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REVIEWING THE DEVELOPMENT IN MONETARY POLICY SINCE 1991 TO THE PRESESNT ERA

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Abstract
The monetary policy, exchange rate policy, and policy regarding the degree of capital account convertibility are the most important in the current global scenario. Many economists have discussed these policy choices from a different point of views, but the most important contribution in this context is made by Robert Mundell and Marcus Fleming in 1960s as they have thrown light on all the three policy goals. These policy choices are discussed in the form of "International Trinity Hypothesis". This hypothesis states that an open economy cannot simultaneously choose the policies of monetary policy independence, exchange rate stability, and full capital account convertibility. Only two out of these goals can be achieved at a given point of time. The selection of a mixed bag of two corners of the trinity triangle is a very cautious decision for every economy due to the fact that three choices have their own merits and demerits. Thus, every economy always tries to select that combination which is most appropriate according to the domestic conditions and international position of the economy.

Key words:
Foreign Exchange Reserves, Liquidity Adjustment Facility Etc

Introduction

The monetary policy is an essential mechanism of an overall economic policy in the process of output stabilization and inflation control. It comprises of the actions of the central banking authority to make adjustments regarding the supply and cost of money. In simple words, the monetary policy refers to a process where the monetary policy authority controls the money supply through interest rate and other instruments in order to achieve its final objectives. The output and price stabilization are considered as the twin objective of monetary policy and there is always a debate regarding the fact that which out of these two objectives is satisfied better by the monetary policymakers and whether monetary policy directly or indirectly targets these objectives or not. According to classical economics, it is the real sector and not the monetary sector which determines the output level in the economy. The monetary sector is responsible only for price setting mechanism.
However, classical economics fails to provide any solution at the time of great depression of the 1920's and it was the Keynesian economics that came to rescue at the time of depression. John Maynard Keynes challenged the principles and propositions of classical economics and had established a nexus between the financial and real sector of the economy by creating a link between demand for money and interest rates in the context of speculative money holdings. In 1956, the Keynesian monetary theory was criticised by Milton Friedman in his restatement of the quantity theory of money. Besides the criticism of the Keynesian, monetarists have also attempted to provide some evidence in the support of the claim that money does matter and they are of the view that inflation is a monetary phenomenon. In India, the Reserve Bank of India (RBI) is the sole authority for the formulation and implementation of the monetary policy, issuance of new currency, and for the management of the foreign exchange market in India. In the RBI act, 1934, the major task given to the monetary policy is to maintain the monetary stability. This can refer to internal as well as external stability. In the case of internal stability, the major objective is of price stability. However, external stability refers to the stability of the overall financial system. The evolution of the monetary policy framework of India has undergone many changes since the establishment of RBI in 1935.

Tight monetary policy (1972-1991)

Price scenario worsened in the course of the final three years of the Fourth Plan 1972-1974. To control inflationary pressures, Reserve Bank pursued a tight or contractionary monetary policy. In India,

monetary policy in India has been framed in response to the fiscal policy of the Government. Fiscal Policy in India throughout the seventies and eighties had been such that massive fiscal deficits had been incurred. A significant part of the fiscal deficit was monetized. Fiscal deficit was financed by borrowing from Reserve Bank, which created money against treasury bills issued by the Government. This resulted in a very massive increase in Reserve Bank credit to the Government, which triggered a rapid increase in the money supply. There exists a close link between the fiscal policy and monetary policy in India. In addition to that, there is a requirement for coordination between both the policies. During the seventies and eighties, monetary policy was mostly concerned with the mission of neutralizing the inflationary impact of the growing budget deficits by way of consistently mopping up massive increases in reserve money, also called high-powered money. The instruments used were changes introduced primarily in Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR), which have been pretty often raised, consequently expand in reserve money. During most of the period, interest rates were entirely administered. Excess liquidity in the banking system was removed by increasing the cash reserve ratio to the maximum limit of 25 per cent. Moreover, the interest rates on Government securities were lower than the market rates; excess liquidity from the banking system could not be removed by way of Open Market Operations. As the interest rates were lower than the market interest rates, banks and financial institutions could not be convinced to invest in Government securities, which in turn would meet the borrowing requirements of the Government[1].

