CHAPTER 5

INTERACTION OF MONETARY POLICY AND EXCHANGE RATE POLICY

5.1 Till the 1990s, the reserve money creation process predominantly originated from the RBI's financing of government and the instruments of monetary control were essentially reserve requirements, interest rate controls and direct credit controls. Against the backdrop of tight capital controls, exchange rate policy was governed by the preoccupation of conserving foreign exchange and maintaining India's competitiveness in international markets. In other words, there was only limited interaction between monetary policy and exchange rate policy. With the gradual relaxation of controls in the domestic financial sector beginning in the early 1990s, there has been a move away from reserve requirements, interest rate controls and other direct controls and increasing reliance on market related instruments.

5.2 With the gradual opening up of the external sector, and the relaxation of capital account controls, there has been an upsurge of capital inflows. The reliance of government on the RBI credit is now reduced and virtually the entire reserve money is externally generated. The preoccupation of monetary policy is to a large extent on managing capital flows while ensuring monetary and financial stability and meeting the real sector's requirements for credit. The progressive integration of India into the global economy exposes the real sectors to the vicissitudes of the international economy.

5.3 As the Indian economy moves to FCAC, albeit at a measured pace, monetary policy and exchange rate policy will be increasingly inter-twined. It is in this context that the conflict of the impossible trinity – independent monetary policy, open capital account and a managed exchange rate comes out in the open. Technically, all poles of the trinity cannot be simultaneously attained, but the approach of the Indian authorities, quite rightly, has been to work towards optimising intermediate solutions.

5.4 Given the Indian policy makers' distinct preference for monetary stability and growth of the economy and the gradual opening up of the capital account, the performance of Indian monetary policy, exchange rate policy and gradual capital account liberalisation has yielded satisfactory results. The move to fuller capital account convertibility would need to derive synergies between the quest for monetary stability and an appropriate exchange rate regime which would be supportive of the growth objectives.

Monetary Policy Instruments and Operations

5.5 The sterilisation and open market operations (OMO) and interventions in the forex markets have to be so calibrated along with domestic monetary instruments so as to be consistent with the monetary policy objectives.

5.6 In the emerging scenario of greater integration of domestic and international markets, interest rate policy comes to the fore. In this context, a few observations would be apposite. First, while interest rate policy has to take into account various factors, both domestic and international, the RBI would need to progressively give somewhat more weightage than hitherto to international real interest rates. Indian real interest rates would need to be better aligned with international real interest rates. Secondly, while skillful open market operations (OMO) need to be developed for modulating liquidity conditions, OMO could also be used to correct any serious misalignments perceived by the authorities between short-term and long-term interest rates. Thirdly, while there is some advantage in a rule based interest rate policy, there are dangers in that monetary policy could become a prisoner of rigid rules.

5.7 Large and sudden capital inflows and outflows can be destabilising to the economy and hence, the economy can face the problem of boom and bust. The Indian authorities have had to rethink the kind of interest rate signals which are given to the system. Till the late 1990s, the signalling rates of the RBI were altered by as large an amount as 1 to 2 percentage points. With the increased opening up of the economy and the development of financial markets, the RBI has recognised that large changes in interest rates would be disruptive. Accordingly, the extent of interest rate changes by the RBI, in the more recent period, have generally each been of the order of 0.25 percentage point. A major objective of monetary policy is containing inflationary expectations and to attain this objective, monetary policy action needs to be undertaken well before the economy reaches the upper turning point of the cycle. If the measures are delayed, small incremental changes are ineffective and moreover could be destabilising, particularly if monetary tightening is undertaken during the downturn of the cycle. With transparency in setting objectives (discussed in the previous Chapter), there would be improved credibility if the RBI had greater independence in optimising the use of instruments and operating procedures.

5.8. The RBI has rightly de-emphasised reserve requirements and interest rate controls as key instruments of monetary policy. Given the nascent state of development of market based monetary policy instruments and the size of capital flows, it would be necessary to continue to actively use the instrument of reserve requirements. It would be necessary for the RBI to have flexibility to alter the Statutory Liquidity Ratio (SLR) below 25 per cent when felt necessary. In this context, it is imperative that legislative amendments relating to the SLR stipulation are put through expeditiously.

5.9. The RBI has in recent years developed the Liquidity Adjustment Facility (LAF) as an effective instrument. The LAF at present provides for a one percentage point spread within the corridor for overnight call money. The LAF is meant to be a short-term discretionary instrument for smooth equilibrating of liquidity in the system and, therefore, the repo and reverse repo interest rates are key signalling rates in the system. Since 2002-03, however, LAF has become a passive facility for CRR/SLR management of banks within the books of the RBI. The LAF should be essentially an instrument of equilibrating very short-term liquidity. The Committee recommends that, over time, the RBI should build up its stocks of government securities so as to undertake effective outright OMO. The Committee recognises that this is easier said than done. Nonetheless, the RBI should use every window of opportunity to build up its stock of government securities.

