*Monetary Policy Developments in India: An Overview**

Y. V. Reddy

I am honoured by the kind invitation of Governor Stefan Ingves to visit Riksbank and give an address at the central bank. It is a great privilege to address an august gathering in the oldest central bank in the world, Riksbank. I came in close contact with Governor Ingves when he was working with the IMF. As a Director in the Executive Board of IMF, I have been an admirer of Mr. Ingves when he headed the Monetary and Exchange Affairs Department, which has now become the Monetary and Capital Markets Department. During his tenure in the IMF, he was instrumental in spearheading the Financial Sector Assessment Programme, which stands today as an important tool for crisis prevention. His comments in recent years on various fora as Governor reflect both his excellent professionalism and proven pragmatism. We, in the Reserve Bank, look forward to continued collaboration with Riksbank. Thank you Governor, for inviting me to your wonderful country, which I visited as a student on vacation in 1968.

My address today is on a theme traditionally close to the heart of any central banker. A review of the recent developments in the Indian Economy would be done in the first section. Second, I would review the trends in monetary policy challenges globally and for emerging market economies (EMEs) in particular. In the third section, I would explain the monetary policy framework in India. Some issues in the conduct of monetary policy in India would be covered in the fourth section followed by a few concluding observations.

I. A Review of Outcomes

Growth with Stability

The average growth rate of the Indian economy over a period of 25 years since 1980-81

* Address by Dr. Y.V.Reddy, Governor, Reserve Bank of India at the Sveriges Riksbank, Stockholm, Sweden on September 7, 2007.

has been impressive at about 6.0 per cent, which is a significant improvement over the previous three decades, when the annual growth rate was only 3.5 per cent. Over the last four years during 2003-07, the Indian economy has entered a high growth phase, averaging 8.6 per cent per annum. The acceleration of growth during this period has been accompanied by a moderation in volatility, especially in industry and services sectors.

An important characteristic of the high growth phase of over a quarter of century is resilience to shocks and considerable degree of stability. We did witness one serious balance of payments crisis triggered largely by the Gulf war in the early 1990s. Credible macroeconomic, structural and stabilisation programme was undertaken in the wake of the crisis. The Indian economy in later years could successfully avoid any adverse contagion impact of shocks from the East Asian crisis, the Russian crisis during 1997-98, sanction like situation in post-Pokhran scenario, and border conflict during May-June 1999. Seen in this context, this robust macroeconomic performance, in the face of recent oil as well as food price shocks, demonstrates the vibrancy and resilience of the Indian economy.

The Reserve Bank projects a real GDP growth at around 8.5 per cent during 2007-08, barring domestic and external shocks.

Poverty and Unemployment

The sustained economic growth since the early 1990s has also been associated with noticeable reduction in poverty. The proportion of people living below the poverty line (based on uniform recall period) declined from 36 per cent in 1993-94 to 27.8 per cent in 2004-05. There is also some evidence of pick-up in employment growth from 1.57 per cent per annum (1993-94 to 1999-2000) to 2.48 per cent (1999-2000 to 2004-05).

Consumption and Investment Demand

India's growth in recent years has been mainly driven by domestic consumption, contributing on an average to almost two-thirds of the overall demand, while investment and export demand are also accelerating. Almost one-half of the incremental growth in real GDP during 2006-07 was on account of final consumption demand, while around 42 per cent was on account of the rise in real gross fixed capital formation. The investment boom has come from the creation of fixed assets and this phenomenon has been most pronounced in the private corporate sector, although fixed investment in the public sector also picked up in this period. According to an estimate by the Prime Minister's Economic Advisory Council, the investment rate (provisional) crossed 35 per cent in 2006-07 from 33.8 per cent in 2005-06.

A Reasonable Degree of Price Stability

High growth in the last four years has been accompanied by a moderation of inflation. The headline inflation rate, in terms of the wholesale price index, has declined from an average of 11.0 per cent during 1990-95 to 5.3 per cent during 1995-2000 and to 4.9 per cent during 2003-07. The trending down of inflation has been associated with a significant reduction in inflation volatility which is indicative of well-anchored inflation expectations, despite the shocks of varied nature. Although, inflation based on the wholesale price index (WPI) initially rose to above 6.0 per cent in early April 2007 it eased to 3.79 per cent by August 25, 2007. Pre-emptive monetary measures since mid-2004, accompanied by fiscal and supply-side measures, have helped in containing inflation in India.

