Future Readying India's Monetary Policy[1]

Namaskar! Good afternoon

I am honoured to be invited to the Lal Bahadur Shastri National Academy of Administration (LBSNAA), a temple of independent India with a rich and hallowed history that predates independence. I thank Madam Sowjanya for her gentle perseverance and deft management of logistics that made it possible for me to be here. I understand that this is the 18th round of phase IV of the Academy's mid-career training programme. Participants here have already put in 15 to 18 years in the service of the nation and are, therefore, primed to lead our country over the next 40-50 years in the quest of our national vision of becoming a developed country. The nation looks up to you to fulfil that vision, as you will wield public policy and confront the challenges of governance as you steer the nation towards its aspirational goal. While doing so, you will have to manage tectonic vicissitudes in the form of organisational and technological changes as well as structural transformations in various sectors of the economy. I do hope my talk will be able to shine a little light on the journey before you.

It is in this context that I will speak to you about monetary policy but I will situate it in the milieu of the next forty to fifty years so as to bring out some perspectives on the opportunities and challenges that will rise up to meet you as you take India towards its future.

---

[1] Address delivered by Michael Debabrata Patra, Deputy Governor, Reserve Bank of India (RBI) in the Mid-Career Training Programme for officials of the Indian Administrative Service on July 9, 2024 at the Lal Bahadur Shastri National Academy of Administration, Mussoorie. Valuable comments received from Harendra Behera, Asish Thomas George, and editorial help from Vineet Kumar Srivastava are gratefully acknowledged.

First Principles

It is important to appreciate the guiding tenets that shape the design and conduct of monetary policy.

First, within the arsenal of public policy instruments, monetary policy is distinguished by its rapid deployability because the situations it has to encounter warrant immediate action. Hence it is typically assigned the task of stabilisation of the economy around its productive capacity. Illustratively, when aggregate demand or total spending exceeds the country's productive potential, imbalances develop that can easily throw the economy off course. The first signs of these imbalances are usually price pressures or inflation. Accordingly, monetary policy acts to dampen aggregate demand and bring it in alignment with productive capacity. Analogously, when demand falls below productive capacity, deflationary conditions can develop and hence monetary policy has to boost the economy to restore balance between demand and supply.

Second, monetary policy has to be forward looking. At any point in time, the information available to monetary policy authorities on the goal variables is lagged – on a measure of economic activity such as gross domestic product (GDP) for instance, information available at any point of time is typically three months old, *i.e.*, relating to January-March in India; information on consumer prices in India is available only for May. Furthermore, policy impulses travel through the structure of the interest rates with variable and uncertain lags – changes in the policy interest rate take time to be fully reflected in lending rates charged by banks and other financial institutions. So, more often than not, monetary policy has to shoot blind. Besides, the goal variables are in motion and hence, monetary policy has to shoot forward. For this purpose, it uses all available

information like a radar screen to track the formations of moving goal variables, and target them accurately. This task becomes even more complicated when dealing with their likely course into the unforeseen future such as over the next forty to fifty years. We shall get there presently.

Third, as Jan Tinbergen, the 1969 Nobel Prize winner for economics showed, any policy is most efficient in achieving its goals when it follows an assignment rule - if there is one instrument such as the policy interest rate, there should be one goal. If instead, monetary policy is overburdened with too many goals but is hamstrung with too few instruments, there is every likelihood that the instrument will end up hitting none of the goals.

Fourth, monetary policy should be conducted in terms of some rule like behaviour that binds it to pursue its goals across time. Instead, if it falls prey to the temptation of exploiting short-run trade-offs – like abandoning inflation control in the short run and boosting growth or what economists call time inconsistency – it will ultimately lose sight of its objective because in the short-run pursuit of growth, inflation may be allowed to rise to levels that can be inimically harmful to growth.

Fifth, modern monetary policy authorities have found that the efficacy of monetary policy is enhanced when it is supported by clear and transparent communication about the intent of policy actions and stance in the context of its goals and the manner and time frame in which they are to be achieved. Communication makes monetary policy accountable as the public is able to measure its impact. This, in turn, makes it credible by binding the policy authority to its stated intent and constraining unbound discretion in seeking short-term gains at the cost of medium-term goals. In fact, high credibility obviates the need for large policy changes or even

of any changes at all if the public believes in the welfare orientation of policy. As a result, communication helps to anchor the expectations of the public to the goals of monetary policy so that policy makers and all stakeholders work with a common set of expectations. Stability in the expectations around policy, its conduct and its goals engenders macroeconomic stability which provides solid foundations for medium-term growth prospects.

