SPEECH

INFLATION, MONETARY POLICY AND FINANCIAL SECTOR REFORM*

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This is the first time I am addressing the Annual Conference of Bank Economists and I am grateful to the Saraswat Cooperative Bank for giving me the opportunity to deliver the Valedictory Address at this sixteenth meet. The Saraswat Bank is in its Platinum Jubilee Year and it is only apposite that this year's Bank Economists' Meet is hosted by this bank. While the founding fathers of the Bank were truly visionaries it would be no exaggeration to say that the bank's achievements could be said to have more than fulfilled the dreams of the founders. The hallmark of the Saraswat Bank is customer service — a much sought after but rarely found virtue in today's banking milieu -- and I salute the Saraswat Cooperative Bank.

The theme of the Conference, viz., "Liberalisation in the Financial Sector" is indeed a relevant one and I am sure that your deliberations will be reflected in progress in this area.

If the reform process in the country is to be an enduring success it will be necessary to achieve a satisfactory rate of growth without inflation. There are many instruments of policy which need to be used to achieve these twin objectives but monetary policy is best suited to the control of inflation and it is to this aspect of the reform process that I would like to focus attention in this address.

The experience the world over has been that central banks get paranoid about inflation control as they realise that once the growth process is fuelled by excessive monetary expansion it can be sustained in subsequent periods only by successively larger monetary expansions and at some point of time when the inflationary pressures are considered by the society as intolerable, the central bank has to undertake a painful monetary contraction which inevitably aborts growth of the economy. While very high inflation rates have obvious deleterious effects on the real sector, creeping inflation is equally insidious as it results in a misallocation of resources and attenuates the growth of the economy. Such creeping inflation hurts long-term economic growth and reduces the possibility of an improvement in the standard of living of the disadvantaged and the dispossessed as it is precisely these segments of society which hold a proportionately larger part of their assets in cash. As such, inflation is a tax on the weaker sections of society which is a total negation of social justice.

What then is the role of the central bank in tackling the problem of inflation? The monetary system is based on bank lending and the disequilibrium in the system is generated by the central bank lending at sub-optimal interest rates. Where central banks rectify this by charging appropriate rates of interest, they are known as the spoil sports just as the party gets going and hence they are constantly under pressure to lower rates of interest.

Progressively, more and more countries are assigning to the central bank the objective of attaining price stability. Let me now make a deliberately provocative statement on the causes of inflation. Despite the attempts of economists to take an eclectic view on the causes of inflation the ground realities are that inflation is, and always is, a monetary phenomenon. Over the long haul it is not possible to have generalised and continuing inflation unless it is fuelled by excessive creation of money. Increasing aggregate demand through created money eventually results

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in a misallocation of resources. The generation of demand *via* created money can be sustained only if the injection of created money accelerates at each round of production and there is a climate of a continuing increase in prices. Thus, the higher level of output and employment can be maintained only if there is rapidly increasing inflation which inevitably disorganises economic activity. Ultimately, the monetary authorities have to press the panic button and stop the injection of created money and a slow-down in real growth is inevitable. What is wrong is not the monetary authorities' action to curb inflation but the inescapable consequences of mistaken policies which generate inflation in the first place. Although it is difficult, it is imperative to resist what Hayek calls the 'seductive doctrine' of attaining salvation through created money. Once inflation is used to achieve a higher rate of growth, cessation of the created money results in an even larger reduction in output and there is no magic trick by which an economy can extricate itself from this perilous position. The most insidious nature of this process is that as a slowing down of inflation results in a slowing down of growth there is an irresistible urge to somehow revive the economy by injecting created money in the system. The adjustment to giving up the inflationary stimulus to growth has to be accomplished and this is admittedly hard and painful; after the drug addiction is given up it is necessary to avoid even a minor relapse for there can never be a return to a mild use of the drug.

All this may appear arcane but the world over central banks are increasingly recognising that inflation control is their primary, if not only, Mission and that a consistent, predictable and coherent anti-inflationary monetary policy is the best contribution that the central bank can make in the pursuit of growth of the economy. The objective of the central bank must be price stability and it has to be recognised that inflation can never buy growth. It would be ideal if inflation can be eliminated without any cost but unfortunately this is merely a Utopian wish.

It is sometimes argued that monetary policy may be far too restrictive and may unnecessarily affect the real growth of the economy. Nothing could be farther from the truth in the case of India. Over the decade 1980-81 to 1990-91 the average rate of growth of M_3 was 17 per cent, real growth 5.6 per cent and the inflation rate 7 per cent. A lower rate of monetary expansion would not have adversely affected output; if at all, it is the rate of inflation which would have come down. In fact, to the extent the transactions in the economy need a certain amount of money, it bears stressing that a slight change in the velocity would suffice to meet the requirements of the economy and as such for quite some time a step-up in velocity would ensure that insufficiency of money is not a factor hindering real growth. It is pertinent to mention that while in the recent period the year-on-year inflation rate has come down to 7 per cent as against twice that level a year ago, this has also to be viewed against the background of a significant reduction in world inflation rates. There have been a number of success stories in countries which historically have had high inflation rates. The inflation rates over the past year for some of these countries were as follows: New Zealand (1.0 per cent), Sweden (1.8 per cent), Australia (1.2 per cent), and Norway (2.5 per cent). As the list of countries with low inflation rates increases it will be imperative for us to also recognise that we cannot but move over to historically low inflation rates. I stress this as a number of distinguished Indian economists genuinely believe that money and prices are not interrelated. It is precisely this view which led a Governor of the Reserve Bank in the late 1970s' to lament that in this land of ours people believe that the laws of money do not work!