The policy preference for the period ahead is strongly in favour of price stability and well-anchored inflation expectations with the endeavour being to contain inflation close to 5.0 per cent in 2007-08 and in the range of 4.0–4.5 per cent over the medium-term. Monetary policy in India would continue to be vigilant and pro-active in the context of any accentuation of global uncertainties that pose threats to growth and stability in the domestic economy.

Improved Fiscal Performance

Yet another positive outcome of developments in recent years is the marked improvement in the health of Government finances. The fiscal management in the country has significantly improved consistent with targeted reduction in fiscal deficit indicators after the adoption of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 by the Central Government. The finances of the State Governments have also exhibited significant improvement since 2003-04 guided by the Fiscal Responsibility Legislations (FRLs).

With gross fiscal deficit of the Central Government budgeted at 3.3 per cent of GDP in 2007-08, the FRBM target of 3.0 per cent by 2008-09 appears feasible. The revenue deficit is budgeted at 1.5 per cent of GDP for 2007-08; the FRBM path envisages elimination of revenue deficit in 2008-09.

External Sector

India's linkages with the global economy are getting stronger, underpinned by the growing openness of the economy and the two way movement in financial flows. Merchandise exports have been growing at an average rate of around 25 per cent during the last four years, with a steady increase in global market share, reflecting the competitiveness of the Indian industry. Structural shifts in services exports, led by software and other business services, and remittances have imparted stability and strength to India's balance of payments. The net invisible surplus has offset a significant part of the expanding trade deficit and helped to contain the current account deficit to an average of one per cent of GDP since the early 1990s. Gross current receipts (merchandise exports and invisible receipts) and gross current payments (merchandise imports and invisible payments) taken together, at present, constitute more than one half of GDP, highlighting the significant degree of integration of the Indian economy with the global economy.

Greater integration into the global economy has enabled the Indian corporates to access high-quality imports from abroad and also to expand their overseas assets, dynamically. The liberalised external payments regime is facilitating the process of acquisition of foreign companies by Indian corporates, both in the manufacturing and services sectors, with the objectives of reaping economies of scale and capturing offshore markets to better face the global competition. Notwithstanding higher outflows, there has been a significant increase in capital inflows (net) to almost five per cent of GDP in 2006-07 from an average of two per cent of GDP during 2000-01 to 2002-03. Capital inflows (net) have remained substantially above the current account deficit and have implications for the conduct of monetary policy and macroeconomic and financial stability.

With the significant strengthening of the current and capital accounts, the foreign exchange reserves have more than doubled from US$ 76 billion at the end of March 2003 to US $ 228.8 billion as on August 31, 2007.

Financial Stability

The Indian record on financial stability is noteworthy as the decade of the 1990s has been otherwise turbulent for the financial sector in many EMEs. The approach towards the financial sector in India has been to consistently upgrade it by adapting the international best practices through a consultative process. The Reserve Bank has endeavoured to establish an enabling regulatory framework with prompt and effective supervision, and development of legal, technological and institutional infrastructure. The regulatory norms with respect to capital adequacy, income recognition, asset classification and provisioning have progressively moved towards convergence with the international best practices. The Basel – II capital adequacy framework is being implemented in a phased manner with effect from March 2008.

We have observed that the Indian banks' balance sheets have strengthened considerably, financial markets have deepened and widened and, with the introduction of the real time gross settlements (RTGS) system, the payment system has also become robust. Currently, all scheduled commercial banks are compliant with the minimum capital adequacy ratio (CRAR) of 9 per cent. The overall CRAR for all scheduled commercial banks stood at 12.4 per cent at end-March 2006. The gross non-performing assets of scheduled commercial banks has declined from 8.8 per cent of advances at end March 2003 to 3.3 per cent at end March 2006, while the net non-performing assets have declined from 4.0 per cent to 1.2 per cent during the same period.

Financial Markets

Development of financial markets received a strong impetus from financial sector reforms since the early 1990s. The Reserve Bank has been engaged in developing, widening and deepening of money, government securities and foreign exchange markets combined with a robust payments and settlement system. A wide range of regulatory and institutional reforms were introduced in a planned manner over a period to improve the efficiency of these financial markets. These included development of market micro structure, removal of structural bottlenecks, introduction/ diversification of new players/ instruments, free pricing of financial assets, relaxation of quantitative restrictions, better regulatory systems, introduction of new technology, improvement in trading infrastructure, clearing and settlement practices and greater transparency. Prudential norms were introduced early in the reform phase, followed by interest rate deregulation. These policies were supplemented by strengthening of institutions, encouraging good market practices, rationalised tax structures and enabling legislative and accounting framework.

