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An Analysis on the Assessment and Reforms of Monetary/Credit Policy System in Rising Financial Systems

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Abstract – In a developing economy, monetary policy has a special role to play. The aim of Monetary Policy is to control the supply of money, often targeting a rate of interest for the purpose of promoting economic growth and stability. The official goals usually include relatively stable prices and low unemployment.

Monetary Policy is related to the availability and cost of money supply in the economy in order to attain certain broad objectives. The Reserve Bank of India keeps control on the supply of money to attain the objectives of its Monetary Policy.

Monetary policy in India has moved towards an increasingly flexible exchange rate regime without any explicit framework for an alternative nominal anchor. The failure of monetary policy to anchor inflationary expectations of agents, coupled with negative supply shocks has kept inflation above the acceptable range of 5-5.5% for last five years in India.

In this paper we present a model for policy analysis for India that provides insights in the setting of an inflation targeting framework to anchor inflationary expectations. The model offers an understanding of the extent to which various shocks, including the post-global crisis fiscal stimulus, accommodative monetary policy and ensuing decline in global demand, explain growth and inflation in India.

INTRODUCTION

The conduct of monetary policy has undergone fundamental changes and regime shifts all over the world, mainly in response to the challenges and opportunities thrown up by structural changes in economic activity as well as by financial liberalization and its outcomes. A clearer focus on price stability as a principal − though not necessarily the sole − objective of monetary policy has evolved through a broad consensus. With the deregulation of financial markets and globalization, the process of monetary policy formulation has acquired a much greater market orientation than ever before. This has been accompanied by institutional changes even as central banks have strived for operational autonomy in pursuit of their goals.

Monetary policy in India is motivated by the multiple objectives of fostering economic growth, controlling inflation and dampening the volatility of exchange rate movements. However, for the past five years, India is suffering from chronic inflation that is persistently hovering above the central bank's acceptable range of 5-5.5%. In this backdrop, anchoring inflation has emerged as one of the major challenges of the central bank, the Reserve Bank of India (rbi).

Monetary Policy in India is an adjunct of economic policy. It is the management of money supply and interest rates by Central banks to influence prices and employment. It works through expansion or contraction of investment and consumption expenditure.

The three major objectives of economic policy in India have been Growth, social justice and price stability. Government of India tries to manipulate it's Monetary Policy, the Reserve Bank of India which is the Monetary authority in the country. The Monetary Policy of the Reserve Bank has been characterized are as of controlled monetary expansion. It aims at controlling inflation by restraining the secondary expansion of credit and regulating the supply of money in order to meet the requirements of different sectors of the economy to accelerate the pace of economic growth.

ORGANISATIONAL STRUCTURE OF MONETARY POLICY

The organizational structure of the decision-making process in monetary policy varies across countries. Most central banks have adopted a committee approach for monetary policy decisions. Among major non-infl ation targeting central banks is the US, where the Board of Governors of the Fed is responsible for the discount rate and reserve requirements, while the Federal Open Market Committee (FOMC) is responsible for announcing the Fed Funds target rate. In Japan, the stance of monetary policy is decided by the Policy Board at Monetary Policy Meetings (MPMs). In China, the Monetary Policy Committee (MPC) is a consultative body, which has an advisory role in the context of comprehensive research on the macroeconomic situation and the macro targets set by the State Council, which is also entrusted with the monetary policy decision.

The monetary policy decision-making process in inflation targeting countries can be broadly summarized as follows2:

- Most infl ation targeting central banks have an MPC which is involved with decision-making.
- The fi nal decision on monetary policy is taken by the board of central banks in many countries (thirteen) while in other (eleven) countries the decision is made by the MPC. There are also countries where the MPC makes recommendations to the board, which then takes the fi nal decision.
- The size and composition of committees vary across countries. The number of members range from five to ten. Among inflation targeting countries, about half have no external members in their MPCs.
- The Government does not have representation in the MPC in most countries (except in Colombia, Guatemala and the Philippines).
- Decision-making in MPCs is mostly by voting while about eight countries arrive at m The major rationale for entrusting the task of monetary policy decision to a specialized committee appears to be that monetary policy formulation requires considerable knowledge and expertise on the subject domain.

A committee also brings in participation from different stakeholders as well as diverse opinion which could help in improving the representativeness in the overall decision-making process. Collective wisdom of a group makes the whole somewhat greater than the sum of its parts because it does not simply mimic the views of (a) the average voter, (b) the median voter, and (c) the most skillful member (Blinder, 2008)3. This view is supported by experimental evidence (Blinder and Morgan, 2005)4 and a cross country assessment of performance of MPCs in about 40 countries (Maier, 2010).

The responsibility, accountability and timing of decision-making relating to monetary policy remains with the Governor who is directly accountable to the Government of India. The RBI Act states that the Central Government shall appoint and remove the Governor and may give the RBI directions in the public interest. Over time, the monetary policy formulation process has become more consultative and participative with an external orientation.

EVALUATION OF MONETARY POLICY IN INDIA

During the reforms though Monetary Policy has achieved higher success. It is not free from limitation or demerits. It needs to be evaluated on a proper scale.

