Oration 5:
2001 K.R. Narayanan Oration

Message from the President of the Republic of India

I am glad that since the establishment of the K.R. Narayanan Oration in 1994 to commemorate the inauguration of the Australia South Asia Research Centre of The Australian National University, remarkable personalities from the academic, intellectual and public spheres have delivered orations on a variety of issues of contemporary significance. Beginning with Dr Raja Chelliah who delivered the first oration in 1994, other outstanding personalities such as Jagdish Bhagwati and Mr P. Chidambaram through their masterly orations have enriched our understanding of different subjects. It is particularly noteworthy that all these prominent figures have played major roles in fashioning India's agenda for development both at the academic and practical levels.

I am glad that this year's oration is being delivered by another renowned economist, Dr C. Rangarajan, who is presently serving as the Governor of Andra Pradesh. I am happy that the topic of Dr Rangarajan's lecture is 'Monetary Policy in a Developing Economy — The Indian Experience'.

Hailed as one of the chief architects of India's monetary policy for several years, Dr Rangarajan during his long and distinguished career, particularly during his association with the Reserve Bank of India as Deputy Governor and subsequently as Governor, devised a monetary policy which would facilitate growth and ensure price stability. Most of the measures such as simplification and deregulation of interest rate structure, policy formulations for improving lendable resources of the Reserve Bank of India, upgradations of the information technologies and introduction of competition in the financial system, have contributed to lay down the foundation of a monetary policy to further strengthen India's new economic environment.

While doing so Dr Rangarajan has proved that in developing countries growth of the economy and price stability can be appropriately blended. New economic policies must not only ensure prosperity and growth, these must also serve other defined goals for the society as a whole. As a moving force behind the liberalisation of our economy and as an active player and economic strategist for building up of a dynamic economy, Dr Rangarajan's contributions have become significant. I am sure that his oration will be an insightful exercise in understanding the economic transformation of India in all its ramifications. I am sure the range of ideas, the depth of understanding and the wide experience of Dr Rangarajan will be of importance for all developing countries grappling with the emerging realities of liberalisation and financial reforms.

K.R. Narayanan
New Delhi
2001

Monetary Policy in a Developing Economy — The Indian Experience

C. Rangarajan

It is a great honour to be asked to deliver the K.R. Narayanan Oration of this year. It is an honour in more ways than one. First, the invitation has come from the prestigious Australia South Asia Research Centre of The Australian National University which has done commendable work in studying the political and economic developments in South Asia and particularly India. The growing integration of the world economy has made the work of the Centre extremely valuable and relevant. Second, the oration is named after one of the most distinguished sons of India, who today occupies the exalted position of the President of India. Narayanan's contributions to India's public life are immense. With quiet diplomacy and skilful and strategic interventions, he has steered the country during difficult times, particularly in the last few years. Through his scholarship and statesmanship, he has endeared himself to one and all. It is truly a great privilege to deliver the lecture bearing his name.

Developments in Monetary Policy

I have chosen to speak to you today on the Indian experience with respect to monetary policy as an instrument of economic management. Developments in monetary policy closely mirror the changes in overall economic policy. The decade of 1990s has seen far reaching changes in India's economic policy. The content and approach to economic policy underwent a sea change. The country has become a more open economy. The roles of state and market are getting redefined. There is a common thread running through the various measures introduced since 1991 and that is to improve the productivity and efficiency of the system. This is sought to be achieved by imparting a greater element of competition in the system. It is in this context that monetary policy in India acquired a new role. Financial sector reforms which were an integral part of the economic reforms program created a new institutional environment in which monetary policy had to operate.

In industrially advanced countries, after decades of eclipse, monetary policy re-emerged as a potent instrument of economic policy, in the fight against inflation in the 1980s. Issues relating to the conduct of monetary policy came to the forefront of policy debates in the 1980s. The relative importance of growth and price stability as the objective of monetary policy as well as the appropriate intermediate target of monetary policy became the focus of attention. Over the years, a consensus has emerged among the industrially advanced countries that the dominant objective of monetary policy should be price stability. Differences, however, exist among central banks even in these countries as regards the appropriate intermediate target. While some central banks consider monetary aggregates and, therefore, monetary targeting as operationally meaningful, some others focus on the interest rate. There is also the more recent practice to ignore intermediate targets and focus on the final goal such as inflation targeting.