II. A Review of Monetary Policy Challenges

The conduct of monetary policy has become more challenging in recent years for a variety of reasons. Many of the challenges the central banks are facing are almost similar which could be summarised as follows:

Challenges with Globalisation

First, globalisation has brought in its train considerable fuzziness in reading underlying macroeconomic and financial developments, obscuring signals from financial prices and clouding the monetary authority's gauge of the performance of the real economy. The growing importance of assets and asset prices in a globally integrated economy complicates the conduct of monetary policy when it is focused on and equipped to address price stability issues.

Second, with the growing integration of financial markets domestically and internationally, there is greater activism in liquidity management with a special focus on the short-end of the market spectrum. There is also a greater sophistication in the conduct of monetary policy and central banks are consistently engaged in refining their technical and managerial skills to deal with the complexities of financial markets. As liquidity management acquires overriding importance, the evolving solvency conditions of financial intermediaries may, on occasions, get obscured in the short run. No doubt, with increasing globalisation, there is greater coordination between central banks, fiscal authorities and regulatory bodies governing financial markets.

Third, there is considerable difficulty faced by monetary authorities across the world in detecting and measuring inflation, especially inflation expectations. Recent experience in regard to impact of increases in oil prices, and more recently elevated food prices shows that ignoring the structural or permanent elements of what is traditionally treated as shocks may slow down appropriate monetary policy response especially if the focus is on "core inflation". Accounting for house rents/prices in inflation measurement has also gained attention in some countries. The central banks are often concerned with the stability/variability of inflation rather than the level of prices. Inflation processes have become highly unclear and central banks are faced with the need to recognise the importance of inflation perceptions and inflation expectations, as distinct from inflation indicators. In this context, credible communication and creative engagement with the market and economic agents have emerged as a critical channel of monetary transmission.

Challenges For Emerging Market Economies

It is essential to recognise that the international financial markets have differing ways of judging macroeconomic developments in industrial and emerging market economies. Hence, the challenges and policy responses do differ.

First, the EMEs are facing the dilemma of grappling with the inherently volatile increasing capital flows relative to domestic absorptive capacity. Consequently, often the impossible trinity of fixed or managed exchange rates, open capital accounts and discretion in monetary policy has to be managed in what could be termed as 'fuzzy' manner rather than satisfactorily resolved - a problem that gets exacerbated due to huge uncertainties in global financial markets and possible consequences in the real sector.

Second, in the emerging scenario of large and uncertain capital flows, the choice of the instruments for sterilisation and other policy responses have been constrained by a number of factors such as the openness of the economy, the depth of the domestic bond market, the health of the financial sector, the health of the public finances, the country's inflationary track record and the perception about the credibility and consistency in macroeconomic policies pursued by the country. Further deepening of financial markets may help in absorption of large capital inflows in the medium term, but it may not give immediate succour at the current stage of financial sector development in many EMEs, particularly when speed and magnitude of flows are very high. Some of the EMEs are also subject to adverse current account shocks in view of elevated commodity prices. Going forward, global uncertainties in financial markets are likely to dominate the concerns of all monetary authorities, but, for the EMEs, the consequences of such macro or financial disturbances could be more serious.

Third, the banking sector has been strengthened and non-banking intermediation expanded providing both stability and efficiency to the financial sector in many EMEs. Yet, sometimes, aligning the operations of large financial conglomerates and foreign institutions with local public policy priorities remains a challenge for domestic financial regulators in many EMEs. Further, reaping full benefits of competition in financial sector is somewhat limited in many EMEs. Large players in developed economies compete with each other intensely, while it is possible that a few of them dominate in each of the EME's financial markets. A few of the financial intermediaries could thus wield dominant position in the financial markets of these countries, increasing the concentration risk.

While it is extremely difficult to envision how the current disturbances in financial markets will resolve, the focus of many EMEs will be on considering various scenarios and being in readiness with appropriate policy strategies and contingency plans. Among the factors that are carefully monitored, currency markets, liquidity conditions, globally dominant financial intermediaries, impact on real sector through credit channel and asset prices are significant, but the list is certainly not exhaustive.

