CHAPTER-III

SIGNIFICANCE OF MONETARY POLICY
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The previous chapter titled as ‘Monetary Theory and Policy’ dealt with the role of money in economic activity and made a theoretical understanding of monetary phenomena. It also explained definition, objectives, targets and indicators of monetary policy.

Role of monetary policy in developed countries and its activities in developing economies, especially in an emerging market economy like India, is of immense importance. Along that, some monetary constraints affecting the policy implementations, policy formulation and its correlation with the banking system are taken into account in the present chapter, for a detailed discussion.

There has been much talk of the revival of monetary policy at present, especially in the climate of some fundamental changes in the economies of both developed and developing countries. The faith in monetary policy was already beginning to wane to some extent. However, the changes in economic policy in the general economic climate seem to have changed the context in which monetary policy has to operate. Whether some consensus on the role of monetary policy likely to emerge from the dust and din of recent crisis? To what extent, does the recent experience of industrial countries have an impact on developing countries? This is a relevant question simply because there are obvious differences between industrial and developing countries and there is, the tendency to follow the trend in the rich almost always. Distressingly, and often enough, such imitation begins when the trend among the more successful is already beginning to bend. There has also been of late far-reaching monetary development at least in some of the developing countries, particularly in the debt-ridden countries. It might be interesting, therefore, at the present juncture to look at the evolution of monetary policy in recent years with one eye so to speak on the developed countries and the other on developing ones.
3.1. ROLE OF MONETARY POLICY IN DEVELOPED COUNTRIES

In developed countries, monetary policy plays a crucial role. Shifts in monetary policy, like those in all economic policy, are a reflection of changing ideology, perception and objective circumstances. The precise line of demarcation between theory, philosophy and objective is difficult to draw but, one can outline the recent conjuncture in the industrial countries as follows:

Inflation has come to occupy the pride of place among the objective of economic policy. There has been a shift of emphasis from achievement of full employment to control of inflation-a shift, which is not of so much relevance to developing countries where the control of inflation has been more or less a perennial preoccupation and where the problem of employment has always been seen as an aspect of long-term economic growth rather than short-term economic management. As far as the trade-off between growth and control of inflation is concerned, there has been common ground now for quite some time in developing as well as developed countries that there is no trade-off here but a virtuous circle where growth and control of inflation mutually reinforce each other.

At the level of objectives, emphasis has shifted from short-term management to long-term growth in industrialized countries i.e. from demand management to supply side economics. It is a mistake to reduce problems of growth to the level merely of efficiency in the allocation of given resources as is commonly implied in micro-economic management. The term ‘supply side economics’ captures better the essence of the process of growth. But here again, the developing countries at any rate should have no difficulty in understanding the shift. Basically, the emphasis in supply-side economics is the same as what economists in developing countries have long emphasized, viz, problems of development, which consist largely of removing rigidities and reducing structural weaknesses while maintaining a proper environment of incentives for work, enterprise, saving, investment and economic efficiency in general.

The reduction in emphasis on short-term demand management which is often described as the final negation of Keynesianism seems to apply asymmetrically only in one direction. While it is vigorously asserted that one cannot increase activity or
employment by raising demand, there is equally firm belief that inflation can be curtailed by controlling demand. As far as the anti-inflationary policies are concerned there is no difference between so called monetarists and Keynesians as to the need for reducing demand; the difference, if at all, is about the instruments or policies to apply for reducing demand. In addition, even here, the ideological belief of so-called monetarists in the need for reducing the size of the public sector in practice leads to greater reliance on fiscal policy through a reduction in the public sector borrowing requirement than on any change in monetary policy. Indeed, it is possible to argue that monetary policy despite all the fanfare and monetary targeting for a while has been a minor side show or shadow play. There is certainly a moral here for all countries.

While a great deal of homage is paid to monetary policy and monetary management in developed countries, this is essentially in the context of inflation or the exchange rate, and not in the context of growth. The financial system in developed countries is a little too sophisticated and over-developed than the developing countries.

Central banks in developing countries like India have an important role to play in promoting development. But apart from the role of the Central Bank in promoting the growth of a diversified financial structure, in creating confidence in it through various devices like supervision and deposit insurance or financial pump-priming and in influencing lending in healthy and desirable direction, there are other considerations more directly related to the traditional concerns of monetary policy which are relevant here.