A similar trend regarding monetary policy is discernible in developing economies as well. Much of the early literature on development economics focused on real factors such as savings, investment and technology as mainsprings of growth. Very little attention was paid to the financial system as a contributory factor to economic growth even though attention was paid to develop financial institutions which provide short-term and long-term credit. In fact, many writers felt that inflation was endemic in the process of economic growth and it was accordingly treated more as a consequence of structural imbalance than as a monetary phenomenon. However, with the accumulated evidence, it became clear that any process of economic growth in which monetary expansion was disregarded led to inflationary pressures with a consequent impact on economic growth. Accordingly, the importance of price stability and, therefore, the need to use monetary policy for that purpose also assumed importance in developing economies. Nonetheless, the debate on the extent to which price stability should be deemed to be the overriding objective of monetary policy in such economies continues.

The Reserve Bank of India was set up in 1935. Like all central banks in developing countries, the Reserve Bank has been playing a developmental and a regulatory role. In its developmental role, the Reserve Bank focused attention on deepening and widening the financial system. It played a major part in building up appropriate financial institutions to promote savings and investment. In the realm of agricultural credit, term finance to industries and credit to export, the apex institutions that are now operating were essentially spun off from the Reserve Bank. Strengthening and establishing new institutions to meet the country's requirements is a continuing process. The promotional role had taken the Reserve Bank into the area of credit allocation as well. Pre-emption of credit for certain sectors and that too at concessional rates of interest became part of the overall policy. Commercial banks over time had been required to provide a certain percentage of their total credit to certain sectors which were regarded as 'priority sector'.

An active role by the Reserve Bank of India in terms of regulating the growth in money and credit became evident only after 1950s. During the 1950s the average annual increase in the wholesale price was only 1.8 per cent. However, during the 1960s, the average annual increase was 6.2 per cent and in the 1970s, it was around 10.3 per cent. In the early years of planning, there was considerable discussion on the role of deficit financing in fostering economic growth. The First Plan said: 'Judicious credit creation somewhat in anticipation of the increase in production and availability of genuine savings has also a part to play'. Thus, deficit financing, which in the Indian context meant Reserve Bank credit to the government, was assigned a place in the financing of the plan, though its quantum was to be limited to the extent it was non-inflationary. Monetary growth, particularly in the 1950s, was extremely moderate. However, as each successive plan came under a resource crunch, there was an increasing dependence on market borrowing and deficit financing. These became pronounced in the 1970s and thereafter. The single most important factor influencing the conduct of monetary policy after 1970 had been the phenomenal increase in reserve money contributed primarily by the Reserve Bank credit to the government.

To summarise, the system as it existed at the end of 1970s was characterised by the following features. The Reserve Bank of India as the central monetary authority prescribed all the interest rates on deposits and lending. The commercial banks were required to allocate a certain percentage of credit to what were designated as 'priority sector'. Credit to parties above a stipulated amount required prior authorisation from the central bank. After the nationalisation of major commercial banks in 1969, nearly 85 per cent of the total bank assets came under public sector. Apart from small private banks, foreign banks were allowed to operate with limited branches.

The increase in the scale of borrowing by the government resulted in: (a) the steady rise in statutory liquidity ratio requiring banks to invest higher and higher proportion of their deposits in government securities which carried less than 'market rates'; and (b) the Reserve Bank of India becoming a residual subscriber to securities and Treasury Bills leading to monetisation of the deficit. The Reserve Bank had, therefore, to address itself to the difficult task of neutralising to the extent possible the expansionary impact of deficits. The increasing liquidity of the banking sector resulting from rising levels of reserve money had to be continually mopped up. The instrument of open market operations was not available for this task since the interest rates on government securities were well below 'market rates'. The task of absorbing excess liquidity in the system had to be undertaken mainly through increasing the cash reserve ratio. In fact, in mid-1991, the cash reserve requirement was 25 per cent on incremental deposits. In addition, the statutory liquidity ratio was 38.5 per cent. Thus, nearly 63.5 per cent of incremental deposits was pre-empted in one form or another.