Monetary policy during 1991 to 1996

The Government of India undertook significant economic reforms to tackle the economic crisis in the early 1990s. In the year 1991-92, a fundamental change in the institutional framework of the proper monetary policy was adopted, and accordingly, monetary policy was required to achieve the twin objectives of price stability and economic growth. Industrial liberalisation policy and deregulation were introduced to promote competition. There was widespread consensus that it would improve efficiency and accelerate economic growth. In the pursuit of economic reforms, it was decided that fiscal deficit would be reduced in order to achieve the objective of price stability. In the external sector, trade liberalisation was introduced by removing the quantitative restrictions on imports and reducing tariffs. All these steps were initiated for sending a strong signal to the world that the Indian economy has reformed and is an open economy. India adopted a floated exchange rate system, and the market forces determined the exchange rate of the rupee. Besides, India allowed foreign investment into the economy in many sectors, and Indian companies were permitted o access to foreign capital markets. Further, India also adopted the convertibility of Indian rupee on the current account of the Balance of Payments. These structural changes required changes in the conduct of monetary policy by the Reserve Bank of India. The changes required were in terms of objectives of monetary policy and the use of various instruments of monetary control[2].

FISCAL-MONETARY RELATIONSHIP

The Central Government and Reserve Bank of India signed an agreement in September 1994. It was decided that, within three years, the practice of the using of ad-hoc treasury bills would be stopped. The use of ad-hoc treasury bills was resulting in the automatic monetisation of the Government budget deficit. This showed that there was no check on the central bank's credit to the union government. Central Bank's credit accounted for 92.6 per cent of the variation in reserve money, i.e., high powered money. It is high powered money, which determines the growth of money supply in the economy. The rapid growth of the money supply is considered to be a very significant factor responsible for the high rate of inflation in India. As a result of the automatic monetisation of the budget deficit, the central bank was required only to take steps to reduce the inflationary impact of the Government deficit. In order to ensure price stability, Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) were continuously raised during this period. The central bank gradually raised the Cash reserve ratio (CRR

[1] "Monetary Policy in a Markov-Switching VECM: Implications for the Cost of Disinflation and the Price Puzzle," Working paper 2003-001D, http://research.stlouisfed.org/wp/2002/2003-001.pdf

[2] "Fiscal policy and monetary integration in Europe," Economic Policy, 18(37), 533–572.

) and Statutory Liquidity Ratio (SLR) to the maximum ceiling of 25 per cent and 38.5 per cent, respectively. Thus, in 1991, the number of reserves through fixation of Cash Reserve Ratio and Statutory Liquid Ration was reached to the extent of 63.5 per cent of bank deposits. It directly impacted and reduced the supply of credit to the private sector. Consequently, it also adversely affected the banking system's profitability.

Open market operations

During the decades of the seventies and the first half of the eighties, the monetary policy instrument of open market operations was non-existent due to the unavailability of the active Government securities market. Active Government securities market was not developed because of lower interest rates offered on dated Government securities and treasury bills. The interest rates were very much lower than the actual market rates of interest. In order to activate the open market operations and also to ensure the profitability of banks, the Chakravarty Committee, i.e., Monetary Reforms Committee recommended increasing of interest rates on Government securities. As a result, during the late eighties, interest rates on Government securities were increased. In the post-reform period, the rate of interest on government securities was market-determined, and Government securities were sold through open auction. Furthermore, the interest rate structure was rationalised, and simultaneously banks were given the freedom to determine their prime lending rates. As a result, it facilitated the use of open Market operations as an effective instrument of monetary policy for liquidity management, including to control short-term fluctuations in the foreign exchange market.[3]

