## Globalisation of Monetary Policy and Indian Experience *

Mr. White, Mr. Turner, distinguished central bankers and friends,

I welcome you all to Mumbai and the Reserve Bank of India (RBI) to this Eighth Meeting of the BIS Working Party on Monetary Policy in Asia. It is an honour for us to host this prestigious event for the central bankers. I would like to thank the BIS for extending this opportunity to the RBI.

Perhaps I should share with you some background on the RBI. It is one of the oldest central banks in the developing world – actually it has entered 70th year of its operations. Lord Keynes had proposed a "State Bank" for India to perform central banking as well as commercial banking and thus, participated in the process that led to consideration of establishing a central bank in India. The Reserve Bank Bill was introduced in 1927 and the legislative process took seven full years. The debate, among other things, was focused on two inter-related issues: one, the relationship between a colonial government and domestic financial sector, and two, whether the Bank should be established with private or government shareholding. The issue was settled in favour of private ownership and, in the meantime, the capital of the country was shifted from Kolkata (known as Calcutta then) to New Delhi, and the headquarters of the Bank was legislated to be in the financial capital of the country, namely, Mumbai (known as Bombay then). The Bank was nationalised in 1949 and thus became government-owned, and, not unsurprisingly, reflected the example of the United Kingdom. Apart from the traditional central banking role, the RBI performed various developmental roles in tune with the national economic planning during the four decades 1950-1990. With the initiation of reforms in 1991, the Bank redefined its role in the public policy arena, mainly in external and financial sectors. The role of the Bank in monetary policy formulation had to evolve taking into account the reform-agenda before the country and the global developments.

In the address today, I propose to start by drawing your attention to what may be termed as the 'globalisation of the monetary policy' and the forces at work shaping it. Of course, each country has its own unique characteristics and

the impact of globalisation on domestic policies is not similar for all countries. In this context, perhaps a brief review of the distinguishing features of the monetary policy in India, and an assessment of how the monetary policy has fared in India in the recent past would also be appropriate.

**The Globalisation of Monetary Policy**

The period since the 1990s has witnessed some convergence in the conduct of monetary policy, worldwide. Currently, there are striking similarities in the tools that monetary authorities employ to assess macroeconomic developments and the formation of expectations. In the choice of instruments as well as in the operating procedures, there are common features. The institutional architectures have begun to display several commonalities. The communication strategies and, thereby, the public accountability are in the forefront in all central banks with progressively increasing globalisation of financial markets and emphasis on central bank autonomy. Finally, there is greater universal recognition of the trade-offs confronting monetary policy decisions.

While individual country experiences vary in tune with country-specific diversities, the cross-country evidence highlights the fact that there are several common features driving this phenomenon.

First, cycles of economic activity have become increasingly synchronized across countries, irrespective of the level/stage of development. Second, there is now widespread recognition of the adverse implications of high fiscal deficits on the conduct of monetary policy. Third, there have been significant shifts in instrument mix. Drastic reductions in statutory pre-emptions, greater reliance on indirect instruments, emphasis on flexibility and timing of policy response and, in general, a greater market orientation are all major elements of this shift. Fourth, there is a greater activism in liquidity management and a focus on the short-end of the market spectrum; this has also been engendered by the growing integration of financial markets domestically and internationally. Fifth, at an operational level, there is greater transparency amongst the monetary authorities as a strategic objective. This, in turn, has brought in emphasis on information

management – the quality and quantity of data dissemination represented by release of adequate, timely and reliable information in a standardised form, and dissemination of information on the dynamics of policy decisions. Sixth, there is greater coordination between central banks, fiscal authorities and regulatory bodies governing financial markets. Seventh, there is a greater focus on appropriate institutional structures that promote efficiency in the conduct of monetary policy. Eighth, in an environment of synchronized economic activity, international policy coordination has become extremely important. Finally, there is a greater recognition that amidst the generalised uncertainty, monetary marksmanship is better adjudged in terms of ranges rather than in precise estimates.

These developments have been globally associated with a distinct lowering of inflation. In conjunction with more effective communication policies, this has earned for the monetary authorities what has been described as a "credibility bonus," which has helped in building a reputation for them in achieving the objectives of monetary policy. There is also a greater sophistication in the conduct of monetary policy today, and central bankers are constantly engaged in refining their technical and managerial skills to deal with the complexities of financial markets.