In 1983, the Reserve Bank of India appointed a committee under the Chairmanship of the distinguished economist Professor Sukhamoy Chakravarty to review the working of the Indian Monetary System. I was a member of the Committee. The Committee's Report covered a wide range. One of its major recommendations was to regulate money supply consistent with the expected growth rate in real income and a tolerable level of inflation. Recognising the fact that government borrowing from the Reserve Bank had been a major factor contributing to the increase in reserve money and therefore, money supply, the Committee wanted an agreement between the Central Government and the Reserve Bank on the level of monetary expansion and the extent of monetisation of the fiscal deficit. Without such a coordination, the Committee felt that Reserve Bank's efforts to contain monetary expansion within the limits set by expected increase in output could become impossible. While this recommendation of the Committee was accepted in principle, it could take a concrete shape only in the '90s.

In the wake of the economic crisis in 1991 triggered by a difficult balance of payments situation, the government introduced far reaching changes in India's economic policy. Monetary policy was used effectively to overcome the balance of payments crisis and promptly restore stability. An extremely tight monetary policy was put in place to reap the full benefits of the devaluation of the rupee that was announced. However, it did not stop with that. Financial sector reforms became an integral part of the new reform program. Reform of the banking sector and capital market was intended to help and accelerate the growth of the real sector. Banking sector reforms covered a wide gamut. The most important of the reforms was the prescription of prudential norms including capital-adequacy ratio. In addition, certain key changes were made with respect to monetary policy environment which gave to commercial banks greater autonomy in relation to the management of their liabilities and assets. First and foremost, the administered structure of interest rates was dismantled step by step. Banks in India today enjoy the complete freedom to prescribe the deposit rates and interest rates on loans except in the case of very small loans and export credit. Second, the government began borrowing at market rates of interest. The auction system was introduced both in relation to Treasury Bills and dated securities. Third, with the economic reforms emphasising a reduction in fiscal deficit, pre-emptions in the form of cash reserve ratio and statutory liquidity ratio were steadily brought down. Fourth, while the allocation of credit for the priority sector credit continued, the extent of cross subsidisation in terms of interest rates was considerably brought down because of the reform of the interest rate structure.

Monetary policy in the 1990s in India had to deal with several issues, some of which traditional but some totally new in the context of the increasingly open economy in which the country had to operate. In the first few years, monetary policy had to contend with the consequences of devaluation and the need to quickly restore price stability to obtain the full benefits of devaluation. While the fiscal deficit was being brought down, the question of monetisation of the deficit continued to remain an issue and a solution had to be found. This eventually led to a new agreement between government and RBI on financing deficit. The system of ad-hoc Treasury Bills under which the Government of India could replenish its cash balances by issuing Treasury Bills in favour of the Reserve Bank and which had the effect of monetising deficit was phased out. It was replaced by a system of Ways and Means Advances which had a fixed ceiling. The Reserve Bank of India continued to subscribe to the dated securities at its discretion. During 1993 and 1994, for the first time monetary policy had to deal with the monetary impact of capital inflows with the foreign exchange reserves increasing sharply from $9.2 billion in March 1992 to $25.1 billion in March 1995. In 1995–96, the change in perception with reference to exchange rate after a prolonged period of nominal exchange rate stability vis-a-vis the US dollar brought into play the use of monetary policy to stabilise the rupee — an entirely new experience for the central bank. Similar situations arose later on also at the time of the East Asian crisis. Monetary policy had begun to operate within a changed institutional framework brought about by the financial sector reforms. It is this change in the institutional framework that gave a new dimension to monetary policy. New transmission channels opened up. Indirect monetary controls gradually assumed importance. With the progressive dismantling of the administered interest rate structure and the evolution of a regime of market determined interest rate on government securities, open market operations including 'repo' and 'reverse repo' operations emerged for the first time as an instrument of monetary control. Bank Rate acquired a new role in the changed context. The '90s paved the way for the emergence of monetary policy as an independent instrument of economic policy.

