Financial Institutions and Markets
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Lecture –19
Challenges and Reforms in Monetary Policy & Central Bank Autonomy

So, after discussing about the different instruments of monetary policy and as well as the operating procedure of the monetary policy of the Reserve Bank of India. So, today we will be discussing about what are those challenges and the reforms which have taken place in monetary policy framework in the Indian context. And as well as another concept will be discussing which is called the Central Bank Autonomy, which is a very debatable issue nowadays which is the people are very much concerned about.

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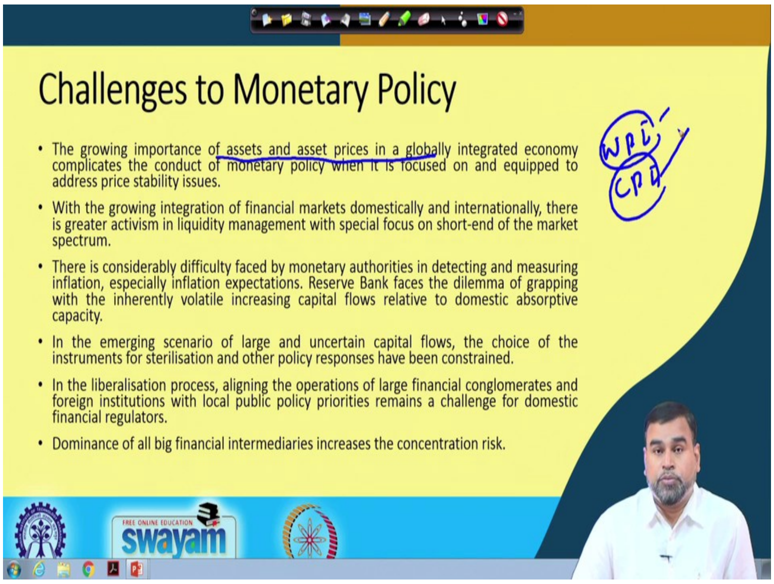

So, let us see what are those challenges we always face or Reserve Bank of India always faces whenever they are implementing the monetary policy. The first challenge basically they face because there is integration in the global economic system every markets are highly integrated both domestically and as well as internationally.

In that particular context the price is basically highly fluctuating, asset pieces, stock price, the instrument which are available in other markets which are very much highly fluctuating. If they are highly fluctuating in that particular contest what is happening it is very difficult to forecast the price in such a way; by that the policy implementation should be done to control the price level.

So, in this context the managing liquidity in greater liquidity management with special focus on short end of the market spectrum is basically very important. But that may not be possible at any point of time because of the volatility of the asset prices. There is also considerably difficulties faced by the monetary authorities in detecting.

And measuring the inflation, how the inflation can be measured particularly this inflation expectations. Why basically it happens because we have the different measure, we have WPI and CPI, there are different components of CPI which should be actual reflection of the pricing which particular index should be considered for measuring the inflation; that is basically the another issue always Reserve Bank of India thinks.

And they cannot also predict the money supply because there is a volatile increasing capital flows relative to domestic absorptive capacity. The absorption capacity of the domestic market whatever we have that sometimes is also in comparison to the increasing capital flows to the system in terms of a FII or FDI. Sometime it is very difficult to predict or to expect that how the price is going to be or how the money supply is going to be in the next period. So, the actual corridor or actual money supply whatever is the intermediate target the RBI may not be followed.

So, that is basically another question. In the emerging scenario there is a large and uncertain capital flows, the choice of the instrument of the sterilization and other policy responses have been constant. You know whenever we will discuss more about the sterilized policy and non sterilized policy. We talk about the Reserve Bank's intervention in terms of the exchange rate and as well as the money supply.