Reading the Pitch

Monetary policy has an intrinsic domestic orientation. Hence, a good understanding of the characteristics of the economy it serves and the path along which economic activity is most likely to evolve is key to fashioning and implementing good monetary policy. In the context of the time horizon that I chose at the outset, the question to ask is: where are we today, and where do we go from here?

By 2023-24, *i.e.*, the year just gone by, India had become a ₹295.4 lakh crore or US$ 3.6 trillion dollars economy at current exchange rates. At a per capita income of ₹2,07,030 or US$ 2,500, India belongs in the lower middle income group of countries. Reaching here has been an eventful and arduous journey, marked by what statisticians call ‘structural breaks’. The first one occurred in 1980, marking the end of a period since independence when GDP growth averaged 3.6 per cent or the so-called Hindu rate of growth. It was the age of inwardness. From 1980 up to the second break around 2002, growth trended up to an average rate of 5.5 per cent as India opened up, dismantled barriers to trade and capital flows, and peered outwards. The third break was caused by the pandemic in 2020. Between 2002 and 2020, the gains of liberalisation and structural transformation were consolidated and trend growth shifted up to close to

7 per cent, only to be interrupted by the precipitous decline in GDP by 5.8 per cent in 2020-21. Backed by nation-wide inoculations and the steadying hand of astute macroeconomic policy support, however, there has been a robust rebound in the post-pandemic period. Although too early to tell in view of lack of adequate data points, another structural shift may be forming that is powering trend growth to above 8 per cent – the fastest growing major economy in the world today. In 2024, the International Monetary Fund (IMF) projects that India is going to contribute about one-sixth of global growth[2].

It has been estimated that if India can grow at the rate of 9.6 per cent per annum over the next ten years, it will break free of the shackles of the lower middle income trap and become a developed economy. These gains need to be reflected in per capita income with two milestones – a per capita income level of US$ 4516-14,005 to reach middle income country status, and beyond that level to attain the position of a developed country today. By 2047, however, the developed country threshold will have moved up to US$ 34,000.

Current exchange rates determined in the market are subject to bouts of volatility and idiosyncratic behaviour that makes them diverge from reality. Hence, their application as denominators to GDP measured in national currencies may not be appropriate for cross-country comparisons. An alternative measure is purchasing power parity (PPP). It is the price of an average basket of goods and services in each country. With PPP, the comparison changes dramatically. In terms of PPP, India is the third largest economy in the world. The US$ 5 trillion milestone for 2027 translates to US$ 16 trillion in PPP terms. The Organisation for Economic

[2] World Economic Forum 54th Annual Meeting; January 15, 2024.

Cooperation and Development (OECD) projects that in PPP terms, India will overtake the US by 2048 to become the second largest economy of the world.

To paraphrase from Victor Hugo, there is nothing more powerful than a country whose time has come. The age of Japan started in the 1960s and lasted up to the 1980s. The age of China began in the early 1990s, taking it to the position of the second largest economy of the world. It is from 2010 that India's time has come. Several forces are coming together for India to surge ahead and assume its rightful place as a world leader over the next two-three decades.

Tailwinds

In the formulation of monetary policy, it is considered good housekeeping to evaluate the balance of risks. There are several positive energies that are helping to shape the vision of India's future over the next few decades. The playout of these forces will condition the setting of future monetary policy.

First, there is a traditional advantage that is likely to continue working in favour of India's growth prospects. The development process has been predominantly driven by capital accumulation, which makes investment the main lever of growth. The investment rate peaked at close to 40 per cent of GDP in 2010-11 but moderated unevenly thereafter until 2020-21. During 2021-23, however, it has stabilised around 31.2 per cent and is showing signs of acceleration. Historically, India's investment has been financed by domestic savings, with households being the prime provider of resources to the rest of the economy. In the period 2021-23, the gross domestic saving rate has averaged 30.7 per cent of gross national

disposable income. Thus, unlike many countries, India does not have to depend on foreign resources, which play a minor and supplemental role in the growth process. In fact, the mirror image of this phenomenon – the current account gap in the balance of payments – has remained modest at around 1 per cent of GDP in 2023-24. This provides insulation to the Indian economy from external shocks and imparts viability and strength to the external sector. Illustratively, India's gross external debt, which is the accumulation of current account deficits over time, is less than 20 per cent of GDP and almost entirely covered by the level of foreign exchange reserves. Debt service, *i.e.*, interest and principal repayments are together less than 7 per cent of current receipts. As regards the supersavers – households – there is evidence of switching from financial saving to physical saving, with the latter being financed by accretions to households' financial liabilities.