III. Monetary Policy Framework in India

Objectives

The basic objectives of monetary policy, namely price stability and ensuring credit flow to support growth, have remained unchanged in India, but the underlying operating framework for monetary policy has undergone a significant transformation during the past two decades. The relative emphasis placed on price stability and economic growth is modulated according to the circumstances prevailing at a particular point in time and is clearly spelt out, from time to time, in the policy statements of the Reserve Bank. Of late, considerations of macroeconomic and financial stability have assumed an added importance in view of increasing openness of the Indian economy.

Framework

In India, the broad money ($M_{3)}$ emerged as the nominal anchor from the mid-1980s based on the premise of a stable relationship between money, output and prices. In the late 1990s, in view of ongoing financial openness and increasing evidence of changes in underlying transmission mechanism with interest rates and exchange rates gaining in importance *vis-à-vis* quantity variables, it was felt that monetary policy exclusively based on the demand function for money could lack precision. The Reserve Bank, therefore, formally adopted a multiple indicator approach in April 1998 whereby interest rates or rates of return in different financial markets along with data on currency, credit, trade, capital flows, fiscal position, inflation, exchange rate, *etc.,* are juxtaposed with the output data for drawing policy perspectives. Such a shift was gradual and a logical outcome of measures taken over the reform period since the early 1990s. The switchover to a multiple indicator approach provided necessary flexibility to respond to changes in domestic and international economic environment and financial market conditions more effectively. Now, liquidity management in the system is carried out through open market operations (OMO) in the form of outright purchases/sales of government securities and daily reverse repo and repo operations under a Liquidity Adjustment Facility (LAF) and repo and reverse repo rates have emerged as the main instruments for interest rate signalling in the Indian economy.

The armoury of instruments to manage, in the context of large capital flows and sterilisation, has been strengthened with open market operations through Market Stabilisation Scheme (MSS), which was introduced in April 2004. Under the MSS, the Reserve Bank was allowed to issue government securities as part of liquidity sterilisation operations in the wake of large capital inflows and surplus liquidity conditions. While these issuances do not provide budgetary support, interest costs are borne by the fisc; as far as government securities market is concerned, these securities are also traded in the secondary market, at par with the other government stock.

While the preferred instruments are indirect, and varied, there is no hesitation in taking recourse to direct instruments also, if circumstances so warrant. In fact, complex situations do warrant dynamics of different combination of direct and indirect instruments, in multiple forms, to suit the conditions affecting transmission mechanism.

There are occasions when the medium-term goals, say reduction in cash reserve ratios for banks, conflict with short-term compulsions of monetary management requiring actions in both directions. Such operations do warrant attention to appropriate articulation to ensure policy credibility. Drawing a distinction between medium term reform goals and flexibility in short-term management is considered something critical in the current Indian policy environment.

Similarly, while there is considerable merit in maintaining a broad distinction between monetary and prudential policies of the central bank, the Reserve Bank did not hesitate, as a complement to monetary tightening, to enhance the provisioning requirements and risk weights for select categories of banking assets, namely real estate, housing and capital market exposures. These measures were needed to specifically address issues of rapidly escalating asset prices and the possible impact on banks' balance sheets in a bank dominated financial sector. This combination, and more important, readiness of the Reserve Bank to use all instruments, has a credible impact, without undue restraint on growth impulses.

Some of the important factors that shaped the changes in monetary policy framework and operating procedures in India during the 1990s were the delinking of budget deficit from its automatic monetisation by the Reserve Bank, deregulation of interest rates, and development of the financial markets with reduced segmentation through better linkages and development of appropriate trading, payments and settlement systems along with technological infrastructure. With the enactment of the Fiscal Responsibility and Budget Management Act in 2003, the Reserve Bank has withdrawn from participating in the primary issues of Central Government securities with effect from April 2006. The recent legislative amendments enable a flexible use of the CRR for monetary management, without being constrained by a statutory floor or ceiling on the level of the CRR. The amendments also enable the lowering of the Statutory Liquidity Ratio (SLR) to the levels below the pre-amendment statutory minimum of 25 per cent of net demand and time liabilities of banks – which would further improve the scope for flexible liquidity management.