1. Monetary Policy fails to tackle Budgetary Deficit-The higher level of budget deficit has made Monetary Policy ineffective. The automatic monetization of deficit has let to high monetary expansion.
2. The coverage area of Monetary Policy is limited-Monetary Policy covers only commercial banking sector. Other non-banking institutions remain untouched. It limits the effectiveness of the Monetary Policy in India.
3. Money market is not organized- There is a huge size of money market in our country. It does not come under the control of the RBI. Thus any tools of the Monetary Policy do not affect the unorganized money market making Monetary Policy less affective.
4. Predominance of cash transaction- In India still there is huge dominance of the cash in total money supply. It is one of the main obstacles in the effective implementation of the Monetary Policy. Because Monetary policy operates on the bank credit rather on cash.
5. Increase volatility –As the Monetary has adopted changes in accordance to the changes in the external sector in India, It could lead to high amount of the volatility.

INFLATION TARGETING STRUCTURE

The RBI does not have a formal mandate to target inflation. Until 1991, prices of many goods were administered, there were limited financial markets and administered interest rates and there was no need felt for a monetary policy framework. After the 1991 liberalization, prices became market

determined, as the exchange rate regime changed from an administered rate to a market determined rate. The Indian economy opened up both on the trade account and on the capital account. Though India maintained permanent capital controls, there was a sharp increase in inflows and outflows of capital both due to easing of these controls and due to the controls being circumvented by the private sector. With the sharp increase in capital flows in and out of India, the rupee became more flexible. In recent years India is trying to set up a framework for inflation control.

Apart from a brief period in the early 2000s, inflation has remained above desired levels. India has witnessed years of consumer price inflation between 8-10%. In recent surveys, inflationary expectations of households have risen above 10%. Until 2008, monetary policy had a nominal anchor: a de facto peg to the usd. However, after that, the rupee has become flexible, but there is no nominal anchor.

MONETARY POLICY IN A GLOBALISED ATMOSPHERE

The conduct of monetary policy in a globalised environment faces the challenge of managing the impossible trinity1. It has become more complicated by spillovers from monetary policies of advanced economies in recent years. Announcement effects of the exit from unconventional monetary policies (UMPs) of systemically important central banks have exposed the limits on the effectiveness of monetary policy in spillovers-receiving economies.

Risk-on risk-off shifts in market perceptions have imparted heightened volatility to cross-border capital flows and to changes in asset prices worldwide. Furthermore, because of hysteresis, implications for the real economy (especially the tradable sector) are not symmetric over phases of inflows and outflows.

Prior to the global crisis of 2008, there was an apparent consensus that flexible exchange rates can engender the space for independent conduct of monetary policy, even if the capital account is open. After the crisis, however, there is a clear intellectual shift justifying a non-trivial role for capital flow management (CFM) measures to mitigate the externalities associated with global spillovers, irrespective of the exchange rate regime, and for a war-chest of international reserves as the fi rst and often, the only line of defence. Thus, the trilemma has collapsed into a dilemma – independent monetary policy is possible only if the capital account is managed.

Over the last decade, trade, finance and sentiment channels have connected constituents of the global economy more than ever before. Repetitive episodes of crises have tended to focus attention on the negative effects of this integration relative to the gains. In particular, shocks emanating in AEs have amplified and prolonged risks to monetary and financial conditions in EMEs, making macroeconomic management for the latter a testing challenge, especially in view of the large influence of capital flows on macroeconomic fundamentals.

CONCLUSION

Since 2009, Indian monetary policy has moved towards a flexible exchange rate regime without any explicit framework for an alternative nominal anchor. The failure of monetary policy to anchor inflationary expectations of agents, coupled with negative supply shocks has persistently driven inflation much above the acceptable range of 5-5.5% for last five years in India. The calibrated model for India sheds new insights on the role of an inflation targeting monetary policy framework to anchor inflation expectation in the country.

Infl ation should be the nominal anchor for the monetary policy framework. This nominal anchor should be set by the Reserve Bank as its predominant objective of monetary policy in its policy statements.

The nominal anchor should be communicated without ambiguity, so as to ensure a monetary policy regime shift away from the current approach to one that is centered around the nominal anchor. Subject to the establishment and achievement of the nominal anchor, monetary policy conduct should be consistent with a sustainable growth trajectory and financial stability.

The Governor of the RBI will be the Chairman of the MPC, the Deputy Governor in charge of monetary policy will be the Vice Chairman and the Executive Director in charge of monetary policy will be a member. Two other members will be external, to be decided by the Chairman and Vice Chairman on the basis of demonstrated expertise and experience in monetary economics, macroeconomics, central banking, fi nancial markets, public fi nance and related areas.

As an overarching prerequisite, the operating framework has to subserve stance and objectives of monetary policy. Accordingly, it must be redesigned around the central premise of a policy rule. While several variants are available in the literature and in country practice, the Committee is of the view that a simple rule defi ned in terms of a real policy rate (that is easily communicated and understood), is suitable to Indian conditions and is consistent with the nominal anchor recommended . When infl ation is above the nominal anchor, the real policy rate is expected, on average, to be positive. The MPC could

decide the extent to which it is positive, with due consideration to the state of the output gap (actual output growth relative to trend/potential) and to fi nancial stability.

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