Second, the rising growth trajectory on which India is poised is entrenched by macroeconomic and financial stability. After a long and arduous battle with the upside pressures unleashed by the pandemic and geopolitical conflicts, and exacerbated by sporadic onslaughts of food supply shocks, inflation has fallen back into the tolerance band around the target of 4 per cent. This reflects the cumulative impact of steadfast monetary policy actions and supply management. In fact, core inflation that excludes food and fuel and is most amenable to monetary policy has fallen to its lowest level ever. The RBI has anchored expectations by remaining committed to aligning inflation with the target and regards the recent easing of price pressures as work in progress. It projects inflation to average 4.5 per cent in 2024-25 and 4.1 per cent in 2025-26. The taming of inflation lays the foundations of sustained high growth in the future by improving

consumption conditions, the investment outlook and external competitiveness.

Alongside macroeconomic stability, financial stability is getting reinforced by prudent financial policies and active on-site supervision complemented with off-site surveillance, which harnesses SupTech, big data analytics and cyber security drills. India's financial sector is predominantly bank-based. Gross non-performing assets (GNPAs) in the banking system have steadily fallen from their peak in March 2018 to 2.8 per cent of total assets by March 2024. Adjusted for provisions, net NPAs are just 0.6 per cent. Capital and liquidity buffers are well above the regulatory norms. Profitability is high and this virtuous circle has supported a credit upswing. Stress tests for credit risk and interest rate risk reveal that banks would remain above minimum capital requirements even under severe stress scenarios. Similar improvements are evident among non-banking financial companies. The rising strength and resilience of the financial sector augurs well for medium-term growth prospects as it is the financial sector which intermediates the resource requirements of the growth process.

Another aspect of macroeconomic stability is the ongoing fiscal consolidation. As a result, the general government debt which is estimated at 81.6 per cent of GDP at the end of March 2024 is expected to decline to 78.2 per cent by end of this decade by the IMF. Our projections show that if expenditures are increased on reskilling/upskilling the labour force in the most productive sectors of manufacturing, investing in digitalisation and promoting energy efficiency, the general government debt will fall

even further to 73.4 per cent of GDP by 2030-31[3]. This is significant in the context of the IMF's projections that show the debt ratio as projected to rise to 116.3 per cent in 2028 for advanced economies and to 78.1 per cent for emerging and middle-income countries.

A potent growth accelerator emerges from India's favourable demographic dynamics. India's population, once regarded as a Malthusian curse, is now regarded as its greatest asset in an inter-temporal perspective, especially when the rest of the world ages rapidly and populations shrink. Today, every sixth working age person in the world is an Indian. With a median age of 28 years, the share of the working age cohort in the total population will keep rising upto the mid-2050s, with commensurate benefits in terms of growth in income and savings. India's demographic dividend is expected to last for more than three decades. Every effort must be made to reap this opportunity.

Another growth multiplier is India's digital revolution. India is emerging as a world leader in leveraging digital technologies for transformative change. The trinity of JAM – Jan Dhan (basic no-frills accounts); Aadhaar (universal unique identification); and mobile phone connections – is expanding the ambit of formal finance, boosting tech start-ups and enabling the targeting of direct benefit transfers. India's Unified Payment Interface (UPI), an open-ended system that powers multiple bank accounts into a single mobile application is propelling inter-bank peer-to-peer and person-to-merchant transactions seamlessly. Payment systems in India operate on a 24 by 7 by 365 basis. Functionalities like offline payments, payments through feature phones and conversational

---

[3] Patra, M.D., Behera, S., Behera, H., Banerjee, S., Padhi, I. and Sood, S. (2024). The Shape of Growth Compatible Fiscal Consolidation. *RBI Bulletin*, February.

payments have been incorporated. The internationalisation of the UPI is progressing rapidly.

Headwinds

India's progress towards its developmental ambitions will encounter challenges or what are termed in monetary policy analysis as downside risks. Successfully navigating them will test the conduct of monetary policy as India forges ahead to seek its destiny.

The key to harnessing the demographic dividend is in raising the contribution of the labour force to gross value added. In spite of recent improvements in job creation and rewards to higher skills, the shares of both quantity and quality – which refers to returns to skill formation – of India's labour is low by international standards. In terms of appropriate skills for a specific job, only 51 per cent is employable, warranting concerted efforts to re-skill and upskill the work force in tune with changing job requirements and technological change[4]. More than 80 per cent of the workforce is employed in the informal sector and this highlights the need for expanding the formalisation of employment. Furthermore, India ranks low in women's participation in the workforce. Increasing female labour participation is a key challenge, needing social norms in favour of working women; incentivising diversity in educational institutions and workplaces; flexible working hours and women friendly policies and facilities at work places; and promoting work-life balance.