On the downside, the challenges facing monetary authorities have become sharper. The heightened uncertainty surrounding the conduct of monetary policy has made interpretation of macroeconomic and financial data difficult. Uncertainty is more easily transmitted across the world than before through the 'confidence' channel, forcing the monetary authorities to contend with the contagion from shocks. Since the 1990s, considerations of financial stability have assumed an increasing importance in monetary policy across the globe.

It is useful to recognise some of the forces at work that indicate the pace of such globalisation of monetary policy. First, the increasing flow of goods and services across national borders brings about networking of production systems, even standardisation of products, tastes and preferences. Second, financial integration powered by mobile capital flows leads to the merging of financial

markets across national borders. Third, the explosion of communication technology makes this integration even closer and faster. Fourth, since the late 1980s, a factor driving the globalisation of financial sector is the setting of common standards in terms of prudential regulations, supervisory practices and disclosures. Under these conditions, monetary policy responses in various countries have tended to exhibit common characteristics. Undoubtedly, complete congruence of national monetary policies is not feasible because of country-specific factors but there are growing elements of globalisation in the sense that there are considerable similarities in the overall setting and conduct of monetary policy.

**The Indian Experience**

In reality, while there are growing tendencies towards globalisation, the conduct of monetary policy depends on a number of factors that are unique to a country and the context. Given policy goals, the contours of the monetary policy are shaped by the macroeconomic structure of the economy and its institutional setting. Other important factors that have a decisive role are the degree of openness of the economy, the stage of development of financial markets, payment and settlement systems and the technological infrastructure. Against this backdrop, let me now turn to the specific features of the monetary policy in India.

First, although there is no explicit mandate for price stability, the conduct of monetary policy has evolved around the objectives of maintaining price stability and ensuring adequate flow of credit to the productive sectors of the economy for sustaining overall economic growth. The relative emphasis between price stability and growth depends on underlying macroeconomic conditions. In essence, monetary policy in India strives for a judicious balance between price stability and growth. The democratic processes in India work in favour of price stability which, in some ways, amounts to an informal mandate to the central bank for maintaining an acceptable level of inflation.

Second, the monetary policy framework in India is guided by a 'multiple indicator' approach wherein besides monetary aggregates, information pertaining to a range of rates of return in different financial market segments along with the movements in currency, credit, the fiscal position, merchandise trade, capital flows, the inflation rate, the exchange rate, refinancing and transactions in foreign exchange – which are available on a high frequency basis – is juxtaposed with data on output and the real sector activity for drawing policy perspectives. The transition to a multiple indicator approach has been a logical outcome of monetary policy reforms. It has provided necessary flexibility to the RBI to respond more effectively to the changes in domestic and international economic and financial market conditions. In a medium-to long-term perspective, the impact of money supply on inflation, however, cannot be ignored and for the purposes of policy, the Reserve Bank still continues to announce projections of money supply compatible with the outlook on GDP growth and expected inflation.

Third, liquidity management is carried out through open market operations (OMO) in the form of outright purchases/sales of government securities and reverse repo/repo operations, supplemented by the newly introduced Market Stabilisation Scheme (MSS). The Liquidity Adjustment Facility (LAF), introduced in June 2000, enables the Reserve Bank to modulate short-term liquidity, of a temporary nature, under varied financial market conditions in order to ensure stable conditions in the overnight (call) money market. The LAF operates through reverse repo and repo auctions, thereby setting a corridor for the short-term interest rate consistent with the policy objectives. The LAF operations, combined with strategic OMO consistent with market liquidity conditions, have evolved as the principal operating procedure of the monetary policy of the Reserve Bank.

Fourth, notwithstanding concerted reforms undertaken since the 1990s, e.g. freeing monetary policy from the burden of automatic monetisation and a significant marketisation of the government's borrowing programme, monetary policy in India continues to be constrained by the fiscal dominance. Debt management considerations of ensuring a smooth passage of the borrowing

programme of the government, at minimum costs and roll over risks, make the overall monetary management difficult when large and growing borrowing year after year puts pressure on the absorptive capacity of the market and on liquidity management. In this context, the Fiscal Responsibility and Budget Management Act of 2003 which envisages a vacation of primary financing of the fiscal deficit by the Reserve Bank from 2006-07 would enhance the flexibility for monetary management.

Fifth, the predominance of publicly-owned financial intermediaries has its implications for monetary policy. Cross holdings and inter-relationships in the financial sector emphasised in planned development were to achieve the social goals of the “joint family” headed by the Government. These are being gradually revamped consistent with the needs of a market economy.