It is arguable that in developing countries, where entrepreneurship is weak, and capacity to assume and assess risks very limited, there is a strong case for a greater degree of stability in the interest rate structure as indeed in the exchange rate at least in real terms. This may mean that a good monetary policy in developing countries may well be one of great self-restraint.

While real interest rates on an average have to be positive to stimulate savings as well as to ration investment efficiently, it has to be recognized that too high a real rate of interest may be totally out of line with the profitability of available investment opportunities in the short-run, so that it might chock off not just risk capital but all or
most of investment. Alternatively, it could breed losses on a scale that would necessitate neutralizing high interest charges by subsidies in other forms. Short-term monetary policy in developing countries cannot thus be pursued without due regard for these longer term consideration.

Controlling inflation has been an important objective of monetary policy always. Apart from that, there has been a general preference among developed countries for the free operation of market forces and resistance to Government intervention or regulation of all kinds. This has been the inspiration for the abolition of exchange controls and for the de-regulation of the financial system which, together with the profound improvement in information technology, have led to a number of financial innovations. These developments have had a serious impact on monetary policy in developed countries. Thus the general belief in the free and unfettered operation of market forces means that monetary authorities have for all practical purposes discarded several of their traditional instruments.

The bank of England, for example, has given up the use of reserve requirements and no longer tries to influence the quantum of credit directly through rationing its own refinance, or to moderate particular areas of credit like mortgage finance. For all practical purposes it relies only on the price of its refinance, i.e. on interest rates at the short end, although occasionally it has relied on what is called over-funding i.e., open-market operations in another guise.

In Italy, where the tradition of more detailed direct control of bank credit was more established, there has been a rapid advance towards control of a more general nature.

It is true that in response to the greater exposure to risks when interest rates and exchange rates change more often and more sharply, there has been a renewed attempt to prescribe capital adequacy requirements. But on the whole, even monetary targeting has become more of a ritual than a reality and monetary policy has operated through changes in interest rates which soon get reflected in changes in exchange rates so that it becomes difficult to follow any kind of harmonious monetary and exchange rate policy in one country without some harmonization of monetary and exchange rate policy at
least among countries, among which capital moves freely. Since such harmonization is far from being a reality and cannot in any case be perfect, and hence expectations play a major role in the determination of interest and exchange rates in integrated financial markets, both interest rates and exchange rates have become very volatile and are often out of gear with longer-term parameters of desirability.

It is interesting to note that, apart from the ideology of laissez-faire and developments in financial markets, some of the theoretical refinements of recent years also argue in favor of a less active role for monetary policy. Whether or not one believes that a fixed and firm rate of monetary expansion is feasible, let alone desirable, there is undoubtedly merit in the point that several kinds of short-term fluctuations are better left alone or dealt with by means other than monetary policy. As we shall notice later, it is possible to put more burden on monetary policy than it can bear and it is important to remind ourselves, particularly in developing countries, of the dangers of fine-tuning and of the merits of a more or less steady course over time in the interest of creating a stable climate of expectations.

Another recent development is the hypothesis of rational expectations. If policy measures are fully anticipated and their impact correctly foreseen, there is little or no scope for policy, as private operators will so adjust their behavior as to neutralize anything that goes against their own preferences. Whatever may be the logical validity of proceeding from such a hypothesis or its realism, the fact remains that policies are made in a climate of passive acceptance and that expectations and anticipations play an important part. In order to generate the right expectations and establish credibility, a monetary authority may be tempted to announce some predetermined target or rule. But when something can be fully anticipated, it can be got around also. Monetary authorities are thus constrained to create an air of mystery around them, to keep their options open but their mouths shut, to pronounce the virtues of discretionary and, therefore, discrete policy changes. But this creates the risk of disbelief or of setting in motion perverse expectations. There is no escape from this dilemma.

The third strand of a theoretical nature which may be noted goes back in a way to the Radcliffe committee Report and relates to the fact that money is only one among
many financial assets each differing only marginally from others in respect of yield and liquidity or credit and market risk. Current developments such as globalization of capital markets, securitization of loans and other financial innovations have vastly increased the range and substitutability of financial instruments so that monetary policy which influences only one end of the spectrum, viz. commercial banks, cannot be very effective in influencing the general liquidity of the economy and the level of aggregate demand except in so far as it raises the general level of interest rates. But apart from the limited impact of changes in interest rates on demand, the impact of monetary policy on interest rates in general is also diluted by the range of financial markets and instruments. Although these considerations may appear to be less relevant for developing countries, where financial innovations have not reached the same proportions, there are other institutional factors like informal credit markets, extensive black economy and external leakages which argue the other way.

