SPEECH

INTERACTION OF DOMESTIC AND INTERNATIONAL MONETARY POLICY IN THE CONTEXT OF THE FINANCIAL SECTOR REFORMS+

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I am grateful to the National Institute of Bank Management for giving me the opportunity to participate in the National Seminar on Trade and Financial Sector Reform. When the definitive monetary history of our life time is written up, the period 1991-93 will be acknowledged as a watershed as this has perhaps been the first time that domestic and international monetary policy action has been undertaken in a consistent and cohesive manner in conjunction with other arms of overall economic policy. In this address, I propose to outline some of the key issues which need to be considered in the pursuit of an effective domestic and international monetary policy.

2. It would perhaps be only fair to admit that until recently there were too many rigidities in the system. While control of inflation has always been an avowed objective of policy, interest rate rigidities, exchange rate rigidities, large monetisation of the Government deficit and a banking system greatly weakened by multiplicity of objectives rendered impossible the meaningful execution of monetary policy. While there has been greater effectiveness of policy execution in the recent period this is not to say that policy conflicts and policy attenuation in certain areas do not remain. Nonetheless, there has been a vast improvement in overall monetary policy effectiveness as a consequence of the reform process.

3. As the economy moves progressively from a relatively closed or insulated economy to a somewhat more open economy the transmission process from the domestic sector to the external sector and vice versa is progressively stronger and faster and if internal and external stability are prime objectives it is necessary to have more sensitive signals which would enable timely policy corrections.

4. While reviewing the role of domestic monetary policy it is necessary to take a hard look at certain facts. An increasing number of central banks the world over are recognising the virtue of making price stability as the principal objective. What often militates against this objective is the irresistible urge to create money under the erroneous belief that such created money can contribute to growth of the economy.. Only a successful track record of low inflation over a long period of time would give credibility to monetary policy action; this is the most prized yet most difficult ingredient of monetary policy. There is a need for an institutional commitment to price stability as the major objective of monetary policy and to achieve this there has to be an intellectual conviction that long-run economic growth is determined by real factors and not by the expansion of money. It is only when these parameters are clearly understood that there is a possibility of achieving a lasting reduction in the inflation rate. Lest this be misconstrued as a view point that monetary policy can miraculously tackle inflation let me hasten to stress that no monetary policy can on its own reduce inflation without a sound anti-inflationary fiscal policy. The choice before the fisc is sometimes posed as a choice between taxation, borrowing or printing money; this is erroneous as an uncovered deficit also carries a price which may be higher than taxation or borrowing from the market. To the extent that other important agents in the economy

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are not totally committed to inflation control the burden on the central bank is to that extent greater.

4. While stressing the inexorable link between creation of money and inflation, i. e. inflation can take place only if it is financed, it is not to repudiate that unanticipated changes in monetary policy can affect output in the very short-run. Institutional developments and changes in velocity do give rise to an esoteric debate on the breakdown of the relationship between money, output and prices but this is largely an intellectual debate. The hard ground realities are that a country that persistently creates excessive money is inevitably afflicted by a high rate of inflation. It is precisely to avoid such problems that some countries have moved over to prescribing a specific target on inflation as also to provide for transparency in the decision taking in pursuit of such targets.

5. The opening up of the Indian economy requires greater attention to what is happening on the inflation front in other countries. While the Indian inflation rate has come down in the recent period, and this is indeed a commendable achievement, we cannot rest on our laurels. Indian inflation rates have fallen from 10-11 per cent (average for 1992-93) to a little over 7 per cent in the recent period; however, what is pertinent is that inflation rates in countries with a history of high inflation have fallen even more sharply e. g. U.K., France, Korea, Sweden, Norway, Australia and New Zealand.

6. The integration of global financial markets has been much faster than the integration of the goods market. As investors are able to switch between different types of assets and also progressively have greater freedom as between currencies, investor sensitivities became vital for the international implications of monetary policy. Thus, global investors have the potential to induce large capital flows when they perceive changes in fundamentals and when they perceive uncertainties particularly in relation to monetary policy. For a country which is just opening up to the rest of the international economy, pressures in the form of potential instability from the external sector could well tempt the country to re-regulate and thereby avoid uncertainties. But this would be precisely the wrong policy response. Central banks which face an increasingly open economy have to redouble their efforts in designing sound policies and persevere with them. So long as the fundamentals are sound a country need not fear any adverse impact from the integration of financial markets. Since the speed of response of market participants would accelerate, policy responses of the authorities have to be faster than hitherto and in this context it is essential that there should be disciplined monetary and fiscal policies with the growing integration of markets, internationally mobile resources inevitably have effects on domestic policies. If a country retains inappropriately low interest rates, relative to its fundamentals, there would be inevitable pressures on the exchange rate and increased inflationary pressures. It is in this context that domestic monetary policy and exchange rate policy have to be mutually consistent.