Monetary policy in the 1990s had also to be conducted in the context of the financial sector reforms. The need to reduce non-performing assets and to conform to the new prudential norms put the banking industry under great strain. While introducing banking sector reforms, care had to be taken to ensure that there was no compromise with the basic objectives of monetary policy.

In the post-reform period, the Indian economy has done well. Since 1992–93 the average annual growth rate of the economy in real terms has been 6.3 per cent. The average inflation rate, as measured by the wholesale price index in the 1990s has been 7.2 per cent. However, the significant fact to note is that the average inflation rate since 1996–97 has been less than 5 per cent. Broad money grew at an average annual rate of 17 per cent per annum. The exchange rate of the rupee in terms of US dollar has declined by 24 per cent since July, 1997. This decline is smaller than what other countries in this region have experienced. The current account deficit has averaged since 1992–93 at 1 per cent of the GDP. The foreign exchange reserves in the country have risen from about $5 billion to $43 billion as of a recent date. These broad macroeconomic indicators show a substantial improvement in the Indian economy, even though several concerns such as slow reduction in poverty ratio and slow growth rate in agriculture persist.

Issues of Concern

Let me now focus on some of the issues which came to be debated extensively during 1990s. These issues are not specific to India or developing economies. They have been debated in the context of the developed countries also. Nevertheless, these issues which I want to highlight have a special significance for developing countries like India.

Objective

The first question that needs to be addressed relates to the objective or objectives of monetary policy. A recurring question is whether monetary policy should be concerned with all the goals of economic policy. The issue of 'objective' has become important because of the need to provide a clear guidance to monetary policymakers. Indeed, this aspect has assumed added significance in the context of the increasing stress on the autonomy of Central Banks. Autonomy goes with accountability and accountability in turn requires a clear enunciation of the goals.

Since the inception of development planning, the broad objectives of India's economic policy have been to achieve a faster rate of growth, ensure reasonable degree of price stability and promote distributive justice. Working of monetary policy in India over the past several decades would reveal that monetary policy has emphasised these broad objectives of our economic policy. In one of my earlier articles, I had said:

> In a broad sense the objectives of monetary policy can be no different from the over all objectives of economic policy. The broad objectives of monetary policy in India have been: (1) to maintain a reasonable degree of price stability and (2) to help accelerate the rate of economic growth. The emphasis as between the two objectives has changed from year to year, depending upon the conditions prevailing in that year and in the previous year.

The question of a dominant objective arises essentially because of the multiplicity of objectives and the inherent conflict among such objectives. Jan Tinbergen had argued decades ago that there should be as many instruments as there are objectives, if all objectives are to be fulfilled. Faced with multiple objectives that are equally relevant and desirable, there is always the problem of assigning to each instrument the most appropriate objective. This 'assignment rule' favours monetary policy as the most appropriate instrument to achieve the objective of price stability. It is this line of reasoning which has led to the single objective approach.

The crucial question that is being debated in India as elsewhere is whether the pursuit of the objective of price stability by monetary authorities undermines the ability of the economy to attain and sustain high growth. A considerable part of the relevant research effort has been devoted to the trade-off between economic growth and price stability. Empirical evidence on the relationship between growth and inflation in a cross country framework is somewhat inconclusive because such studies include countries with an inflation rate as low as one to two per cent to those with inflation rates going beyond 200 to 300 per cent. These studies, however, clearly establish that growth rates become increasingly negative at higher rates of inflation.

The case of price stability as the objective of monetary policy rests on the assumption that volatility in prices creates uncertainty in decision-making. Rising prices adversely affect savings while they make speculative investments more attractive. The most important contribution of the financial system to an economy is its ability to augment savings and allocate resources more efficiently. A regime of rising prices vitiates the atmosphere for promotion of savings and allocation of investment. Apart from all these, there is a social dimension particularly in developing countries. Inflation adversely affects those who have no hedges against it and that includes all the poorer sections of the community. The fiscal consolidation also becomes easier in an environment of reasonable degree of price stability. In a period of rising prices, the gap between revenues and expenditures widens. Expenditures tend to grow at a faster rate than revenues because many components of expenditures such as employees' compensation are closely linked to variations in prices.