The recent developments in monetary theory and practice in developed countries suggests that despite the apparent revival of monetary policy in these countries, the reality perhaps is that monetary policy has been relegated to a more modest role in the industrialized world. It is at any rate confined to what might be called harmonization of interest rate and exchange rate policy which as yet remains difficult of achievement. The primary responsibility for the control of inflation which has undoubtedly been achieved, has been that of fiscal policy assisted at times by overvalued exchange rates and often by high rates of unemployment and measures to reduce trade union power.

The recent developments in monetary theory and practice in developed countries shows that even in developed countries the jury is still out and the appropriate policy – mix has yet to be settled down. If there is any strong, surviving strand, it is to be emphasize longer-term or real factors such as productivity or efficiency, savings and incentives and enterprise as distinguished from monetary or financial manipulation. This is, in fact, music to the ears of orthodox development economists.

The only question is whether financial and other market can be made so to behave as not to distort unduly the nexus between current market prices and desirable
as well as feasible longer –term adjustment. But our knowledge of what a desirable and feasible adjustment might be, and what might bring it about will never be certain or perfect. Does this argue for a less interventionist monetary policy, smoothing out, on an average excessive variation but leaving trends alone without worrying about whether such trends are consistent with fundamental forces?

Or whether a more interventionist but harmonized policy in order to reinforce what might be perceived as basic or fundamental trends? This is still an unresolved question for the developed world, and is by no means irrelevant for the developing countries.

Money and exchange market become jittery and they try to hedge by employing the ever-growing number of financial derivatives. Corresponding to hedging, there must be speculation, which after a while grows into astronomical dimensions. Everybody was happy about it- national financial institutions, regulatory authorities, industrial units and of course financial brokers and jobbers. There is a lot of anonymity in these markets so that anybody can build up huge open positions, endangering the stability of the markets. Thus, speculations become a way of life and the financial sector grows and grows, has been regarded as a sure sign of a rapidly growing and mature economy.

For many years now, there has been a total freedom for funds to move across national frontiers, so far as the developed countries are concerned. Some countries like France and Japan were reluctant to remove controls on capital transactions wholly, but had to yield under pressure of other members of the G-7 countries, especially the U.S.A. However, Japan has still to go the whole hog; the Japanese authorities are always extremely cautious in their economic liberalization.

All the developments have led to a marked diminution in a national central banks’ ability to perform its regulatory role effectively. The fantastic growth of non banking financial intermediaries affected commercial banks seriously; so they were driven to enlarge the area of operations to engage in particular, in industrial financing, investment and merchant banking business, directly or through subsidiaries. All in all, the segregation of commercial and investment banking was abandoned in favor of a
composite or integrated system. This naturally made central bank control over the banking system more difficult. Diversification in industry is good, of course up to a point, but financial diversification may not be that good, especially with general managerial culture not being of a high order.

Simultaneously, there took place an important change in the monetary policy of central banks. While even before the 1970s it was common for central banks to use just one instrument of central bank control, such as variable cash reserves, discount rate or open market operations, that instrument was not used for all time. After some years, the central bank turned to another instrument. But the position for over three decades now is reliance on the same instrument day in and day out, namely the discount rate, which has been varied frequently in both directions. The general rule seems to have been to follow the market. The market is far from knowledgeable and wise. Secondly, if a central bank is to follow the market all the time, one wonders why a central bank is necessary at all, except for carrying out some routine functions. The central bank has to take a view about both the present and the future, and try to enforce it with various instruments at its disposal.

That monetary policy, in general has failed may be seen tremendous instability in exchange markets, growing number of failures of banks and other financial intermediaries and the ups and downs of growth of GNP. However, interest rates may be, inflation will not be checked and the exchange rate strengthened, unless the basic course of fiscal profligacy is removed. The United States of America is a classic example of this phenomenon. This country has been complacent far too long because of the belief that the dollars will be held in unlimited amounts and indefinitely. Look at the sad spectacle of the US economy now. The USA is the largest recipient of aid for many years now. Why, for the simple reason it has huge budgetary deficits, which are financed by foreign funds, this has been going on for years and years, in a most irresponsible and shocking manner.