Easy and liberal monetary policy during November 1996 to 2006

Before explaining the soft-interest rate and liberal monetary policy adopted for encouraging the private sector since 1996, there were two significant changes in monetary instruments used for monetary management by RBI since 1996. The first significant step taken in April 1997 was reactivation of bank rate by initially linking it to all rates, including RBI refinance rates. Besides, in April 1997, the repo rate system was introduced under which banks could get short term advances from the RBI to meet their demand for liquidity. Under the repo system, RBI buys securities from the banks and provides funds. The funds are to be repaid by the banks after a specific period, along with the rate of interest. The rate at which the central bank lends funds to the banks against securities for a short time is called repo rate. Repo rate is the short-run lending interest rate, and the bank rate is the long-term lending interest rate, at which commercial banks can borrow from the RBI. Repo rate helps the Reserve Bank of India to increase the liquidity of the commercial banks by purchasing Government securities and giving them funds when the needs for funds arise. Under reverse repo mechanism, banks park their surplus funds with the RBI against securities. The rate of interest at which RBI pays to the banks for the funds they keep with it for a short period under this scheme is called reverse repo rate. Through the reverse repo system, the RBI reduces liquidity from the banking system. Repo transaction refers to an agreement between RBI and commercial banks through which RBI supplies funds immediately to commercial banks against government securities. The RBI simultaneously agrees to purchase the same securities after a specified period, which may vary between one day to 14 days. Through reverse repo, RBI reduces liquidity from the banking system by selling them securities. Reverse Repo operations are conducted when RBI finds that there is excess liquidity in the system, which may create inflation pressures. Under the repo agreement, banks can get short-term loans from RBI against the securities to meet the needs of liquidity. Repo and Reverse Repo operations are constructive in short-run liquidity management by Central Bank[4].

(a) Liquidity Adjustment Facility (LAF): An essential instrument of monetary policy of the Central Bank during the post-reforms period is the Liquidity Adjustment Facility (LAF). Liquidity Adjustment Facility was introduced in June 2000 based on recommendations given by the Narsimhan Committee to adjust daily-to-day liquidity in the banking system. Through the Liquidity Adjustment Facility, the Central bank regulates shortterm interest rates while the bank rate policy of Central Bank serves as a

[3] "The Science of Monetary Policy: A New Keynesian Perspective," Journal of Economic Literature, 37(4), 1661–1707

[4] "Sustainable debt and deficits in Emerging Markets," International Journal of Trade and Global Markets, 4(2), 113–136.

signaling device for its interest rate policy during the intermediate period. Until 1996, ensuring price stability by controlling inflation had been the principal objective of monetary policy in India. As explained above, substantial fiscal deficits incurred by the Government resulted in excessive growth in the money supply, which caused inflationary pressures in the economy. To contain these inflationary pressures, Reserve Bank pursued the tight monetary policy. However, in 1995-96, 1996-97 rates of inflation sharply declined. Besides, from the latter half of the 1996-97 industrial recession gripped the Indian economy. To encourage economic growth and to tackle the recessionary trends, Reserve Bank of India eased its monetary policy with effect from November 1995. Since then, the Reserve Bank of India has pursued easy monetary policy and has taken several steps to both increases the availability of credit and reduce the cost of credit.

(b) Foreign Exchange Reserves and its Impact on Monetary Policy: An essential feature of the post-reform monetary situation was a significant increase in foreign exchange reserves. Foreign exchange assets of Reserve Bank of India increased from the US $ 5.8 billion in March 1991 to the US $ 48.0 billion in Dec. 2001 and sharply increased to about US $ 85.0 billion in Dec. 2003 to $ 107 billion in end-March 2004 and further to 135 billion US dollars in end-March 2005. Against addition to foreign exchange assets, RBI has to issue new rupee currency to pay to those who deliver these foreign exchange assets. This led to the expansion of the money supply and liquidity in the banking system. As regards the exchange rate of rupee with other foreign currencies, the RBI managed it well. Through its intervention, changes in the foreign exchange rate of rupee have been within reasonable limits. The exchange rate policy of the RBI continues to be guided by broad principles of careful monitoring and management of exchange rate flexibility without a fixed target or pronounced band of change in the foreign exchange rate. It may, however, be noted that the accumulation of these vast foreign exchange reserves has been possible because of large capital inflows that have been accommodated by RBI. The capital inflows have come through exports, foreign direct investment, and NRI deposits. If the abundant money supply created as a result of the accumulation of foreign exchange assets had been allowed to be used in the economy, it would have severe repercussions on price stability. Therefore its effect on money supply has been neutralized through open market operations by Reserve Bank of India. Under this, RBI has sold Government securities to the banks to mop up extra liquidity created in the banks as a result of the accumulation of foreign exchange assets. This has helped in reducing the government's reliance on credit from RBI, which leads to monetisation of the Government's budget deficit. As a result, there was a fall in monetized deficit, which in the past was referred to as deficit financing[5].