5.10 The interest cost of sterilisation to the Government and the RBI in 2005-06 is reported to be in the broad range of Rs.4,000 crore (though reduced somewhat by corresponding earnings on the forex reserves). While the costs of sterilisation are often highlighted, the costs of non-intervention and non-sterilisation are not easily quantifiable as the costs are in terms of lower growth, lower employment, loss of competitiveness of India, lower corporate profitability and lower government revenues; these costs could be much more than the visible costs of sterilisation.

5.11 While appreciating the RBI's dilemma of a shortage of instruments, the Committee recommends the following:

(i) The way the LAF is operated, it is used by banks like a current account on which they are remunerated. The RBI needs greater freedom in operating the LAF. Under the present system of fixed rate repo/reverse repo auctions, these rates become a major policy announcement and this restricts the degree of freedom the RBI needs in its day-to-day operations. The RBI should activate variable rate repo/reverse repo auctions or repo/reverse repo operations on a real time basis.

(ii) Apart from overnight LAF operations the RBI should consider somewhat longer-term LAF facilities, say, for a fortnight or a month.

(iii) To the extent the RBI assesses the excess liquidity to be more than transient, it should also use the CRR and SLR. Where there is a large increase in liquidity and credit expansion way above the trend line, bank profitability is higher and the banks can be legitimately expected to bear a part of the burden of containing the deleterious expansion of liquidity. The Committee recognises that the CRR cannot be as effective as in earlier years as banks are anyway maintaining large balances for settlement operations.

Nonetheless, it can be a supportive instrument and the entire burden should not be on the LAF and the Market Stabilisation Scheme (MSS).

(iv) To the extent the capital inflows are exceptionally high and the economy is inundated with excess liquidity, arising out of FII inflows, the authorities may consider, in very exceptional circumstances, the imposition of an unremunerated reserve requirement on fresh FII inflows. This would need to be imposed under the FEMA Rules for FIIs. Under such a dispensation, FIIs would be required to retain a stipulated percentage of the inflows with the bank and the bank in turn would be required to transfer these balances to the RBI. The impounded balance would be released to FIIs after a stipulated period. The Committee recommends that measures of such a nature should be exceptional, to be used only in extreme situations wherein the liquidity arising out of extremely large and volatile FII inflows reaches unmanageable proportions. Furthermore, such a measure, to be effective, should be used as a temporary measure only for a few months.

Exchange Rate Management

5.12 Exchange rate management, in the context of a liberalised capital account, calls for skillful operations by the central bank as there could be large capital inflows resulting in appreciation of the exchange rate and a loss of India's international competitiveness; equally, large capital outflows could result in sharp depreciation of the currency which could be dislocative to the economy. The articulation of the exchange rate policy gives the Committee some concern. The Indian exchange rate regime is classified by the IMF as a "managed float with no predetermined path for the exchange rate". The authorities have centered the articulation of the exchange rate policy on managing *volatility*. The Committee is of the view that apart from volatility what is more important is the *level* of the exchange rate. Movements of the Indian rupee *vis-à-vis* different currencies would show sharp directional differences as these currencies could move in different directions. While these cannot be controlled, sharp appreciation or depreciation of the exchange rate in real effective terms can have adverse impacts on the economy.

5.13 The RBI in its Bulletin for December 2005 has undertaken a revision of indices on the nominal effective exchange rate (NEER) and the REER. The base year and country composition of the 6-country and 36-country indices have been altered. While appreciating the limitation of the REER index in the context of a rapid growth of services, the Committee recommends that work needs to be undertaken by the RBI to refine the REER index by incorporation of services to the extent possible. Furthermore, for periods where there are large import duty adjustments, these should be built into the construction of the REER. According to the RBI, these indices are constructed "as part of its communication policy and to aid researchers and analysts". The

Committee would, however, stress that the REER should also be a valuable input into the formulation of the RBI's exchange rate policy.

5.14 The 1997 Committee recommended that :

> "The RBI should have a Monitoring Exchange Rate Band of +/- 5.0 per cent around the neutral REER. The RBI should ordinarily intervene as and when the REER is outside the band. The RBI should ordinarily not intervene when the REER is within the band. The RBI could, however, use its judgment to intervene even within the band to obviate speculative forces and unwarranted volatility. The Committee further recommends that the RBI should undertake a periodic review of the neutral REER which could be changed as warranted by fundamentals."

The present Committee endorses the recommendations of the 1997 Committee.

5.15 The Committee recommends that, as an operative rule, if the CAD persists beyond 3 per cent of GDP (referred as an outer sustainable limit, at the present time) the exchange rate policy should be reviewed.