But here whatever the way basically the foreign capital flows are coming to India or whatever fluctuations they have realized in terms of that capital flows that basically is creating difficulty for the Reserve Bank of India to device certain domestic policy which can control the money supply in such a way by that the price can be stable as well as the growth can also be increasing on that particular point of time. And another point is in the liberalization process aligning the operations of the large financial conglomerates and foreign institutions with the local public policy priorities remains challenge for the domestic financial regulators.

There is increasing in the number of MNC's, the parent company is somewhere in U.S. or some other countries and their operations are in India and their operations and the objective of those companies and the objective of the public policy priorities within that hosting country sometimes differ. So, the money which is circulated through that kind of transactions that also sometime may create the problem for the public policies in that particular hosting country.

So, whatever actual process of for the monetary policy should be adopted by RBI or by the reserve bank of by the central bank that also create sometimes the challenges for them. The dominance of all being financial intermediaries increases the concentration risk because, you see if there is a dominance of big financial intermediaries they can also regulate the price.

If the price is not very competitive in that sense what is happening the concentration risk in the market may also increase; which also creates the problem to devise a proper monetary policy for them. So, these are more or less the different challenges for this Reserve Bank of India face whenever they devise this monetary policy or implement this monetary policy in this particular country.

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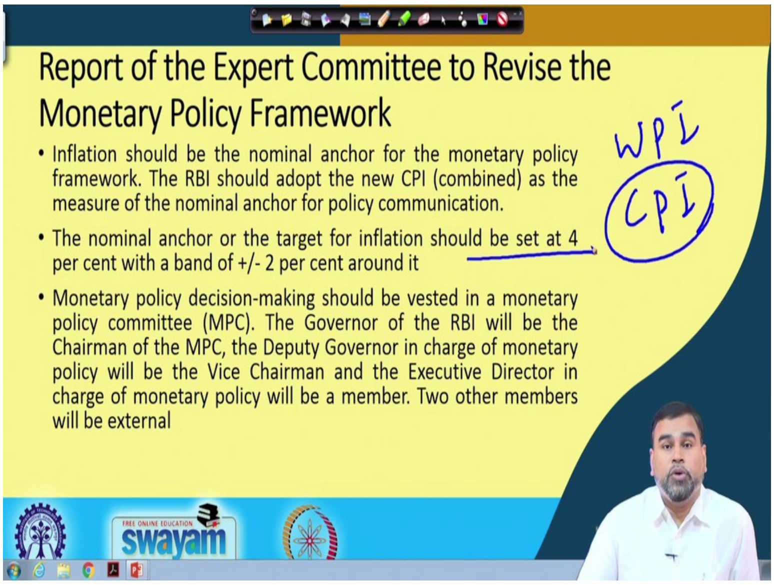

So, keeping those things in the mind way back in 2014 India not 19 it is 2014 there was a committee which was established and this committee was headed by the current governor Urjith Patel. Mr Urjith Patel was the governor of that was the chairman of that particular committee that time he was the deputy governor and that committee has recommended certain things to revise the monetary policy framework for the Indian context.

Then how this revised framework basically looks like we have summarized that particular report in this case we just discussed certain major issues or major points which has been highlighted in that report. So, the first of all the first thing what this particular policy or policy revised document has said or the recommendations have said; the inflation should be nominal anchor for the monetary policy framework. More or less instead of a multiple objective they are going towards a single objective.

Previously we have what is happening we have to control the price the price stability should be controlled or price should be stable, or the in volatility of the price should be controlled, or the inflation should be controlled, in the general sense and as well as the growth rate of GDP also should increase. So, that a multiple indicator approach the central bank was following, but now what is happening this objective of the monetary policy is going towards a single objective function mostly they are concentrating on controlling the inflation. Because the argument is if the price becomes stable than growth can take place; so, that is the basic notion or basic intuition of the revising the monetary policy framework in the Indian context.

So, therefore, what they said the inflation should be nominal anchor for the monetary policy framework. And they have taken CPI or consumer price index as the measure of the nominal anchor for the policy communication. Previously there was a debate confusion was whether they should go for WPF wholesale price index or CPI. But they have said that CPI should be used and here they have constructed a new CPI index which basically covers of more commodities which are really in the true sense it is used as a necessity commodity there are necessary products in the day to day life.

So, CPI has been used as the indicator for measuring the price in the Indian market. This is the first kind of recommendation whatever they have given. And already I told you that they are going towards the inflation targeting; so, because of that the targeting inflation of 4 percent with a band of 2 percent plus or minus around it.

So, there is a model whatever they have formulated and using that model what they trying to say if the inflation is 4 percent, then the growth rate can be achieved this is a particular amount of growth rate can be achieved or if the inflation will deviate by 2 percent either it can become 2 percent or it can become 6 percent that also should not hamper the expected growth rate what the economy is trying to achieve.

So, the inflation target means that should be this 4 percent in the Indian context plus or minus 2 percent and for that we have the contingency plan or the monetary policy has made the contingency plans, this is the way these particular things will work out. Then monetary policy decision making should be vested in a monetary policy committee that we separate a monetary policy committee should be established and the monetary policy committee is basically governed by certain bodies.

And here governor of RBI will be the chairman, 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. And two other members will be the external basically who are the experts in the monetary policy in the macroeconomics monetary policy experts who are the external they are not a part of RBI, but they are the members and from their time to time they will device that how the monetary policy should look like and what are those way basically the system should work. Then we have if you see, what are the other recommendations they have given.

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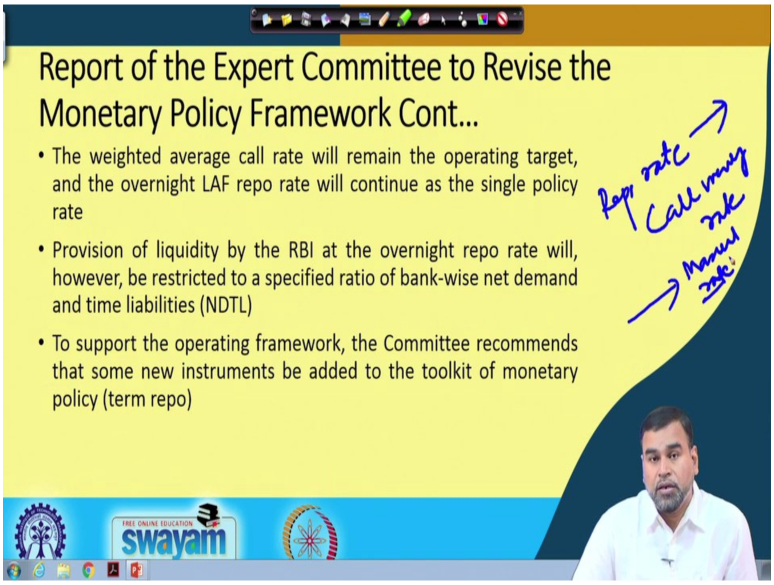

The other recommendation they have given that the weighted average call money rate should be remain the operating target. And the overnight repo rate liquid adjustment facility repo rate will continue as the single policy rate. Previously if you have remembered.

The either repo rate and reverse repo rate was changing by RBI, but nowadays you might have observed RBI is only changing the repo rate because reverse repo rate marginal standing facility rate and everything are basically linked to repo rate. If repo rate will change automatically reverse repo rate will be 0.25 percent less than repo rate and MSF rate will be 0.25 percent above the repo rate. So, repo rate is used as a single policy rate.

The target rate is the call money rate, if the repo rate will change then it will have the impact upon the call money rate or the weighted average of the call money rate. If the call money rate will change then it will have the impact upon the market rate. So, already I told you in the previous class that the intermediate target is the call money rate; that means, the target is the call money rate if the call money rate is below the standing facility rate then the amount of money supply whatever the RBI has predicted.

That can be maintained in the system at that particular point of time. So, that is why this is called the operating target. Then provision of liquidity by RBI at the overnight repo rate will have however, be restricted to specified ratio bank wise net demand and time limit. How much money the commercial banks can borrow from RBI through repo operation; that also will be a certain percentage of the total deposit base whatever they have that has been fixed by Reserve Bank of India.

That means, the unlimited amount of money cannot be borrowed by commercial bank from RBI whenever they required. Then this support this operating frame work. The committee recommends that some new instruments can be added that is basically call the term repo rate. Because this repo rate which was working now which is basically the overnight rate they have also recommended we should have a term repo rate if any bank wants to borrow money little bit for longer period of time.

Then for that also this different interest rate should be determined or different kind of a policy they should be determined. And by that maybe sometime can be given to that particular bank to repay that particular money to the central bank or the reserve bank. So, that is another recommendation, but this recommendation also is considered to device the new policy framework for the monetary policy.

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Then we have another recommendation they have consistent with the time path of fiscal consolidation mentioned SRL should be reduced to a level in consonance with the requirement of the liquidity coverage ratio. That means, they said this statutory liquidity ratio whatever we have that basically should be reduced to a level in accordance with the liquidity coverage ratio of the Basel III norms.

The liquidity coverage ratio is a ratio which is basically measured are used to measure the liquidity of the commercial bank. So, the liquidity coverage ratio and SRL should go together by that if the liquidity ratio is maintained or the liquidity coverage ratio is maintained then what is happening that automatically takes care of the investment in the government securities and different kind of liquid instruments whatever we have.

Then another revision they basically recommended that open market operations have to be detached from fiscal operations; instead links only to the liquidity management. To control or to fulfill the gap of the government financing the open market operations were using to finance this kind of deficits by the government sometimes open market operations were used as an instrument. But what RBI has recommended let us detach that open market operation from the fiscal operations part open market operations should be totally related to the control the liquidity in the market.

That should not be any kind of link between the open market operations and the fiscal policy or fiscal operation of the government. It should be directly linked to the liquidity management or the change control of the money supply in the system. That is why the open market operations should be totally monetary policy instrument not are the instrument to also take care of the fiscal consolidation of the government.

And a proper sterilized policy for foreign exchange reserves the foreign exchange already I have told you sterilized policy means whenever there is a change in money supply for the buying and selling of the foreign securities or foreign currencies so in that particular point of time this may affect the total money supply in the system. So, in that particular context what RBI does they take the reverse position in the domestic economy.

For example, if they are buying more dollars in the domestic economy this particular domestic economy the demand for foreign assets should be there. So, because of that the total money supply may get changed and that particular point of time they make certain kind of policies, they take certain kind of steps by which the domestic money supply will go down.

If the domestic money supply will go down and the foreign money has been injected in the system the net effect on the money supply will be 0. Any way that is called the sterilized intervention that we will discuss more, but this is the way this sterilized policy for foreign exchange reserve should be properly utilized. By that it will not basically affect adversely the price stability in the economic system. So, these are the different recommendations whatever they have given and over the period of time this recommendations have been incorporated in the monetary policy framework of the RBI.

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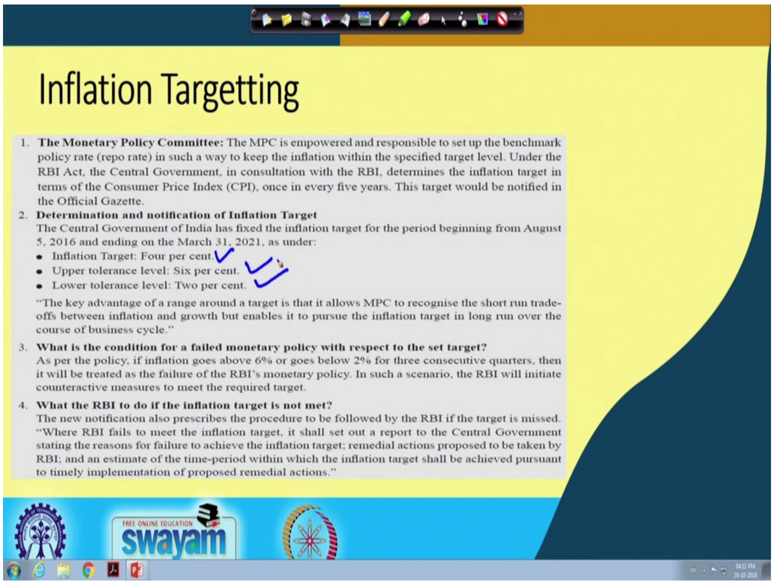

If you see this one I have just giving the glimpse of what we mean by the inflation targeting. Here the inflation targeting means that this monetary policy committees empowered and responsible to set up the benchmark policy rate that is repo rate, in such a way that the inflation can be kept within a certain limit. Then here the inflation target always can be maintained and it can be changed in every 5 years so that is basically depends upon the consumer price index.

And here what basically here the central government of India has fixed the inflation target for the period beginning from august 2016 ending on the March 31st 2021. So, this is the target now whatever is working now that is an inflation target is 4 percent, upper tolerance limit is 6 percent lower tolerance limit is 2 percent that already I told you. The key advantage of a range around the target is that it allows the monetary policy committee to recognize the short run tradeoff between inflation and growth what enables into to pursue the inflation target in the long run over the course of the business cycle.

So, what is the condition for a failed monetary policy with respect to the set target as per the policy if inflation goes above 6 percent or goes below 2 percent for three consecutive quarters then it will be treated as the failure of the RBI monetary policy in such scenario the RBI will initiate counter active measure to meet the required target. If it is fluctuated within the 2 percent then no action will be taken for that. If what the RBI should do if inflation target is not met, then the new notification also prescribe the procedure to be followed by RBI if the target is missed.

Where RBI fails to meet the inflation target, it is all sell out, it will set out a report to the central government stating the reason for failure to achieve the inflation target. Remedial actions proposed to be taken by RBI and an estimate of the time period within which the inflation targets are achieved pursuant to the timely implementation of the proposed remedial actions. So, those kind of actions will be taken if the inflation target is not met.

If it is met it is fine if it does not met then those kind of things or those kind of action should be taken by the Reserve Bank of India with respect to the Government of India. So, this is called basically or features of the inflation targeting what we can say and up to 2021 this particular target will work. And after 2021 one revised target can be created. And accordingly one range also can be created like upper tolerance can met and lower tolerance can met. So, this is about the different kind of instrument challenges and revisions of the monetary policy.

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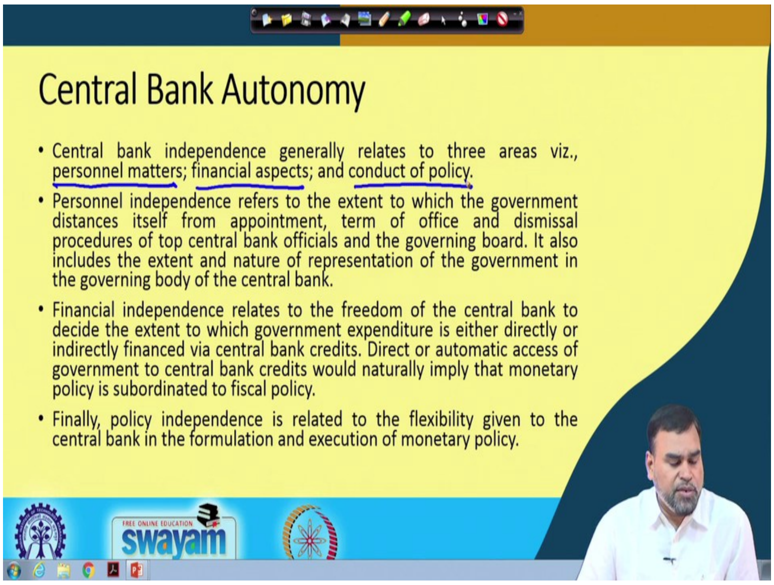

Then we can move to another important issue which is called the central bank autonomy. Some days back you might have read in the newspaper that one of the central bank deputy governors Viral Acharya had said that more autonomy should be given. Before that also the other governors deputy governors upgraded for the autonomy. And in that context; obviously, the question can arise what do you mean by the autonomy?

How the autonomy is define and whether the autonomy is good or bad from the central bank perspective and from the public perspective. So, in this contest if you see in general sense the autonomy is or the independence is related to three areas; one is personal matters, financial aspects, and conduct of the policy. These are the three things always comes whenever it can related to personal issues, financial issues, and policy issues. These are the three issues through which the autonomy can be defined autonomy can be examined. What do you mean by the personal independence?

The personal independence means to what extent the government distances itself from the appointment term of office dismissal procedures from top central bank officials and the governing board. It also includes the extent or and nature of representation of the government in the governing body of the central bank. Who appoints the governor? Central bank. Who appoints deputy governor? Central bank. So, all those top bodies are basically appointed by the government and again in the central board of directors.

There are many government bodies or government representatives who basically work on behalf of the government. So, in that context up to what level the policy decisions or particular appointments which are taken for the Reserve Bank of India are free from any kind of government interventions. So, one is your personal matter; in the personal point of view that how far the particular reserve bank or particular central bank is autonomous that is first point.

Whenever you talk about the financial independence; the financial independence basically relates to the freedom of the central bank to decide the extent to which government expenditure is directly or indirectly financed by the central bank. Previously what was happen if there is kind of deficit by the financing deficit by the government then it has to be financed by the issuance of the treasury bills. The Reserve Bank of India will automatically issue the treasury bills to overcome or to fulfill the deficit what the government has; that is called the automatic monetization of the financing the deficits.

There is no need to do anything there is no such kind of it is mandatory by the RBI to do that, but this has been discontinued since 1997 to some extent this Reserve Bank of India has got the financial autonomy. That means, to fulfill the financing deficit Reserve Bank of India it is not mandatory for the Reserve Bank of India or the Reserve Bank of India is not bound to do that whenever there is a deficit in the system.

So, financial autonomy to some extent we have. So, direct or automatic access of government to central bank credit to natural imply that monetary policy subordinate to the fiscal policy. So, this is what basically what we can see, that whenever there is some automatically financing deficit is taken place then we can say that fiscal policy dominating over the monetary policy and to fulfill that financing deficits RBI has to do some kind of decisions or there has to take certain kind of decision by that the deficit can be covered up. Finally, the policy independence is related to the flexibility given to the central bank in the formulation and execution of the monetary policy.

Government or finance ministry should not interfere for the formulation or are the use of instruments for the monetary policy by the reserve bank. What instrument is Reserve Bank of India is interested to use; whether they want to increase the interest rate or they want to decrease the interest rate, those kind of an interference from the government side should not be there. If from the government side the interference will be there then we can say the autonomy is less if the interference is less, then we can say that autonomy is more. So, in that context the three types of autonomy is defined.