From the foregoing, it should not be concluded that fiscal policy alone matters and not monetary and credit policies. There are situations when the economy can get heated or otherwise, through over expansion of credit for industry and trade or
inadequate supplies. Such situations can be handled with modest doses of credit control measures and less frequently than when fiscal and other governmental policies are imbalanced.

3.2. IMPORTANCE OF MONETARY POLICY IN DEVELOPING ECONOMIES

It is now generally accepted that the primary role of monetary policy in developing countries is to facilitate economic growth with a reasonable stability in prices.

Balance of payments is more a constraint than an objective; and it makes sense to interpret stability broadly as control of inflation or keeping the general price-level from rising by more than a few percentage points per year. Regarding a rise of this order as reasonable has no intrinsic merit although it is sometimes argued that it is necessary to permit required changes in relative prices. In truth, it is only recognition of reality as in practice very few countries manage to do as well. But once more and more countries achieve low rates of inflation, it should be feasible to aim at even lower rates; and it has to be regarded as a major achievement of recent years that it is no longer considered unthinkable to aim at a zero rate of inflation on an average such as what has prevailed in fact over much of the industrial era.

For achieving stability, it is generally considered necessary to keep the growth of money supply in step with the demand for it, which is assumed to be uniquely related to national income, at any rate over the medium-term and when due allowance is made for secular changes such as those arising from growing monetization of the economy. This line of reasoning has led in practice to some version of monetary targeting in developed as well as developing countries, often encouraged by stabilization programs initiated under IMF or World Bank auspices. As early as 1953, an IMF mission to India had recommended such a practice which has later found support also from the Chakrabarty Committee set up to review the working of monetary policy in India.
Despite the general support and indeed practice of monetary targeting as a necessary instrument for achieving and maintaining stability, criticism of this approach is also heard often. Some of the criticism of monetary targeting, however, is certainly beside the mark. It can be easily shown, for example, that the velocity of circulation of money or the income elasticity of demand for money is not constant over relatively short periods of time. But there is some relationship which can be calculated as being reasonably stable over a period and it can be assumed as what is likely to prevail in the near future. No one in the realm of practical politics recommends a strict monetary target. Most such targets are set as a range, and there is always the admonition that monetary targets must be kept under review. The Chakrabarty Committee thus speaks of monetary targets with a feedback.\(^{(1)}\)

What needs perhaps to be emphasized is that monetary targeting should not lead to constant tinkering with monetary policy so as to counteract every deviation from the target set. Such tinkering or fine-tuning can be destabilizing and counterproductive. But systematic and large deviations from monetary targets already set should serve as a signal for reviewing policy. The criticism that monetary targeting while necessary is not sufficient is of course valid, and it was echoed long ago by Joan Robinson.

Monetary targeting makes sense only if the permissible increase in money supply is correctly distributed between the legitimate claims of the budget, the private sector and the country’s need for foreign exchange reserves. But surely advocates of monetary targeting are aware of this and, in fact, monetary or credit budgeting is generally attempted on a disaggregated basis. Indeed, it can be claimed as a merit of monetary targeting that it focuses attention on a proper mix of budgetary, monetary and foreign exchange policy.

It is not easy to apportion the permissible increase in money supply between the budget, the private sector and the external sector. As an economy grows and its external trade expands, it will need more foreign exchange reserves and this should have the first priority in the allocation of the permissible increase in money supply. Much of the debate centers on allocation between the public and the private sector. The bias in developed countries now is to under play the needs of the public sector. In most
developing countries, there is a tendency to put the needs of the public sector before those of the private sector- witness the Chakrabarty Committee which lists among the functions of the Reserve Bank the provision of the urgent needs of the Government without any reference to the competing claims of the private sector.

The Reserve Bank cannot perform its developmental role properly unless it assumes responsibility for the establishment of a diversified financial structure that supports the borrowing and lending needs of the private sector. Part of this responsibility can be discharged by the Central Bank directly providing resources to credit institutions that support the private sector. But if any a priori rule about how much of a central bank’s assets should be in foreign exchange reserves and how much in claims on Government and how many in claims on the private sector including claims on developmental financial institutions can be laid down. The relative importance of the public and private sector in national productive investment should be borne in mind and some room must be left for the accumulation of foreign exchange reserves.