EASY MONETARY POLICY DURING NOVEMBER 1996 to 2006

The tight monetary policy followed in the pre-1996 period succeeded in containing inflation in the Indian economy. Not only a further rise in prices was arrested, but also the annual rate of inflation came down below 4 percent. The annual rate of inflation of 4 percent was described by Chakravarty committee as a reasonable and tolerable target to be achieved. At one time, there was a thought that a 4 percent rate of inflation was challenging to achieve. The tight monetary policy pursued by Reserve Bank of India before November 1996 and efficient management of liquidity through Open Market Operations and newly introduced Repo system after 1996 played a significant role in achieving this price stability. During 2003-04, public investment expenditure substantially increased, agriculture registered 10 per cent growth, and exports grew at the rate of 21 per cent. As a result, demand conditions improved, which triggered a recovery in 2003-04, and there was a further gain in the growth momentum in 2004-05 and 2005- 06. Thus, when due to improvement in demand conditions in the three years (2003-06), the higher industrial growth occurred. However, the easy monetary and credit policy of the RBI helped a lot in achieving the growth potential. A great achievement of the RBI's monetary policy in these years was to keep the growth of money supply within reasonable limits, and also through changes in repo rates; it has succeeded in making proper adjustments in the liquidity

[5] “Interaction of Monetary and Fiscal Policies: Why Central Bankers Worry about Government Budgets,” Presented at an IMF Seminar on Current Developments in Monetary and Financial Law.

position of the banking sector. Despite the pressures from rising international crude oil prices, the annual inflation rate remained between 4 and 5.5 per cent from 1996-97 to 2005-06[6].

Monetary policy of rbi from 2006 to 2007-08

During the period 1996 to 2005, the rate of inflation remained low. Nevertheless, from 2006, the problem of inflation again cropped up. During 2008-09, it became severe as the rate of inflation rose to a double-digit level in 2008-09. The major thrust of the monetary policy of Reserve Bank of India (RBI) throughout has been to promote economic growth without inflation. The changes in domestic and global economies affect the price level, financial stability, and economic growth. These fluctuations pose severe challenges in the performance of the monetary policy. RBI has been changing its monetary policy perspective from time to time, depending on the economic situation of India. The formulation of Monetary policy is done based on the estimated rate of economic growth and a fixed target rate of inflation. Targets for growth of money supply and credit expansion are fixed, keeping in view the twin objectives of promoting economic growth while keeping inflation under control. During the financial year 2006-07, there was a massive surge in inflation as a result of a tremendous increase in liquidity due to substantial capital inflows despite the hardening of interest rates. High level of capital inflows received during 2006-07 and 2007-08 caused a tremendous increase in the foreign exchange assets of RBI and resulted in a significant increase in the rupee liquidity into the system. To contain inflation, RBI raised the repo rate from 6.50 to 6.75 in June 2006 and went on increasing it to 7.75 in March 2007. All this while reverse repo rate was kept fixed at 6 per cent from July. 2006 to March 2007. Besides, to control inflation and to ensure price stability Cash Reserve Ratio (CRR) was also raised from 5.25 per cent on December 2006 to 5.50 per cent in January 2007. With the increase in repo rate and cash reserve ratio, the rate of inflation was reduced in the second half of 2006-07. As a result, the annual rate of inflation was estimated to be 5.9 per cent at the end of the fiscal year 2006-07. Economic survey 2007-08 states that "The fiscal administration and monetary measures which were taken at the beginning of June 2006 together with improved availability of wheat, pulses and edible oils started working through in terms of decline in the inflation rate”[7]

Conclusion

1) Since the initiation of the economic reforms, the RBI has demonstrated many times that the monetary policy pursued by it can achieve the twin objectives of promotion of economic growth and maintaining price stability.
2) Even after the introduction of economic reforms in the 1990s, the most crucial objective of monetary policy has been stability in prices. Successive governments and governors of RBI have been unanimous in concluding that the high rate of inflation is not suitable for the Indian economy.
3) If we observe the CPI data for the research period of 1991 to 2011, it brings about that price stability results in financial stability is not correct.
4) During the post-reform period, the way the RBI operates the monetary policy has gone through a significant transformation. Even though the objectives of monetary policy have remained the same, i.e., price stability and the promotion of economic growth.
5) It has been observed at times that RBI has taken some policy initiatives, and there has been no significant impact on the money supply, but still, there has been an impact on the price level. It proves the fact that price level can be affected by many other factors apart from changes in policy rates by RBI.

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