Sixth, a factor that further complicates the transmission mechanism of monetary policy is the limited size of the Indian financial system. Although India is essentially a bank-based economy, commercial credit penetration in the Indian economy is still relatively low. Concerns about credit to agriculture and small- and medium- enterprises usually relate to inadequacy, constraints on timely availability, high cost, neglect of small and marginal farmers, low credit-deposit ratios in several States and continued presence of informal credit markets with high interest rates. It is in this context that the monetary policy in India continues to take cognisance of the need for ensuring financial inclusion of all segments of population, interests of depositors and for promoting a conducive credit culture.

Seventh, the Indian financial system still shows some signs of stickiness in interest rates. Consequently, apart from the efforts to ensure reduction in existing high levels of revenue and fiscal deficits, rationalising administered interest rates on contractual savings to impart efficiency and operational flexibility to the financial sector is amongst the priorities in policy.

Eighth, monetary management in India is somewhat constrained by the lack of comprehensive and timely information in some areas relative to the demands of a fast growing and increasingly globalising economy. One lacuna is the absence of credible data on the labour market. Employment data essentially

pertain to the organised sector which constitutes less than 10 per cent of the total labour force. There is also considerable ambiguity about the very definition of 'employment' given the prevalence of under-employment and disguised unemployment. In the absence of data on the natural rate of unemployment, it is difficult to assess with reasonable level of confidence the underlying conditions. Similarly, an assessment of the inflationary conditions in the economy is constrained by the lack of a comprehensive measure of consumer price inflation. The multiple consumer price indices, on the basis of occupational classification and residence (rural/urban), compound the problem, especially when differences in weighting diagrams of the commodity baskets lead to differences in inflation numbers.

Ninth, the financial system in India, however, has a relatively low vulnerability to asset bubbles. There is limited exposure of bank lending to the sensitive sectors, including real estate. While the demand for housing is strong, overall exposure is moderated by assigning higher risk weights to housing loans than required under the Basel norm. The share of housing loans in the overall loan portfolio stood at about 10 per cent in March 2004 and net non-performing assets were 1.4 per cent of the net outstanding loans as compared with 2.8 per cent of the aggregate portfolio.

**An Assessment**

An assessment of expectations *vis-à-vis* outcomes suggests that monetary policy in India has performed reasonably well in terms of its objectives.

First, compared to many developing countries, India has been able to maintain a moderate level of inflation. Historically, inflation rates in India have rarely touched double digits and when they did, it was the result of supply shocks from agricultural commodity prices or international oil prices.

Second, monetary policy has been reasonably successful in dampening the volatility of output and imparting to the economy a growing resilience. The trend rate of GDP growth has risen steadily to around 6.0 per cent for about 25

years, and India has emerged as one of the fastest growing economies in the world.

Third, monetary policy has been successful in ensuring financial stability in India through a decade and a half when frequent visits of financial crises led to debilitating losses in growth and welfare in large parts of the developing world. This period was also marked by pressures from within such as geo-political tensions, drought and international sanctions. While we might have enjoyed an element of luck, we believe that we also benefited from exercise of sound judgment and enhancement of skills at all levels. It is useful to note that the Reserve Bank has been engaged in the development of sound and efficient financial intermediaries and markets so as to provide solid foundations for effective transmission of monetary policy.

Fourth, success has been achieved in turning around and strengthening the external sector. Restrictions on imports have been virtually abolished and current account convertibility has been instituted since 1994. The capital account is virtually open for non-residents. An exchange rate policy of focusing on managing volatility with no fixed rate target, while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way, has stood the test of time. India's external sector management has been endorsed by the growing international investor confidence in the face of sub-investment grade sovereign ratings. Today, India holds the sixth largest stock of reserves in the world, sufficient to cover its entire external debt. Since 2002, India has turned creditor to the IMF and is engaged in pre-paying bilateral and multilateral debt.

The conduct of monetary policy is getting increasingly sophisticated and forward looking, warranting a continuous upgradation of monitoring scan and technical skills. Flexibility and timeliness in policy response coupled with transparency and accountability hold the key to further enhance credibility. Above all, the monetary authority has to address dilemmas, which exert conflicting pulls at every stage, and blend the desirable with the feasible. We have to recognise

that judgements are involved at different stages which call for both knowledge and humility.

I conclude, wishing you all success in your deliberations.

*** Inaugural address by Dr. Y.V. Reddy, Governor, RBI at the Eighth Meeting of the BIS Working Party on Monetary Policy in Asia, held at the RBI, Mumbai during June 6-7, 2005**