It is difficult to prescribe a precise boundary for ‘money’ when there are so many near substitutes for money. It is also true that money which is easy to control such as reserve money may not be in the most stable relationship with national money income. But the point is that as long as monetary targeting is used only as a significant indicator and not as a rigid framework, there is nothing wrong in watching trends in money supply as variously defined and interpreting the trends in the light of all the facts currently available. Indeed, any sensible economic analysis which must precede any policy decision must include the analysis of monetary and financial developments and analysis implies at least in part, comparison with some standard or target.

The criticism of monetary targeting is the one which starts by pointing out those monetary targets at best are intermediate targets and the policy response to them has to be discretionary rather than rule based. If the objective is price stability and external viability, one can look simply at trends in prices and balance of payments and analyze them and wield such instruments of policy as may appear relevant in the light of this analysis. Indeed, concentrating too much on an intermediate target like stocks of money
is not just second best; it may even be misleading as it may narrow the focus on monetary factors and lead to the overlooking of other factors. Current pressures on prices, for example, may be the result of interruptions in key supplies, or due to some external shock, or due to wages exceeding productivity increases, rather than the result of excessive demand resulting from excessive credit creation. A strictly monetary response in such cases, may be inadequate or of little use.

One should speak of monetary targeting only as a minor key. There is a great deal of merit in this line of reasoning. But let us also remember that it only reminds us that mere analysis of monetary trends and setting of monetary targets may not be sufficient. It does not say they are not necessary. Undoubtedly, it is useful to remind ourselves that the starting point should be the final goals of price stability and B.O.P stability and not some intermediate and approximate indicators such as money supply which may be relevant as a part of the analysis as well as of the cure but are never the full story.

There is another valid criticism of monetary targeting which is of an analytical character, viz; that for an indication of inflationary pressures and their cure, it is better to think in terms of the familiar Keynesian categories of budget deficits, current account deficits, and the difference between private savings and investments. In other words, the significant question is not the allocation of the permissible increase in money supply between the public and the private sector but the allocation of available savings, or who crowds out whose investment and how. Merely talking of money creation or money supply obscures this fact.

It is important to emphasize that if the basic budgetary position is not right, it cannot be set right by action on the fiscal front itself. But if the fiscal front is set right, monetary policy can be relaxed. Given fiscal prudence, it is of little avail. In most developing countries, inflationary pressures arise from the operations of the budget rather than from any upsurge in credit to the private sector. Monetary policy cannot really correct this situation. It can at best bring home more effectively the consequences of important public finance. Whether it does so through rocketing interest rates or rising prices is not of much comfort or consequences except perhaps to ideologues.
It has to be remembered that where interest rates are controlled or administered and where the central Bank virtually underwrites budgetary deficits as is the case in most all developing countries, the savings and investment approach and the monetary targeting approach come to virtually the same thing. The monetary approach has at least the advantage that monetary data are more readily available so that they are a better or more feasible basis for planning and monitoring.

Each exercise of activist monetary policy becomes irreversible in practice because as long as budgetary policy is inflationary, any relaxation of monetary restraint will be open to criticism. The result is that there is a kind of Ratchet effect whereby interest rates, reserve requirements and all the rest keep going up and monetary instruments in effect become blunt and arbitrary in their impact on private investment and activity. The major responsibility for maintaining stability in developing countries is considered as that of fiscal policy and that monetary policy at best has a subordinate role. Its actions, therefore, should be muted and more self-restrained.

In the ultimate analysis, there is no alternative to the good sense of the people in power and the pressure of public opinion. It might nevertheless, be desirable at least to try and set some norms for the Government budget and for debt management. Thus, as a minimum, there should be no borrowing to finance current expenditure. Commercial banks should not be forced to take up Government securities beyond a certain proportion of their liabilities and this proportion should not be changed except after relatively long intervals. This proportion is generally fixed in response to prudential considerations. It is also worth considering whether norms cannot be fixed for central Bank support for Government Securities – such norms are implicit in monetary targeting in any case, and it may be worthwhile to make them explicit over a number of years ahead. But in the ultimate analysis, norms are norms and cannot be binding particularly in countries where the market for Government securities outside the banking system is rather thin, and the credibility of norms will depend on how closely they are observed.
3.3. SOME MONETARY CONSTRAINTS

There has been a great deal of debate and experimentation with monetary programs in developing countries. Much of the debate and discussion has centered around programs prescribed by the IMF, the central part of which has been insistence on monetary targeting. So far as we see some practical value in monetary targeting, we cannot object to IMF programs in principle. It is not valid to criticize the IMF for any program of stabilization, such as the conflict in the short-run between growth and stability or the conflict between desirable social goals and budgetary restraint and so on. If there are better answers for resolving such conflicts, surely the countries concerned should know them better than the IMF.