Another formidable challenge is the building of high quality infrastructure. India's per capita investment in infrastructure at US $ 90 in constant 2015

[4] Wheebox: India Skills Report 2024.
https://wheebox.com/assets/pdf/ISR_Report_2024.pdf

dollars needs to be scaled up by lifting infrastructure investment from around 4 per cent of GDP to at least 6 per cent of GDP. This will require enabling regulations, faster clearances, smooth land acquisition and climate clearance policies, and adequate infrastructure finance. The sustained infrastructure spending and logistics push across successive union budgets is creating the environment for financing India's infrastructure goal.

The formalisation of jobs will be facilitated by developing a high class manufacturing base to absorb low- and intermediate-skill labour migrating from primary occupation. India largely bypassed manufacturing in its developmental journey - services account for two-thirds of India's economy today while manufacturing accounts for about 17 per cent. Since the 1990s, the average growth of manufacturing has been 7 per cent. With 7.5 per cent growth, manufacturing's share could rise to 20 per cent of GVA by 2030-31. If the growth rate of manufacturing can be raised to 10 per cent, the share of manufacturing in gross value added can rise to 25 per cent, bringing India into striking distance of becoming a global manufacturing hub with forward and backward linkages for other sectors of the economy. To achieve this, India must adapt to the fourth industrial revolution (automation; data exchange; cyber-physical systems, the Internet of things; cloud computing; cognitive computing and creating the smart factory, advanced robotics). In order to succeed as a manufacturing power, a skilled labour force will hold the key.

India's manufacturing must find expression in global markets – make in India for the world. A vibrant and diversified manufacturing base is essential for boosting India's exports. Intensified efforts need to be made to raise India's exports of goods and services from US$ 768 billion or 2.4

per cent of the world total to US$ 1 trillion each for merchandise and service exports or 5 per cent of the global total by 2030. The potential exists in the form of sectors such as IT and digital services, high value agricultural products; high-value tourism; financial services; retail and e-commerce. India is preparing for this export thrust through initiatives such as the production-linked incentive scheme, districts as export hubs; and supporting the export potential of micro, small and medium enterprises (MSMEs). Global Capability Centres (GCCs) set up in India are already exploiting these innate strengths. They are already leveraging on India's workforce, leading product innovation, driving technological advancements, creating next-gen intellectual property (IP) and spearheading digitalisation initiatives.

As India emerges as an export powerhouse backed by a strong manufacturing base, a natural corollary will be the full internationalisation of the Indian rupee. Several factors are already in place. The Indian diaspora is the biggest in the world and India is the top recipient of remittances. The Indian rupee trades three times more offshore than onshore. India is expanding local currency settlement arrangements with several countries in Asia and the middle east and interlinking of payment systems is underway. Deep and liquid financial markets are developing. The international financial centre in GIFT city, Gujarat is emerging as global financial and technology hub with a thriving financial ecosystem. The policy emphasis on macroeconomic and financial stability is also a positive for the INR going international.

The last challenge I will dwell upon is the greening of the Indian economy for sustainable development. This involves managing climate change. Climate change is overwhelming us, putting the planet and humanity at

risk. It is manifesting itself at an alarming scale and pace globally, undermining livelihoods, infrastructure, and endangering health, food, energy, and water security. Climatic disasters are occurring more frequently and across the globe. The year 2023 turned out to be the hottest ever. In 2024, India is experiencing among its worst heatwaves and forest fires. Bengaluru is facing a water crisis. Reservoirs are going dry. Australian and US weather agencies are predicting floods in this monsoon season due to La Nina. We cannot be immune or inactive any longer.

At the Conference of the Parties 26 (COP26) in 2021, India's commitment towards the environment by 2030 has included: (i) 500 GW non-fossil energy capacity; (ii) energy mix comprising 50 percent renewable energy; (iii) reducing total projected carbon emissions by one billion tonnes; (iv) reducing the carbon intensity of its economy by less than 45 percent; and (v) achieving net zero by 2070. It is estimated that a cumulative investment of US$ 10.1 trillion is needed along with adequate access to meet technological requirements.

Conclusion

Given the innate strengths I described and the resolve to achieve its aspirational goals, it is possible to imagine India striking out into the next decade to become the second largest economy in the world not by 2048, but by 2031 and the largest economy of the world by 2060.

What is the role of monetary policy in this context? The principal task of monetary policy is become the anchor of the Indian economy. Short-run fluctuations of aggregate demand have to be managed pro-actively so that a broad alignment with the economy's evolving productive capacity is

ensured. Price stability is the best contribution that monetary policy can make to strengthen the foundations of the aspired trajectory of growth over the next few decades. The formation of inflation in India needs to be navigated towards convergence with global inflation so that both the internal and external value of the rupee is preserved. This will prepare the ground for the internationalisation of the rupee and the emergence of India as the economic powerhouse of the world of tomorrow.

****