Chapter III

INDIAN MONETARY POLICY IN THE LIBERALISED REGIME

3.1 Introduction

Indian economy witnessed significant changes in its policy regime during the decade of 1990. The major characteristic of the new generation policy framework lays down in its market orientation. In order to facilitate the proper environment for the working of market forces, institutions brought out several liberalized measures during the same period. Moreover, monetary policy came out from the clutches of fiscal formulations during the years. The macroeconomic crisis of early nineties helped the authorities to identify the fallacies of traditional frameworks and it lead to inevitable transformations in the frameworks of monetary policy as well as institutional settings.

Until the crisis years, monetary policy managed a supportive role in order to implement the fiscal programmes in the Indian economy. Un-sustainable fiscal ratios, which had been maintained over the period at the cost of monetary ratios, constrained the monetary policy to be inefficient in the country. Indian economy had been experienced large amounts of fiscal deficits on a continuous basis and its monetisation through ad-hoc treasury bills brought out adverse developments in the liquidity scenario of the country. The economy experienced liquidity spurt at several occasions and the system faced uneasiness in managing the conditions in the absence of fiscal controls. Adding to worry, during the Gulf war of 1990, exchange reserves drained out due to the imbalances in the terms of trade. Further developments led the country in to a serious balance of payment crisis. The overall macro economic conditions worsened during 1991-92. With the adverse development in the economy, the Gross Domestic Product (GDP) growth rate has dropped into 1.06 percent and liquidity has increased by 19.27 percent during the
year. As a consequence, inflation rate surged beyond 20 percent in the system. Because of the large deficits, fiscal measures became ineffective in controlling the short run problems in the economy. While fiscal measures became ineffective, the authorities were forced to depend upon alternative measures. Within due course of time, monetary policy was recognised as an independent tool for achieving higher levels of economic growth and stability. The importance of policy independence and in turn its impact on policy effectiveness was observed during the period.

This chapter looks in to the major developments in the Indian monetary policy regime during the liberalised era. The next section gives an overview of the transformation in the policy regime. The preceding sections sketch the major characteristics of the monetary policy framework in the liberalised era. The chapter ends with a summary of these developments.

3.2 Monetary Policy Scenario during the Liberalised Era: The Transformation.

From an orthodox policy regime, which had been dominated by direct controlling measures, the monetary policy had been transformed into a market oriented one, wherein indirect measures were considered as the major tools of operation. Major changes in the policy framework can be identified in operating procedures, choice of instruments and intermediate targets.

There was an array of instruments viz., open market operations, bank rate and discretionary control of refinance, direct regulation of interest rate, cash reserve ratio, statutory liquidity ratio, direct credit allocation and credit rationing, selective credit control, credit authorisation scheme, fixation of inventory and credit norms, credit planning and moral suasion, which were used by the Reserve Bank to conduct its policy operations. Having started the orientation towards a

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23 The new generation policy regime gives importance to market oriented operations. However, as the financial markets are not developed in to full extend, conventional measures are also used optionally.
market driven policy regime, the central bank has been attempting open market operations as the major tool of its operation instead of direct measures.

Changes in monetary relations have resulted in the loosening of the control over monetary ratios and have led to a switch over from a single intermediate target to a multiple indicator approach. Under multiple indicator approach, changes in most of the macroeconomic variables are utilised for framing an action plan. In the earlier case, liquidity growth or short term interest rate changes used to dominate the decisions. In the light of liberalisation, factors such as foreign investment became more important in determining the monetary position of the country. In the multiple indicator approach, information content of most of the macroeconomic variables is used for policy operation.  

Under structural reforms, there have been some fundamental changes happened in the institutional settings such as fiscal-monetary relationship, pre-emption of resources through reserve requirements, structure of interest rates, growth of the non-banking financial sector and changes in exchange rate policy. The ‘custom’ of automatic monetisation of the fiscal deficits through ad hoc treasury bills was terminated with an agreement between Government of India and the RBI, which adopted a new system of ‘ways and means of advances’. The new system came into the existence in the late nineties during which time ‘due period’ for the advances made by the Government from the RBI has been controlled.

24 From 1998-99 onwards the Reserve Bank of India uses a multiple indicator approach in the policy framework in order to track the developments in the economy especially in the real sector. Tracking business cycle movements based on a single macroeconomic variable in a diversified economy like India is very difficult. One of the major reasons is the unavailability of high frequency data on national output and other real variables for a long duration. Under such conditions an elaborated data base which includes most of the available indicators can give a better idea about the real sector dynamics. Multiple indicators include interest rates or rates of return in money, capital and government securities markets, data on monetary and credit aggregates, fiscal position, trade balance, capital flows, inflation rate, exchange rate, refinancing and transactions in foreign exchange etc.
The importance of a sound financial system in economic development was recognised during the period. The practice of pre-emption of resources through reserve requirements, which had acted as an additional tax on the financial intermediation, adversely affected the operational freedom of banks. In this regard, reserve ratios were reduced to the minimum level over the years in order to enhance the operational freedom of the banks.  