The IMF can be criticized for two things. First, its faith in monetary targeting was too absolute. Surely any transgression of monetary targets is or reason for reviewing policy, not for stopping IMF assistance and thus creating a further crisis of confidence. Second, and perhaps more important to begin with at any rate the Fund took to moralistic view towards developing countries only. It seems that even if difficulties arise for reasons beyond our control, we have to adjust as long as these difficulties or circumstances are not likely to be reversed. But surely this general argument could have been strengthened by advocating strongly that the adjustment can only be made sensibly over a period. The IMF and the Central Banks of developed countries talked for a long time as financiers rather than as a body of world statesmen. But that is the politics of the world economy, which is unfortunately not likely to change.

One moral of recent experience in developing countries that once inflation is allowed to accelerate, it is difficult to bring it under control except by strict monetary measures. Even when monetary measures like currency reform and total restructuring of prices are necessary, they would stick only if at the same time orthodox measures are taken to correct the budgetary imbalance and to rein-in the unions and the speculators. There is, in other words, no magic solution to hyperinflation any more than the problem of correctly guessing the changing needs for liquidity when high inflation rates are suddenly brought down. Experience shows that the demand for money often increases
with stabilization so that unless this is met, a crisis may result causing much loss of output and employment. But it is not easy to guess the extent of the change in the demand for money correctly.

An interesting chapter that is unfolded in many developing countries is that of liberalization from a regime of extensive controls to greater reliance on market forces. This general shift has embraced not just the developed world or the socialist world but also many of the developing countries like India which have had a mixed pattern of ownership with a heavy bias in favor of public control or intervention. An interesting question in all these countries at the present juncture is the role that financial liberalization can play as part of the total process of liberalization and globalization. But difficult to generalize on a question like this where the institutional and other specifics of each country are of obvious importance.

There is need for diversification among financial institutions and for a degree of deregulation and competition leading to greater financial innovations. Thus banks may be encouraged to go in for mortgage finance or long-term industrial finance; industrial banks, unit trusts and provident funds can also diversify their portfolios, and indeed more private banks, private unit trusts or private industrial and other financial institutions should be encouraged.

The spirit of liberalization will also imply that even public financial institutions, including the central Bank, should be freed from routine governmental intervention and so this should be reflected in appropriate managerial and constitutional structures. The financial institutions themselves should avoid policies and procedures which give too much discretionary powers to individual officers as well as for the Government. After all, abuses of power and corruption or politics and being over-burdened with too many objectives can do harm to financial institutions as much as they do in most other institutions.

Developments in industrialized countries are of significance to developing countries and some of them may be profited by the later. At the same time, the policy-mix in developed countries has not yet settled down. As far as monetary policy is concerned, it can at best have a sub-ordinate and supporting role in both sets of
countries. There is little reason to think that it can be more effective in one group of countries than in another. Economic logic often transcends institutional frontiers as well as national frontiers.

There is a greater danger in developing countries and it is that of giving to the central Bank an exaggerated role under which it assumes rather hyper-active poses. It has to demonstrate to its masters that it is doing something. Actually, the central Bank cannot wash away the supply-side shocks. At the same time, it has a very important developmental role. It also has an important role in terms of analysis and advise on matters relating to inflation and balance-of-payments adjustments; and its part of advice can often best be transmitted by analysis of monetary and financial aggregates and by persuading governments to adopt procedures such as monetary target setting which facilitate focusing on the interactions between budgetary, monetary and foreign exchange policy.

When it comes to inflation, it is best to resist in the first place. Two plus two never makes five when it comes to allocation of national resources in the short-run, but it is possible to have two plus two make five in the long-run if proper supply side policies are followed. This include better savings and efficiency in investment as much as a proper framework of incentives for work, investment and enterprise. Sometimes, so dismal is the science of economics that two plus two can also make three when wrong policies are followed and the dividing line between the right and the wrong in economics is never very sharp or stable!

3.4. MONETARY POLICY AND BANKING SOUNDNESS

Y.V. Reddy pointed out some special links between monetary policy and banking soundness.

