

Reviewing rbi's monetary policy framework



**ASSIGN
BUSTER**

Of late, Mr. Deepak Mohanty, RBI's ED has been giving some excellent speeches.

The speeches are basic and tell you a lot about economic issues in India. His recent speech looks at RBI's monetary framework. He even reviews performance of Indian economy in each of the frameworks. See my previous blogpost on RBI's monetary framework as well. He divides RBI's monetary policy framework into three time periods: 1. Pre-monetary targeting (India independence to 1984-85): Till 1970s, inflation was mainly caused by agricultural failures.

Therefore RBI's main effort was towards selective bank credit management and ensuring flow of credit to increase agricultural production. In 1970s inflation increased because of increase in money supply which rose to finance rise in government expenditure. Inflation also rose because of the oil shocks in 1974 and 1979 which increased prices of oil in world markets. 2. Monetary targeting (MT, 1985-86-1997-98): By early 1980s, there was some consensus in RBI that inflation was rising because of a surge in money supply. Agriculture and oil shocks could not raise inflation permanently.

It was a sustained rise in money supply that led to rise in inflation. This led to RBI's monetary targeting framework in which RBI started targeting money supply. Under this RBI made a projection for money supply for a given year and tried to keep money supply around the projected levels. 3. Multiple Indicators approach (MI, 1998-99 onwards): After reforms in 1991, it became difficult to look at the relationship between money supply and inflation. Financial liberalization led to more innovative financial products.

Earlier RBI could monitor money supply as banks were the only financial intermediaries. As non-banking sources of finance grew, monitoring money supply and thus inflation became difficult. Hence, RBI adopted the multiple indicators approach which looked at variety of economic indicators to track impact on inflation and economic growth. He points to excellent tables which looks at RBI projections, GDP and inflation in both monetary and multiple indicators approach. And all this is given every year.

So in MT era, the targets were achieved only 3 times against 13 times they were set. Till 1990s, inflation continues to be higher than projections. So, overall it was not very successful. But yes, it helped guide monetary policy towards a framework. GDP growth was better in MT era compared to pre-MT era.

If we look at MI era, there is an improvement across most indicators.

Mohanty also compares the inflation and economic growth in the three monetary frameworks. He says * GDP growth, on an average, improved successively in each framework. The average GDP growth was 4.

6% in pre-monetary targeting period, 5. 5% in monetary targeting period and further to 7. 1% in the multiple indicators period. * The WPI inflation increased from 7% in pre-monetary targeting phase to 8. 3% during the monetary targeting regime.

This was also because of significant increase in fiscal deficit in this period. In the multiple indicators approach, both WPI and CPI inflation fell significantly. The fall in inflation was accompanied by substantial reduction in fiscal deficit.

This underscores the importance of fiscal consolidation to sustain higher levels of growth with price stability.

* Third, while the volatility of WPI inflation reduced during the multiple indicators period, it increased for CPI inflation reflecting higher volatility in food prices. This underlines the importance of supply management and a greater focus on agricultural development to contain food price inflation. * Fourth, money supply (M3) growth declined over the regimes though volatility of M3 increased slightly during the multiple indicators regime reflecting emerging importance of interest rate in monetary transmission. The shift in operating objective to stabilise overnight interest rate so that it transmits through the term structure is reflected in a discernible reduction in the overnight interest rate with lower volatility.* Fifth, exchange rate, on an average, has depreciated successively both in nominal and real terms. However, it has become more stable during the multiple indicators approach than the monetary targeting regime.

This could be partly attributed to accumulation of reserves and management of exchange rate to contain volatility. * Sixth, the improved performance of monetary policy was facilitated by supportive fiscal policy - discontinuation of the practice of automatic monetisation and rule-based deficit reduction programme under the Fiscal Responsibility and Budget Management (FRBM) Act - which enhanced instrument independence of the Reserve Bank.* Finally, the recent overall improvement in macroeconomic performance cannot be ascribed to monetary policy alone. Apart from a rule-based fiscal policy, productivity enhancing structural reforms, sharp increase in saving and investment, increasing integration with the global economy, a low global

<https://assignbuster.com/reviewing-rbis-monetary-policy-framework/>

inflation environment and the unleashing of the entrepreneurial spirit of the private sector played an important role.