The question that recurs very often in the minds of the policymakers is whether in the short run, there is a trade-off between inflation and growth which can be exploited. In the industrial countries, a solution is sought through the adoption of Taylor's rule which prescribes that the signal interest rate be fixed taking into account the deviations of inflation rate from the target and actual output from its potential. In this rule, the coefficient of inflation deviation term is fixed at a level higher than unity. While the rule is intuitively appealing, there are serious problems in determining the value of the coefficients. In this context, the critical question to raise is: At what level of inflation, do adverse consequences begin to set in? It is this inflation threshold which will provide some guidance to the policymakers. Below and around this threshold level of inflation, there is greater manoeuvrability for the policymakers to take into account other considerations. Interestingly, the Chakravarty Committee regarded the acceptable rise in prices as 4 per cent. This, according to the Committee, will reflect changes in relative prices necessary to attract resources to growth sectors. I have myself indicated that in the Indian context, inflation rate in the range of 5 to 6 per cent may be acceptable. There is some amount of judgement involved in this, as econometric models are not in a position to capture all the costs of inflation. This approach provides some guidance as to when policy has to become tight or to be loosened. It is also necessary for the policymakers to note that this order of inflation is higher than what the industrial countries are aiming at. This will have some implications for the exchange rate of the currency. While the open economy helps to overcome domestic supply shocks, it also imposes the burden to keep the inflation rate in alignment with other countries.

Intermediate Target

The second issue relates to the intermediate target. In India since the mid-'80s the target chosen has been broad money. The Chakaravarty Committee recommended a system of flexible monetary targeting. It is true that central banks in several countries in the industrial world have abandoned intermediate targets and have focussed on the final target such as inflation control. While this has the advantage of specifying the ultimate objective in clear and precise terms, it must be admitted that there is some uncertainty regarding the route through which this will be achieved. One of the reasons for the abandonment of intermediate targets in these countries has been the breakdown of the relationship between monetary aggregates and the inflation rate. The demand function for money has been found to be unstable. However, in India, studies show that the money demand function is a stable function of select variables and it can be used to reasonably predict inflation. Several statistical functions of the demand for money estimated by using the equilibrium and disequilibrium analysis provide overwhelming evidence on the long run stability of the money demand function. Perhaps some of the factors that have contributed to the instability of the demand function for money in the industrially advanced countries such as financial innovations and large movements of funds across the border are yet to have the same impact in India. In the demand function for money in India, income emerges as the most dominant variable. Such a function enables the authorities to estimate the appropriate growth in money supply, given the expected increase in real output and the acceptable level in price increase. With the freeing of the interest rate structure, interest rate may also emerge as an appropriate intermediate variable in the coming years. In fact, with the inflation rate coming down and remaining in a narrow range, it will be possible to focus on interest rate along with overall monetary aggregates. However, as of now, money supply seems to be an appropriate target. Such a target is relatively well understood by the public and provides unambiguously the stance of monetary policy.

The literature on monetary economics talks of four distinct monetary transmission channels. They are: (1) Quantum Channel, especially relating to money supply and credit; (2) Interest Rate Channel; (3) Exchange Rate Channel; and (4) Asset Prices Channel. While the emphasis in India so far has been on the quantum channel, with the development of financial markets and closer integration of such markets, the interest rate channel will assume importance. It must be noted that at the equilibrium both quantity and price are determined. Changes in interest rates cannot be ordained. The appropriate quantitative changes in money will have to be brought about even though the signal for change may be given by the price variable like interest rate.