Institutional Mechanisms

Monetary policy formulation is carried out by the Reserve Bank in a consultative manner. The Monetary Policy Department holds monthly meetings with select major banks and financial institutions, which provide a consultative platform for issues concerning monetary, credit, regulatory and supervisory policies of the Bank. Decisions on day-to-day market operations, including management of liquidity, are taken by a Financial Markets Committee (FMC), which includes senior officials of the Bank responsible for monetary policy and related operations in money, government securities and foreign exchange markets. The Deputy Governor, Executive Director(s) and heads of four departments in charge of monetary policy and related market operations meet every morning as financial markets open for trading. They also meet more than once during a day, if such a need arises. In addition, a Technical Advisory Committee on Money, Foreign Exchange and Government Securities Markets comprising academics and financial market experts, including those from depositories and credit rating agencies, provides support to the consultative process. The Committee meets once a quarter and discusses proposals on instruments and institutional practices relating to financial markets. Besides FMC meetings, Monetary Policy Strategy Meetings take place regularly. The strategy meetings take a relatively medium-term view of the monetary policy and consider key projections and parameters that can affect the stance of the monetary policy. In pursuance of the objective of further strengthening the consultative process in monetary policy, a Technical Advisory Committee (TAC) on Monetary Policy has been set up with Governor as Chairman and Deputy Governor in charge of monetary policy as Vice Chairman, three Deputy Governors, two Members of the Committee of the Central Board and five specialists drawn from the areas of monetary economics, central banking, financial markets and public finance, as Members. The TAC meets ahead of the Annual Policy and the quarterly reviews of annual policy. The TAC reviews macroeconomic and monetary developments and advises on the stance of monetary policy.

IV. Some Issues in the Conduct of Monetary Policy in India

Let me now discuss some issues in the conduct of monetary policy in India, in the current context.

First, one of the major challenges relates to managing the transition of Indian economy to high growth trajectory accompanied by a low and stable inflation and well anchored inflation expectations. There is growing evidence that the upward shift in growth trajectory in India is of enduring nature as it is supported by high saving and investment rates, improved productivity and vast potential lying by way of demographic dividend. However, it is still important for monetary policy formulation to identify the cyclical and structural components of growth achieved in recent years, despite this task being rendered somewhat difficult in an economy that is undergoing a rapid and deep structural transformation.

Second, a situation in which the aggregate supply is evidently less elastic domestically imposes an additional burden on monetary policy. While open trade has expanded the supply potential of several economies, significant supply in-elasticities do persist domestically, particularly due to infrastructure constraints. Further, persisting impact of supply shocks on prices of commodities and services, to which headline inflation is sensitive, can therefore exert a lasting impact on inflation expectations. Faced with longer-term structural bottlenecks in supply with less than adequate assurance of timely, convincing and demonstrated resolution of these issues, monetary policy needs to respond appropriately.

Third, some categories of interest rates are yet to be fully liberalised in the system, thereby muting at least partly, the impact of monetary policy actions on the structure of interest rates.

Fourth, in the Indian context, it is recognised that monetary policy has to contend with large fiscal deficits and high levels of public debt by international standards. While the recent improvements in the fiscal position of States and significant consolidation in the finances of the Centre provided greater manoeuvrability, monetary policy needs to closely coordinate with cash and debt management of governments in a non-disruptive manner.

Fifth, the operation of monetary policy has to be oriented around the predominantly public sector ownership of most of the banking system which plays a critical role in the transmission of monetary policy to the extent other public policy considerations dominate their overall operations.

Finally, though India is essentially a bank-dominated 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 Reserve Bank continues to address the need for ensuring financial inclusion of all segments of population, protecting interests of depositors and promoting a conducive credit culture. These considerations invite the attention of the Reserve Bank, even while monetary policy aims at financial stability by moderating excess volatility in financial markets.

V. Concluding Observations

In the current environment, monetary policy in India would continue to be vigilant and pro-active in the context of any accentuation of global uncertainties that pose threats to growth and stability in the domestic economy. The domestic outlook continues to be favorable and would dominate the dynamic setting of monetary policy in the period ahead. It is important to design monetary policy such that it promotes growth by contributing to the maintenance of financial and price stability. Accordingly, while the stance of monetary policy would continue to reinforce the emphasis on price stability and well-anchored inflation expectations and thereby sustain the growth momentum, contextually, financial stability assumes greater importance at the current juncture.

Friends, before concluding, I want to emphasise that several transitions and structural transformation are taking place in the diverse and large society that is India. These encompass social, political, cultural and of course economic factors. Monetary policy is but one element in the complex web of challenges to public policy and there may be occasions when purely technical responses to monetary policy challenges would be less than appropriate. Public policy, including monetary policy, has to reckon with the complexity of managing these multiple transitions. We are fortunate that we have a supportive and stable political system and well functioning public institutions. We, in the Reserve Bank, are conscious of these complexities and approach issues in a flexible manner with a sense of humility.