Minor Research Project On

IMPACT OF MONETARY POLICY ON THE POST REFORMS ECONOMIC GROWTH IN INDIA

Principal Investigator:

Azil Melwyn Castelino, Lecturer in Economics, St Mary's College, Shirva 574116

EXECUTIVE SUMMARY

Monetary policy operations since 1991 reflect the responses of the Reserve Bank of India (RBI) to the challenges posed by the Indian economy's transformation from financial repression to a liberalized market orientation. Recent efforts to develop and integrate financial markets established a closer linkage of monetary management operations with internal debt management, exchange rate, and reserves management operations. The basic objective of monetary policy to maintain price stability and support growth by ensuring adequate flow of credit continued to be paramount, while its scope was broadened to encompass aspects of financial stability by maintaining orderly conditions in financial markets and achieving greater interest rate flexibility. Greater transparency has also been imparted through institutional mechanisms for internal coordination within the central bank and for external consultations.

With procedures increasingly shifting to market-based interventions, monetary policy operations have become primarily a process of managing liquidity on a day-to-day basis. These operations are, however, consistent with the overall policy announced in April and reviewed in October for every fiscal year. These announcements are considered useful as a framework for relevant measures, for capturing events affecting macroeconomic

assessments including fiscal management and seasonal factors, and as a means of greater transparency, better communication, and an effective consultation process.

The period up to 1996–1997 reflected the challenges of macro stabilization and adjustment against the background of a high inflation rate, a difficult balance of payments situation, and massive draw down of foreign exchange reserves. The focus was on reining in inflationary pressures, and therefore a tight and cautious policy stance was taken. This period also saw far-reaching financial reforms, such as rationalization and liberalization of interest rates, greater autonomy for the central bank with elimination of automatic monetization of fiscal deficits, financial markets development and integration, and considerable easing of operational constraints on the financial system. The latter half of the 1990s and the early years of the new millennium represented a gradual phase of easing liquidity, softening interest rates reflecting the lowering of inflationary expectations, and further deepening of financial markets. This period also witnessed, however, a comparative slowdown in industrial and economic activity until 2003–2004, contributed by a variety of domestic and external shocks. Consequently, the focus was upon containing volatility in markets, particularly the foreign exchange market, strengthening reserves, and efficiently coordinating internal debt management with monetary operations.

Institutional arrangements for monetary policy formulation had also undergone changes since 1997. An interdepartmental Financial Markets Committee now monitors developments in financial markets, reviews market developments with regard to both volume and rates in money, foreign exchange and government securities, and makes quick daily assessments of liquidity conditions for market interventions.

While there is a growing consensus that central banks should have operational independence and concentrate on a single target, such as inflation, there is some sense of discomfort in India as to whether this will survive the test of time. This is particularly true as a result of a conflict between the goal of preventing future inflation, and avoiding a sharp downturn in industry. Under such circumstances, the reliance on mechanistic, simpler, and narrower rules restricting discretion or judgment does not appear feasible. The RBI is likely to pursue its multiple indicator approach for some time to come.

There is definite and remarkable economic impact of monetary policy on Indian economy in the post-reform period. The importance of monetary policy has been increasing year after year. Its role is very relevant in attaining monetary objectives, especially in managing price stability and achieving economic growth. Along that, the use and importance of monetary weapons like Bank rate, CRR, SLR, Repo rate and Reverse Rate have increased over the years. Repo and Reverse Repo rates are the most frequently used monetary techniques in recent years. The rates are varied mainly for curtailinginflation and absorb the excess liquidity and hence to maintain price stability in the economy. Thus, this short-time objective of price stability is more successful on Indian economy rather than other long-term objectives of development.