Indian economy had experienced a system of administered interest rates for a long period. Concessions and priorities had been given to different sectors according to the development plans. Concessions and priorities were executed through the structure of interest rate, such as differential rate of interest for different categories of bank credit. This structure of interest rate curtailed the profitability and operational freedom of the banks. In order to dismantle the system, the number of categories was reduced and the rates were rationalised.

Apart from these measures, cautious attempts have been made to improve the financial system, especially the development of non-banking institutions. As a result, the decade of nineties witnessed quite impressive development in financial markets such as Treasury bill and calls as well as in financial institutions.

Apart from these developments that happened during the nineties, exchange rate regime faced a major shift from fixed exchange rate system to market determined one. More or less, it became a floating exchange rate regime in Indian case. The monetary authority confined its operation only to stabilise the rate fluctuations within a given band width which is highly required to avoid balance of payment crisis.

Financial sector reforms in India can be addressed under five major heads viz., banking sector reforms, reforms in the government securities market, other...

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25 There was a change in this stance as the financial markets are not fully developed in the economy and CRR has increased to higher levels to control liquidity growth.
assets markets reforms, reforms in foreign exchange market and reforms in monetary policy framework. A detailed analysis of all these reforms is out of the scope of this chapter. So, further discussions are mainly focussed on the reforms related to monetary policy framework only.

3.2.1 Changes in the Monetary Policy Measures.

As already mentioned, one of the major characteristic of the new generation policy framework is the choice of indirect measures. Under general conditions, new generation policy framework prefers open market operations to achieve the policy goals. The transformation of the policy framework and short run stabilization measures taken by the central bank at each point of time are inseparably interlinked. As a result, it is not possible to classify the changes in the policy measures as easily as in the case of institutional set ups. Although changes in the major policy measures during the liberalised regime are described below to provide a better picture of the transformation (see figure.3.1).

3.2.1.1 Changes in Interest Rate Structure.

Interest rate structure in Indian economy has been changed drastically from 1990-91 onwards. From an administrative interest rate structure, it has been transformed in to a market oriented one. With the implementation of Liquidity Adjustment Facility (LAF), reserve bank of India had changed its emphasis from bank rate to repo and reverse repo rates in order to influence the short-run interest rate. The importance of bank rate as a policy instrument has declined drastically with this transformation. Nowadays, the importance of bank rate is mainly related with the credit to the governments as the interest rates on credit to the governments were linked with the bank rate during 1998-99. Gradually, sector specific and program specific interest rate structure has been dismantled and

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banks received higher level of autonomy in determining their own saving and lending rates.

Initial reforms were started with de-compartmentalization in lending rate in 1990-91. In the same year, banks were allowed to fix interest rate above the minimum rate, on their lending. With 1992-93, most of the sector specific and program specific lending rate system was removed. During 1994-95 and 1998-99 banks received more freedom in this direction. During 1999-2000, banks were allowed to use multiple prime lending rates for different maturities. With 2002-03, banks were allowed to fix their own interest rate on lending with reference to their prime-lending rate.

Similar to the changes happened in the lending front, banks experienced substantial improvement in savings activities also. During the period 1994-95 to 1997-98, banks received freedom to fix interest rate on term deposits through a step-by-step deregulation scheme. By 2002-2002, banks were allowed to fix their new deposits schemes with higher rate of interest. On similar grounds, 2002-2003 onwards banks were encouraged to undertake a flexible interest rate system for their deposit schemes. With the deregulation programs, the banks attained significant level of operational freedom in handling all types of deposits including non-resident term deposits.

Similar to commercial banks, co-operative banks also received a substantial level of autonomy in determining, lending and deposits rates during the period. Moreover, banks were interest rates on non-resident term deposits of maturity over two years were freed.
3.2.1.2 Changes in Reserve Ratios

Similar to the changes happened in the interest rate structure, system of maintaining reserve ratios has changed significantly in the nineties. Reserve bank used to change the level of reserve ratios directly related to two basic criterions viz., liquidity in the system and governments’ budgetary conditions. There was a corresponding increment in the Cash Reserve Ratios (CRR) with respect to the growth in liquidity. Similarly, Statutory Liquidity Ratio (SLR) was used create a captive market for governments’ securities. Apart from general prescriptions, incremental reserve requirements also have been maintained in the system during persistent liquidity growth. Incremental reserve ratios can be considered as a method of bypassing statutory limits. However, these additional restrictions were removed from the system during the later years of nineties.