7. Participants would be familiar with the changes in domestic monetary policy in the past two years and as such I would not want to dwell on these changes. The central theme of the policy has been to move away from direct controls to indirect controls and to reduce the minutiae of regulation while strengthening prudential norms. There has been a significant reduction in reserve requirements and it is expected that the effective SLR would be around 33 per cent by the end of March 1994 (taking into account the lower SLR on certain non-resident deposits as also the nil SLR on certain external liabilities) and as such the adjustment is on track with the medium-term programme of attaining a 25 per cent SLR over a three year period. The reduction in the CRR has also been undertaken, albeit a little slowly in view of the large primary money overhang. The innovations in the instruments of internal debt management policy have been substantial — the move towards market - related rates of interest on Government paper and the auctions for dated securities, 91 Day and 364 Day Treasury Bills, and Repos. Steps are also being taken to develop the institutional framework for the secondary

market in Government securities. In the area of interest rates there has been substantial rationalisation of lending and deposit rates and the number of prescriptions are now minimal and the groundwork has been laid for the ultimate deregulation of interest rates by the Reserve Bank. The Reserve Bank could well develop a system of a reference rate. A convention could develop whereby banks take cognisance of this reference rate and fix their deposit and lending rates at appropriate differentials below and above the reference rate.

8. One of the weak links in the operation of monetary policy has been the automatic monetisation of the budget deficit through the creation of *ad hoc* Treasury Bills. In the Annual Report of the Reserve Bank of India for 1992-93 it has been suggested that the proportion of auction bills in the total creation of 91 Day Treasury Bills should be raised in a phased manner so that by 1996-97 the system of *ad hoc* Treasury Bills is totally discontinued. The Reserve Bank as part of its open market operations can then decide on the extent of Government paper it wants to hold. The cessation of automatic monetisation of the budget deficit would restore monetary policy to its intended vital role in the regulation of money and credit. It is pertinent to note that in 1993-94 the important first phase of the reduction in automatic monetisation has already been introduced. While as of October 8, 1993, the increase in net RBI credit to the Centre was Rs. 13,297 crore, the net absorption by the market of 91 days auctioned Treasury Bills was Rs. 5,247 crore.

9. As mentioned earlier, with the opening up of the external sector, the transmission of impulses from the domestic to the external sector and vice versa would be more powerful and in this context the domestic monetary policy and the policies relating to the external sector need to be more closely integrated. In this context, it is useful to review the impact of changes in exchange rate policy and other policies which impinge on the external sector.

10. In the period since July 1991 there have been certain vital policy changes in the exchange rate regime. Central to these policy responses was the perception of the integral link between domestic monetary policy and exchange rate policy. The adjustment in the exchange rate in July 1991 corrected an overvalued rupee and it was perhaps the one single important measure which facilitated the subsequent liberalisation of the trade and payments regime. The dual exchange rate system which came into existence in March 1992 was, once again, a transitional arrangement, adopted primarily to prevent the reserves from being depleted by persistent excess demand in the foreign exchange market. It also insulated 'essential' imports from exchange rate fluctuations. The unification of exchange rates on March 1, 1993 was in many ways a logical culmination of various policy responses since July 1991.

11. The operation of the inter-bank market under the unified exchange rate has been encouraging. These early experiences have to be carefully sifted even as efforts go into crafting the policy framework for an appropriate exchange rate regime. A concatenation of events have favourably affected the working of the exchange rate regime since the unification of exchange rates in March. The depreciation which would result from the unification had been erroneously discounted by the market by a much larger proportion than eventuated and as such in the immediate post-unification period, the rupee gained strength in the inter – bank market. Given the interest rate structures in major currency centres and the prevailing interest rates in India, and the prospects of a steady exchange value of the rupee, there was an upsurge of funds flowing into the Indian foreign exchange market.