Level of Interest Rate

Another question of importance that has arisen relates to the appropriate level of interest rate. The nominal interest rate comprises of three elements: (1) the real rate of interest; (2) inflation expectations; and (3) a discount factor for uncertainties. The effectiveness of monetary policy to bring down the nominal interest rate will depend on the impact that this policy will have on inflation expectations and on the perception of uncertainty in the economy. A monetary policy that is geared to maintain reasonable price stability, if it is successful, can help to bring down the interest rate in sympathy with the downward drift in inflation. Inflationary expectations can be broken, if the monetary authority enjoys high credibility. However, this leaves the real rate of interest to be determined. The real interest rate is not an observed variable. The real interest rate is influenced by several long-term factors such as saving and investment balance in the economy and the rate of return on capital. Theory tells us that on an economy-wide basis, this rate should not exceed the real rate of growth. In fast growing economies the real rate of interest will be higher. In South Korea during the years of very rapid economic growth the real rate of interest was around 6 to 7 per cent in several years. The real rate of interest is thus related to the rate of growth of the economy. In the early 1990s in India, the real rate of interest was low because the inflation rate was in the range of 8 to 10 per cent. However, with the break in the inflation rate beginning 1996–97, the real rate of interest has gone up. As mentioned earlier, the inflation rate on an average has remained at less than 5 per cent since 1996–97. However, it must be kept in mind that the real rate of interest will have to be relatively higher in developing economies which seek to maintain a high savings rate and which aim at growing at more than 6 to 7 per cent per annum. This is typically the situation in India. A situation of high real rate of interest accompanied by high growth rate must be distinguished from other situations when real rates of interest may remain high. In this context, it is worth noting that the high level of nominal interest rate in developing economies may also be due to high intermediation costs. Improved efficiency can reduce the spread between the deposit rate and lending rate and bring the lending rate in closer alignment with fundamental factors.

Exchange Rate Management

The role of monetary authority in exchange rate management came into focus in the 1990s. Since 1975, the exchange rate of the rupee was determined with reference to the daily exchange rate movements of a selected number of currencies of the countries which were India's major trading partners. The Reserve Bank of India was required to maintain the exchange rate within a band on either side of a base 'basket' value. This allowed the achievement of a medium-term real effective exchange rate (REER) objective through changes in the NEER. Such a regime could be maintained only with the support of extensive exchange controls and import controls. The reform measures introduced in 1991 included significant changes in the foreign trade regime and exchange rate management. The devaluation of the rupee in mid-1991 was followed by a system of dual exchange rate system in March 1992. A year later, the dual system was abolished and the country moved towards a unified market determined exchange rate system. The monetary authority does not intervene in the market process of rate determination as long as orderly conditions prevail in the exchange market and the exchange rate reflects macroeconomic fundamentals.

The approach to exchange rate by the monetary authorities in the developed world generally has been to let the market determine the rate. However, there have been several exceptions. There have been occasions when central banks in these countries have intervened, some times in a concerted way, when exchange markets became volatile. The Indian experience with market determined exchange rate system is that there have been several occasions when the RBI had to intervene strongly to prevent volatility. This happened in 1995 and 1996 and later in 1997 and 1998 at the time of the East Asian crisis. The impact of the East Asian crisis on the Indian market was minimal. This was partly due to the reason that while India subscribed to current account convertibility under Clause VIII of the IMF agreement, the capital account liberalisation was undertaken cautiously. Besides, India's current account deficit during this period was low. In fact, in 1991, a High-Level Committee on Balance of Payments had made specific recommendations regarding the level of current account deficit, the size and composition of capital flows, the management of external debt including short-term debt and the quantum of foreign exchange reserves. Implementation of these recommendations stood India in good stead at the time of the East Asian crisis.

In narrow, underdeveloped markets like in India, there is a tendency for the herd instinct which amplifies the fluctuations. This can cause volatile and destabilising movements in the exchange rate which may go beyond any correction, required by the fundamentals. Even in developed markets there is a tendency for the market to 'overshoot', when a critical mass in terms of the perception of overvaluation in the exchange rate is reached. With narrow markets, the danger is greater. On such occasions, the monetary authority has to step in to ensure orderly market conditions. The monetary authority must, however, recognise that integration of markets is inevitable and therefore action must be spread across the markets to achieve results.

In developing economies like India, trade flows both visible and invisible, dominate the balance of payments. That is why for the exchange rate regime in India, continuous monitoring of the real exchange rate with an appropriate base becomes important. It provides valuable information to the authorities on the behaviour of the current account to which it is intrinsically linked. A monetary policy geared to domestic price stability in this situation helps to avoid disruptive adjustments in the exchange rate. In that sense monetary policy and exchange rate management become intertwined.