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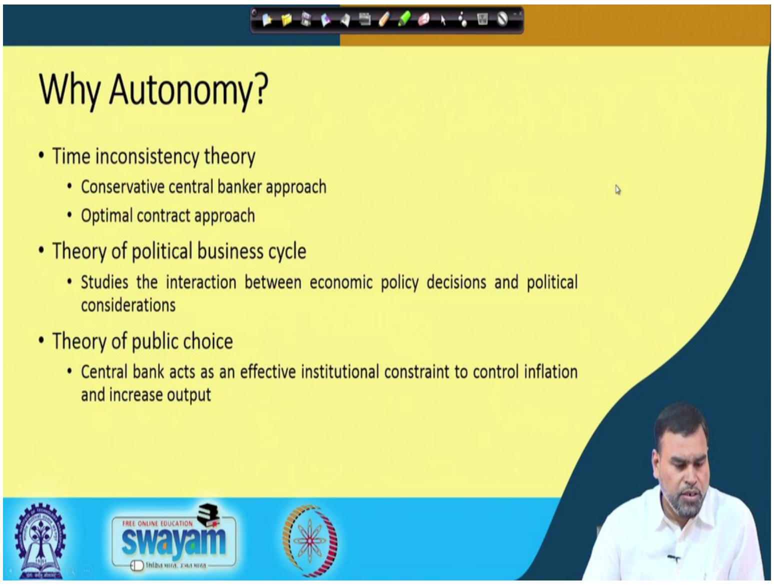

Then we can see that why basically we are in support of autonomy what are those advantages of the autonomy. If autonomy will be given then what is the merits. There are three things we discuss in this context one is time inconsistency theory, theory of political business cycle and theory of public choice. You see if a conservative central banker is there then they will always look for something by that the price can be stable and inflation can be controlled.

But some times what has happened there is a contract that there is no such kind of autonomy when sometimes the Reserve Bank of India governor will be appointed or any central bank governor will be appointed. And, there is an optimal contract between this government and this governor and they will act on their own benefits or the particular political system or political parties can work or the government can work in such a way that it to some extent maximize the social welfare.

But it also help this government and as well as the public in such a way that maybe this total control will not be there in terms of the price stability or the output increase. So that means there is a tradeoff between or there is some kind of contract between the governor and the government by that any decisions which are taken that may not be in the public interest. But if this there is an autonomy then the governor can take their own decisions by that it may be with the special interest which is driven by the economic factors.

And another one is there is a theory of political business cycle which tells that; whenever any new election takes place, this incumbent policymakers who basically they do or the incumbent party which comes to the power they take certain decisions which are very much relax decisions which may; deviate from the actual kind of target whatever the central bank has.

So, that may destabilize the price and all these things and whenever they were going towards the end of this period or their term is going to be over. Maybe some decisions will be taken which may be friendly towards the public and it may be a populist policy which can create some kind of economic disturbances. So, in that particular point of time what happened in the beginning maybe policies are good, but after the period or over the periods whenever this term is going to over they take certain policies which is beneficial for them, but may not be beneficial for the public.

So, in that particular point of time what happens in the long run that may affect the economic system adversely. So, if the governor is independent or the autonomy is given more then maybe the monetary policy part will be taken in such a way that those kind of problem may not arise. Basically the theory of public choice says that central banks has an effective institutional constant to control the inflation and increase output because they have expertise.

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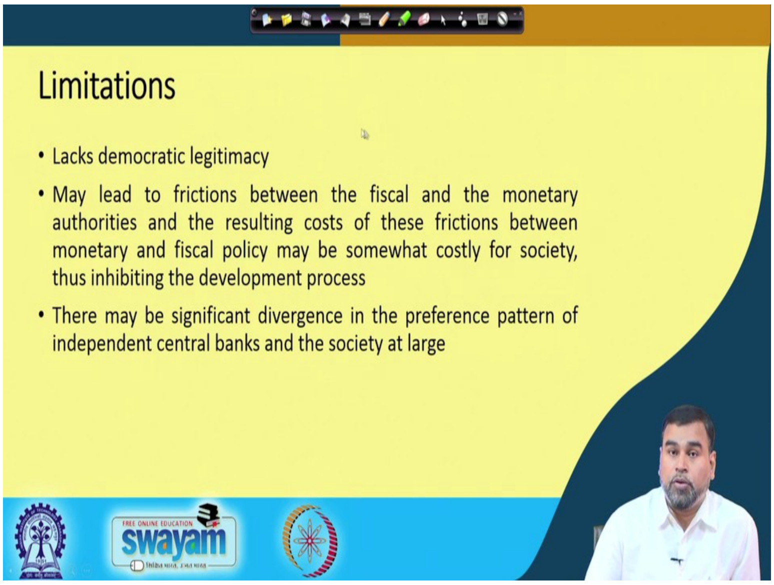