12. The range of market rates have converged around the RBI buying rate which remained firm supported, as it were, by passive intervention purchases by RBI of US $ 4544 million upto the end of September 1993. The strength of the rupee is quite clearly more than transitory. The foreign currency assets of the Reserve Bank upto the end of September 1993 rose to US $ 7.6 billion from US $ 6.4 billion at the end of March 1993 i. e.

an increase of US $ 1.2 billion. There has, however, been a qualitative improvement in the reserves as in the same period the swaps came down from US $ 1,243 million to US $ 2 million and Foreign Currency (Banks and Others) Deposits (FCBOD) from US $ 1,039 million to US $ 851 million. Furthermore, the State Bank of India's (SBI) short-term liabilities on account of Public Sector Units (PSU) came down from US $ 1,030 million to US $ 168 million. In the recent period there has been some restructuring of the Foreign Currency Non Resident Accounts (FCNRA) scheme (under which the RBI provides exchange guarantees) and deposits of less than 2 years are no longer permitted under this scheme. While there was a net outflow of US $ 667 million under the FCNRA scheme between the end of March and the end of September 1993, this was more than compensated for by inflows under the two new schemes viz., Foreign Currency Non Resident (Banks) (FCNR (B)) scheme and Non Resident (Non Repatriable) Rupee Deposit (NR (NR)RD) scheme. As such, the restructuring of the FCNRA scheme is being achieved without a net outflow under all the non-resident deposit schemes taken together and without curtailing the facilities to non-resident depositors. As a result, the reserves have shown a distinct qualitative strengthening with a large reduction in short-term liabilities.

13. During the Liberalised Exchange Rate Management System (LERMS) period the inter-bank swap premia ruled consistently above the RBI premia upto November 1992. This period also coincided with the prevalence of high interest rates in the call money market. Between November 1992 and March 1993 however, the inter-bank premia were in better alignment with the RBI premia. With the unification of exchange rates, the inter-bank premia declined especially in July and August 1993. Since September 1993, however, there has been some rise in the inter-bank swap rates but these rates are still less than 3.50 per cent per annum for a three month swap. This points to the relative strengthening of the rupee.

14.The experience with unification of exchange rates in India and the strengthening of the foreign exchange reserves has also been the case in other countries undertaking such reforms. The fact that Indian interest rates were substantially higher than in key currency markets while the inflation rate remained moderate in India resulted in foreign exchange inflows in response to favourable real interest rate differentials and the low cost of exchange risk cover in the context of stability of the rupee.

15. The future stability of the exchange rate depends crucially upon the degree of success that is achieved in holding down inflationary pressures and the continuing of an interest rate structure which provides for appropriate differentials as between rupee interest rates and interest rates in key currencies. If there is excessive monetary expansion it can spark off a spurt in import demand and a loss in competitiveness as exports become costlier. As such rising prices and exchange rate pressures could follow each other in a mutually reinforcing spiral. Holding down inflation is of course, easier said than done. The large increase in net RBI credit to government and the build up of foreign exchange reserves in the first half of the year has resulted in a substantial injection of primary liquidity in the economy. While emphasising the need for fiscal restraint and the control of domestic liquidity, it is necessary to recognise that opening up of the external sector accelerates the transmission process and domestic monetary policy can no longer operate in an insulated environment.

16. Macro economic policy, and in particular, monetary policy has to be designed to reconcile the objectives of price stability and exchange rate stability. The structure of the exchange rate regime has major implications for monetary policy. The exchange rate system would need to subserve the monetary stance and to pursue the objectives set by the latter, the principal one being the control of inflation. A stable exchange rate provides an anchor for the price level. Under these circumstances, the balance of payments would be determined by domestic economic activity and the exchange rate will have an equilibrating role. As such, in a deregulated environment there is an inextricable link between monetary policy and exchange rate policy.

17. The basic premise of a floating exchange rate system is that the exchange rate will settle at levels consistent with economic fundamentals. A floating rate will then achieve adjustments in the balance of payments through price signals impinging upon demand and reflect in higher inflation to the extent that the real sectors do not respond rapidly to these signals.

18. While the Indian exchange rate system avoids very short-term day-to-day volatility there is no attempt to stand in the way of fundamental changes. As such, it would only be reasonable to expect that in future the two way signals between the domestic and external sectors would be stronger than hitherto and it is in this context that domestic and international monetary policy will be increasingly intertwined.