First, the banking system continues to be, and will continue for quite some time, especially in developing countries, as the main vehicle for monetary policy signals.

Second, the banking system enables the transmission of monetary policy. So, transmission channels, especially the credit channels are important.
Third, the payment system is critical to monetary policy, and crisis of the banking system spills over to the payments system.

Fourth, those banks which are in an unsound position are unable to respond to signals.

Fifth, while ideally, monetary policy on the one hand and regulation or supervision on the other should operate independent of each other, in practice, the two often get intertwined. Thus, monetary policy initiatives, such as tightening liquidity, credit conditions and interest rates may, on occasions take into account the impact on bank’s profitability, especially fragile banks.

Sixth, unsound banks could become captive to insolvent debtors and their response to market signals could get perverse.

Seventh, as already mentioned, managing capital inflows, the exchange rate and the monetary base is facilitated or hampered by banks which are sound or not solvent.

Eighth, it is possible that the credit channel is choked due to non-economic or institutional rigidities usually ascribed to principal agent relationships in banks. The effectiveness of monetary policy and perhaps even the regulatory or supervisory regime could be influenced by such non-economic factors.

Ninth, monetary policy has to recognize the strains of deregulation on the banking system. Also, the data needs keep changing with transition, apart from the importance of timely and reliable data from banks if monetary policy has to cope with fast changing realities and markets.

Finally, and as a sum-up there is a clear two-way intimate interrelationship between monetary policy and banking soundness.\(^{(2)}\)

The process of monetary policy in India had traditionally been largely internal with only the end product of actions being made public. The process has overtime become more consultative, participative and articulate with external orientation. The internal work processes have also been re-engineered to focus on technical analysis, coordination, horizontal management and more market orientation. The process leading
to monetary policy actions entails a wide range of inputs involving the internal staff, market participants, academics, financial market experts and the Bank’s Board (Chart: III.1).

**Chart: III.1 Process of Monetary Policy Formulation**

Several new institutional arrangements and work processes have been put in place to meet the needs of policy making in a complex and fast changing economic environment. At the apex of the policy process is the Governor, assisted closely by Deputy Governors and guided by deliberations of the Board of Directors. A Committee of the Board meets every week to review the monetary, economic and financial conditions and renders advice on policy. There are several other standing and *ad hoc* committees or groups which play a critical role with regard to policy advice. An
interdepartmental Financial Markets Committee focuses on day-to-day market operations and tactics while periodic monetary policy strategy meetings analyze strategies on an ongoing basis.\(^{(3)}\)

### 3.5. MONETARY POLICY IMPLEMENTATION

Since the structure of the economy is unknown, the exact effect of a policy on ultimate policy objectives cannot be ascertained. Also the goals of monetary policy are observable only after a considerable and variable lag. In such a case, from a pragmatic point of view, a target variable is introduced which is assumed to be closely related to the ultimate policy objectives and is observable with little or no lag.

Saving suggested target-indicator approach to examine the effectiveness of monetary policy. This approach which focuses on operational and intermediate target variables can be rendered schematically as follows:

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+---------------------------------+
| Instruments of monetary policy  |
+---------------------------------+
      | Influence                     |
+---------------------------------+
| Operational Variables           |
+---------------------------------+
      | Influence                     |
+---------------------------------+
| Intermediate target variables   |
+---------------------------------+
      | Influence                     |
+---------------------------------+
| Final goal variables            |
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The success of monetary policy in the operational intermediate target approach, thus, depends on the stability and predictability of the relation between the operational and the intermediate target variables on the one hand, and between the intermediate and
ultimate goal variables on the other. The two pertinent issues for the conduct of monetary policy, are those of controllability and predictability. While the issue of controllability requires a strong stable and one way causal relation running from operational to intermediate target variables, the issue of predictability concerns the direction, strength and stability of relation between the intermediate target variables and the final goal variables.\(^{(4)}\)

In India too, monetary authorities have been using the operational intermediate target approach for the implementation of monetary policy. A perusal of measures undertaken by the RBI would indicate that the Bank, for achieving its objective of ‘growth with stability’, announced various monetary targets from time to time. While some variant of bank credit was used as an intermediate target till 1983-84, M3 was targeted after 1985-86 following the Chakrabarty Committee Report. Indeed, the monetary measures in India were so designed as to influence through proximate target variables, the intermediate target variables and finally through them, the final goal variables.\(^{(5)}\)

**REFERENCES**