Where there are some limitations of the autonomy because it lacks the democratic legitimacy because government is chosen by the public. So, any decision which is taken by the government we should ensure that it is in for the interest of the public. But here if everything is totally driven by only the economic factors or by theoretical factors may be that lacks the democratic legitimacy. It may also lead to fictions between fiscal and the monetary authorities and that will basically will be costly for the participants in the market and as well as for the society.

Because the government and the reserve bank or the central bank if they do not go together that will also create the problem for the society at a large. So, there may be significant divergence in the preference pattern of the independent central banks in society at a large. Because society need something else, but in terms of functioning point of view Reserve Bank of India or the any central bank wants something else that creates the divergence in terms of their choices in that may create the problem in the economic system. So, these are the different limitations of the autonomy that also always we see.

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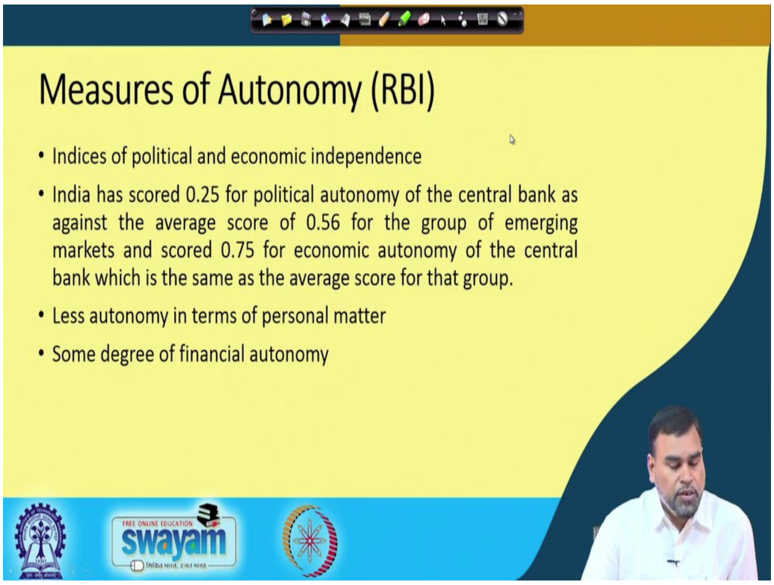

So, this there are indexes which are available to measure the autonomy for the central banks. So, autonomy is measured from two angles; one is political autonomy and the economic autonomy or political independence and economic independence. So, if you see ranks have been given and this is an index which is created for all over the world to the different central banks. And India have scored 0.8. Basically it is in the percentage basis it can maximum go to 1, 0 to 1. So, India has scored 0.25 for political autonomy of the central bank, as against the average score of 0.56 for the group of emerging markets.

That means we do not have any political autonomy or our political autonomy is very less in comparison to the other emerging economies which are existing in India. But they have scored 0.75 for the economic autonomy of the central bank which is the same with the average score of that group. That means, in terms of economic autonomy like financial autonomy because there is a removal of automatic monetization of the financing deficit etcetera etcetera. We have some economic autonomy or the financial autonomy, but political autonomy in terms of appointment in terms of the implementation of the policy and all these things are relatively less.

Less autonomous in terms of the personal matter but some degree of the financial autonomy that already I told you. So, in terms of the measures we are basically to some extent we better off in terms of the financial autonomy. But whenever it is political autonomy we are basically lagging behind.

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Please go through these particular references for this particular session. So, this is about the autonomy of the Reserve Bank of India and as well as the central bank as a whole. It has both merits and demerits. But still it is a debatable issue and this is basically the brief idea about that. And we can explore more that whether the autonomy is good or bad for the central bank or for society at a large.

Thank you very much.