still largely met from the Reserve Bank. There are, however, signs of some change in that a part of the short-term borrowing is through auctions of 91 Day Treasury Bills and moreover, recognising the longer-term requirement, periodic funding in the market has been undertaken successfully.

10. While the manner of financing the government has an important bearing on the effectiveness of monetary policy, there are other important issues which have to be considered when gauging the efficacy of monetary policy. Apart from providing for freedom for the Cenrtal Bank to decide how much government paper it wishes to hold for a truly effective monetary policy, there must be a clear mandate and the Central Bank can then be required to be accountable for its actions. There are various views on what this mandate should be but I would submit that there is no better and clearer mandate than the achievement of price stability. It is here that there is a need for a broader national consensus before prescribing a mandate for a Central Bank. It is an accepted fact that a

1 See Cottarelli Carlo, Limiting Central Bank's Credit to Government, Theory and Practice, IMF Occasional Paper No. 110, December 1993.

Central Bank cannot run policies totally at variance from the national objectives of a society. It is in this context that there has to be a broad national accord that control of inflation is an over-riding objective of economic policy; in such a milieu it would then be legitimate to expect monetary policy to achieve this mandate.

11. There is one important aspect of the emergence of indirect instruments of control to which I would like to draw attention to, especially as all of you are in the academic world and some of you would be undertaking research on monetary matters. With indirect instruments of monetary policy, control of the usual monetary and credit aggregates becomes imprecise and as such it is not prudent to focus excessive attention on the traditional monetary aggregates which become less relevant in the new milieu. The efficacy of direct instruments of monetary control such as reserve requirements and administered interest rates is likely to diminish over time. If monetary and fiscal policies have to have an impact on output and the price level, it is necessary that the demand for money is stable over time. The changes following financial sector reform are likely to result in shifts in the asset demand and portfolio behaviour of the household sector as also the demand for credit by the corporate sector. Financial disintermediation and financial innovations are likely to render the task of monetary control more difficult and the question of choice of appropriate monetary indicators would need greater attention as traditional indicators will become progressively less meaningful.

12. Before I conclude, I would like to reiterate that the objective of monetary policy as also other components of economic policy is to maximise the welfare of the society and I would unequivocally submit that monetary stability contributes in no small measure to this welfare. Autonomy of a Central Bank does not mean the right to set arbitrary objectives; these macro economic objectives should be consistent with those established by the Government and shared by the public. It is in such a milieu that monetary policy can be effectively operated in the pursuit of price stability. Finally, I would like to stress that an institution viewing the concept of autonomy has to undertake a critical assessment of its track record *vis-a-vis* its objectives. In this context, it is necessary to recall the old adage that autonomy is never 'given', it is always 'earned'.