In all those countries where there has been a sharp reduction in the inflation rate, monetary policy has had a strong and unequivocal anti-inflationary focus. While stressing the role of monetary policy I do not wish to underestimate the crucial role of other arms such as fiscal, trade and exchange rate policies. While some relaxations from the restraints of the crisis situation of 1990-91 and 1991-92 are warranted, it would be unfortunate if, in the pursuit of an elusive growth, there is too rapid an easing of monetary policy as this would throw away a one chance in a decade to excoriate inflation from the system.

The need for monetary relaxation is often argued as being helpful to the weakest sections of society. Nothing could be farther from truth. The curtailment of inflation is the best anti-poverty programme and therefore a strong anti-inflationary monetary policy is in consonance with societal concerns. There is now increasing recognition among economists that inflation does not foster investment nor facilitate income distribution nor improve international competitiveness and as such there is much merit in a strong anti-inflationary monetary policy.

I have dwelt at some length on the subject of inflation essentially as a backdrop to the emerging issues in financial sector reform. The issues in financial sector reform are manifold but I would like to briefly touch upon only a few select issues.

The financial sector reform which has been the subject of debate in recent years in India can be broadly classified into three areas. First, there are overall monetary policy issues relating to reserve requirements, interest rates, refinancing facilities and indirect monetary control *via* the securities market. Secondly, there are issues of strengthening banks and institutions by way of prescription of prudential norms, clean-up of balance sheets, restructuring of banks and institutions and questions relating to the credit delivery system including priority sector credit. Thirdly, there are issues relating to institutional development such as entry of private sector banks, the development of the securities, money and capital markets and the non-bank financial companies.

The principal reason for reducing reserve requirements is to ease the burden on banks and this would ostensibly make them more competitive. To the extent that the monetary authorities continue to rely on the direct link between reserves and money supply, a precipitous decline in reserve requirements would result in an attenuation of monetary control. In a system like ours, where there has been heavy recourse to reserve requirements it would not be prudent to rapidly dispense with reserve requirements before putting in place various policy instruments and institutional and market structures. Moreover, banks should have the strength to deal with major portfolio decisions which they will be forced to undertake once reserve requirements are reduced. One need hardly stress that the realities of the Government budget and its pace of adjustment are also necessary inputs in determining the extent and sequencing of reducing reserve requirements. In the recent period there has been a significant start of a phased reduction in reserve requirements and a major thrust towards developing a Government securities market with the development of new instruments, viz., 364-Day and 91-Day Treasury Bill auctions, repos auctions, auctions of dated securities, and, more importantly, appropriate interest rate adjustments. While these salutary measures have been taken, the development of a genuine secondary market has, as yet, shown no signs of emergence; such a secondary market is crucial and reform in this area has to be high on the agenda. With capital adequacy norms in place and realistic pricing of Government securities it is likely that there would be a trade-off between high-risk credit and low-risk investments in securities. The imminent developments in the securities market in the foreseeable future call for development of entirely new skills in the Reserve Bank, the commercial banks and financial institutions and bank economists would need to equip themselves to be able to give advice to bank managements in this area which is going to become vital in the years to come.

Quite often Indian financial sector reform is criticised as being excessively cautious. In retrospect, it is being increasingly recognised that in the area of interest rate deregulation India has benefited from the gradual step-by-step approach rather than the Big Bang approach which country experience elsewhere has shown results in a loss of monetary control and consequent acceleration of inflation. Before a complete deregulation of interest rates can be considered, it is necessary to have stable macro-economic conditions and banks and financial institutions should have the financial strength and skills to effectively use their discretion with maturity and judgement. A carefully planned interest rate reform should not be mistaken for stagnancy in the reform or a deliberate policy of inaction.

Interest rate liberalisation would require active intervention by the central bank in the money market to ensure timely and adequate draining out or pumping in of liquidity in consonance with the overall monetary policy stance. In this context, it is necessary for the Reserve Bank to be able to have a Reference Rate for its own operations. For such a system to be effective, a basic prerequisite would need to be that sector-specific refinance facilities should be drastically reduced or even phased out and market-related refinance and auctions for central bank funds need to become the predominant form of Reserve Bank intervention in the market. In an era of flexible interest rates, banks and institutions cannot afford to have serious maturity mismatches. The direction of reform in this area is clear and bank economists must give early attention to these attendant problems.

Much has been discussed in the recent period regarding the impact on banks of the introduction of capital adequacy norms and the provisioning requirements. Greater transparency by itself does not result in a deterioration in the solvency of banks. The entire financial sector reform works towards a reduction in the cost wedge between deposit and lending rates and this should improve rather than deteriorate the true profitability of banks. Provision of artificial props over a long period of time defeats the very purpose of financial sector reform which is intended to improve the efficiency of operations.

With the opening up of entry into the commercial banking sector, existing banks would need to gear up to facing increasing competition. Increasingly, the distinction between bank and non-bank financial intermediaries will get blurred and both banks and financial companies would need to adjust to the rapidly changing scenario.

Before I conclude may I say that in the run up to the turn of the century, bank economists have a challenging and difficult role to perform as the entire financial sector is going through metamorphic changes and in such a setting the tasks of the economist will be changing rapidly. Bank economists should be able to pick out early signals of changes in other sectors which will have an effect on banks. Bank economists will need to upgrade their skills to develop a clear understanding of the working of financial markets in which they will be operating and specialisation in sub-sectors of the financial markets will become inevitable. Above all, bank economists should have a clear understanding of the lessons of history so that the same costly mistakes are not repeated. There are challenging and exciting vistas for bank economists as they approach the turn of the century and I wish them all success in their endeavours.