Financial Stability

Increasingly macroeconomic stability as an objective of central banking is closely linked to financial stability. It is easy to see how the two are interlinked. Financial stability broadly implies the stability of the important institutions and markets forming part of the financial system. Financial stability requires that the key institutions in the financial system are stable, in that, there is a high degree of confidence about meeting contractual obligations without interruption or outside assistance. While the complementarity between the objectives of macrostability and financial stability is easily recognised, the one question that needs to be addressed is whether there can be a conflict between the two objectives. It is not inconceivable to have situations in which the price stability objective might call for a restrictive policy, while the financial market conditions may demand a somewhat liberal policy to provide relief. The Reserve Bank of India was extremely conscious of this dilemma. Banking sector reforms were in full swing in the 1990s which necessarily put the banking system under strain. While facilitating the smooth transition, RBI took care that there was no dilution of the basic objectives of monetary policy. However, viewed as part of overall economic stability, financial stability need not run at cross-purpose with other dimensions of macroeconomic stability. Normally, price stability should provide an environment favourable to financial stability. If on occasions dealing directly with financial stability becomes necessary, it must be done as in the case of intervention in the foreign exchange markets. Actions to maintain financial stability in those circumstances may be in the long run interest of economic stability.

Autonomy of Central Banks

Autonomy of central banks has become an article of faith in the industrial countries. It has been written into the constitution setting up the European Central Bank. The literature on this subject is growing. There is a general consensus to give instrument independence to central banks among countries that have decided that the single objective of monetary policy is inflation control. Autonomy implies discretion to central banks to decide on the timing and nature of monetary policy intervention. It also calls for transparency in relation to both objectives and strategies. The increased use of explicit targets by central banks is part of the broader move to build credibility through transparency. It is quite true that in India, monetary policy has been very much conditioned by the stance of fiscal policy. The system of the scheme of ad hoc Treasury Bills facilitated monetisation of the fiscal deficit without limit and without prior approval.

The 1990s saw the phasing out of the system and the introduction of the scheme of Ways and Means Advance. This was a major step towards the achievement of greater discretion. The Fiscal Responsibility Bill that is now before the Indian Parliament takes this to its logical conclusion. When enacted this would be a great step forward not only in fiscal but monetary management. Two associated comments may be made in this context.

First, an autonomous central bank does not mean lack of coordination with the government. Nor does it imply lack of harmony. In fact, harmony in the sense in which it is used in classical symphonic music will be achieved. In a symphony, different artistes play different notes simultaneously but in effect create a blend that produces the best of music. However, the stances of monetary policy and fiscal policy cannot run at cross-purposes. For example, a lax fiscal policy accompanied by a tight monetary policy can lead to a sharp increase in interest rate. On the other hand, an accommodative monetary policy in a period of lax fiscal policy can lead to explosive increase in prices. While monetary and fiscal coordination is desirable, it is important at the same time that the monetary authority which has its own specific agenda must have the institutional autonomy and should not be burdened with functions which may come in conflict with its own special objective. It is in this context that the Reserve Bank of India and the Government of India are examining the issue whether the management of public debt can be delinked from RBI.

Second, the emergence of an autonomous central bank does not mean that the 'state of bliss' has arrived. It only enables the central bank to pursue a consistent monetary policy over a long time. Then the onus of responsibility for the conduct of monetary policy will rest on the shoulders of the Reserve Bank, where it should logically rest. In an open economy, the task of the central bank will be rendered more difficult if it does not have the autonomy and discretion to make changes quickly in response to external shocks.

There was a time when it was said that central banking was neither a science nor an art but a craft. This is at best a half-truth. Central banking has never been a case of applying well known remedies to well-known problems. 'Rules versus discretion' has been a subject of long-standing debate in monetary policy. Rigid rules such as those implicit in gold standard will give to central banks no room for manoeuvrability. On the other hand, total discretion with respect to objectives and instruments will make monetary policy indeterminate. That is why the new phrase 'constrained discretion'. This will require the central banks to be transparent and explicit with respect to objectives and strategies, while leaving the freedom to them to choose the timing and nature of their actions. This is the type of autonomy towards which every central bank should move.

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