Because of liquidity growth, CRR was raised up to the statutory limit of 15 percent on 01-07-1989. The spurt in liquidity continued in the initial years of nineties. Until 06-08-94, the CRR was maintained at very high level. Apart from highest CRR and incremental CRR level, Statutory Liquidity Ratio (SLR) was raised by half a per cent from 38 per cent to 38.5 per cent on net time and demand liabilities of banks on 22-09-90. The SLR was maintained above 38 percent up to 06-08-1993.

Higher levels of reserve ratios are considered as a burden on banking sector. Highest levels of reserve ratios sector specific and program specific interest rates and credit allotments adversely affected the performance of banking sector in India. In order to revive the financial sector, several initiatives have been taken by the reserve bank of India. In this regard, reserve ratios have reduced gradually. CRR level reduced up to 4.5 percent (14-06-2003) and SLR level reduced up 25 percent (25-10-1997). SLR level was at 25 percent up to 2008. With the persistent increase in the liquidity, from 2004 onwards, CRR has been
adjusted upward continuously and it has crossed above 7.75 percent with the end of 2007. During the de-regulation program, in several occasions, CRR ratio has been adjusted with respect to liquidity growth. CRR has been considered as one of the most powerful tool with RBI in controlling liquidity. However, the reserve bank didn’t rely upon incremental CRR or SLR in order to control the liquidity growth after nineties.

3.2.1.3 Liquidity Adjustment Facility (LAF)

Following Narasimham Committee (1998) recommendations, Reserve Bank of India introduced Liquidity Adjustment Facility (LAF) in different faces. With an objective of managing short run liquidity in the economy, LAF works through repurchasing options (repos) and its mirror image (reverse repos) operations done by the Reserve bank. Initially an Interim Liquidity Adjustment Facility (ILAF) was introduced in April 1999. Refinancing facilities provided by the Reserve bank has reformed in to a new level with this development. The General Refinance Facility (GRF) was withdrawn and replaced by a collateralised lending facility. In the second stage LAF was introduced effective from June 2000. The third stage of LAF started with the full computerisation of Public Debt Office (PDO) and introduction of Real Time Gross Settlement (RTGS) and repo operations became carried out mainly through electronic transfers. The LAF operates through daily repo and reverse repo auctions thereby setting a corridor for the short-term interest rate consistent with policy objectives. Along with open market operations (OMO) and Market Stabilisation Schemes (MSS), LAF became an effective tool to manage short liquidity in the Indian economy.

3.2.1.4 Changes in Other Measures

Apart from reserve ratios and interest rate structure, significant changes has been made on terms of refinance facilities with banks and prescriptions on sector specific lending activities. Instead of sector specific refinance facilities, a general refinance facility (GRF) was introduced during 1997-98 and has withdrawn later with the development of LAF. In the case of priority sector lending activities, more importance was given to the infrastructure development. Non-food credit to deposits ratio is a major indicator for the central bank in deciding the liquidity growth. Restrictions on this dimensions has been maintained according the liquidity growth. With the improvement in foreign exchange reserve position, restrictions on import credit have relaxed significantly over the years.

3.3 Performance of the Monetary Policy Framework during the Liberalized Era

The Reserve Bank of India is considered to be one of the most successful central banks around the world. It was mostly successful in resisting the South East Asian crisis of the late nineties compared to its counterparts. Similarly, in a medium term perspective, the Reserve Bank of India proved its competency over controlling inflation and other imbalances. However, it has been identified that under a formal analytical perspective the claims could be challenged and the policy framework could be criticised thoroughly.

Although policy objectives are explicitly stated in the documents, it is very difficult to find any systematic rules specified under the monetary policy frameworks for a long duration.\textsuperscript{28} As a result, a scrutiny of the policy effectiveness based on a well-defined policy reaction function is not possible in

\textsuperscript{28} Vasudevan A (2004) critically observes that reserve bank has followed any systematic rules during the period.
the Indian case.\textsuperscript{29} Similar criticisms may hold good even in the case of short term liquidity management. The short run liquidity forecast model RBI (2002) just released with the inception of the LAF practically failed in achieving its goals.\textsuperscript{30}

Like most of the other central banks around the world, Reserve Bank of India consider monetary policy as the most suitable tool for short run stabilisation. The RBI mainly target at price stability because inflation is a major cause of worry in the short run\textsuperscript{31}. Maintaining price stability and credit availability in the economy is considered as the major objective of the monetary policy in India\textsuperscript{32}. In a market oriented policy environment, achieving both of these objectives are critically associated with the success of liquidity management in the system\textsuperscript{33}.

According to the recommendations of the Narasimhan Committee report (1985), RBI adopted monetary aggregate (M3) as the intermediate target in its policy framework. However, monetary aggregate targeting was not a complete

\textsuperscript{29}One of the available reaction functions is based on bank rate, see RBI (2001). However, bank rate was not an active tool in the eighties or earlier. