

MONETARY AND CREDIT POLICY

Monetary policy is, by common agreement, the defining function of a central bank. Uniquely for a central bank, the Reserve Bank of India undertook a variety of developmental initiatives in independent India, though monetary policy remained its central preoccupation. The principal structural features of the Bank's economic and financial environment and the resulting diversity in the nature of its responsibilities as a central bank have already been discussed in the introductory chapter. Monetary policy, which is usually understood to represent policies, objectives, and instruments directed towards regulating money supply and the cost and availability of credit in the economy, could not remain unaffected by this inherited context. Therefore the Reserve Bank of India was prone to take a rather wider view of its monetary policy than more traditional central banks, including within its ambit the institutional responsibility for deepening the financial sector of the economy. Thanks to the Bank's own initiatives and the stimulus of the ongoing process of planned development, the institutional context of monetary policy underwent substantial change during our period. At the same time, tensions between the Bank's concern to regulate credit and its wider responsibility to spread and deepen the domestic financial system were often not far in the background. Some of these tensions might be regarded in the light of experience as transient or short-term while others persist to this day, but their impact on the Bank's decision-making at the time can hardly be overlooked.

As important, the financing of planned development in a poor economy was a source both of challenge and of constraints for the Bank in its role as the monetary policy authority. While the short-term management of seasonal,

inflationary, and balance of payments pressures remained an important focus of monetary policy, the overall investment targets proposed in the five-year plans provided the backdrop against which this responsibility had to be discharged. The interactive nature of the relationship between inflationary pressures in the economy and the mobilization of real resources to finance the plan effort gave monetary management a particular salience during these years. In practice, this relationship too translated into a conflict for whose resolution the Bank had much responsibility but little power. On the one hand, inflation had to be controlled in order to promote savings and investment and the plan effort. But on the other, having to step in frequently to cover the budgetary gaps of the central and state governments weakened the Bank's ability to conduct an independent monetary policy. For the Reserve Bank of India therefore, short-term monetary policy meant not merely managing clearly identified variables such as the price level or the exchange rate, but doing so consistent with supporting a given plan effort. Unfortunately but perhaps unavoidably in the circumstances, this reconciliation was generally effected at the cost of the private sector's credit requirements.

Given the formidable constraints they had to negotiate, the Bank's persistent efforts to balance its diverse responsibilities represent, on closer inspection, an important source of insight for historians as well as for others interested in the broader issues of economic development. Faced with the growing gulf between everyday practice and the canons of orthodox central banking, few contemporary officials recognized they were blazing a trail (whatever may have lain at the end of it), nor were they conscious of the ingenuity they brought to addressing the challenges facing them. In tackling these largely short-term challenges, they did not entirely lose sight of the larger picture. But the practical necessities of decision-making under multiple constraints often led to the adoption, sometimes against the better judgement of its officers if not always of the Bank, of measures which created bigger problems in the longer term than the more immediate ones they helped to resolve. As the logic of decision-making became endogenized in the form of precedents and institutional evolution, the course was set for departures which however small or partial in the beginning, exercised over a period of time a tangible influence on the overall effectiveness of the Bank's monetary policy.

This part of the volume is organized in three separate but related chapters. The first begins with a broad overview of fiscal developments during the three five-year plan periods covered by this volume and of the Bank's evolving attitude towards deficit financing and its impact upon monetary variables in the economy. From being initially passive about the resource assumptions of five-year plans, the Bank learnt from experience to be more proactive and to

urge upon planners the importance of realistic estimates of growth and resource mobilization targets. Concerns such as this led to efforts to formulate a monetary budget for the third five-year plan. Apart from defining the context for monetary policy, deficit financing also raised new questions about currency management and the effectiveness of the Bank's existing tool-kit of monetary policy. In addressing these questions, the Bank endeavoured to augment its powers, as well as adapt the Indian currency and monetary apparatus for the changes and challenges lying ahead. Its efforts in this direction are also discussed in this chapter.

The second and third chapters of this section present a largely chronological account of the Bank's monetary and credit policies during the years covered by this volume.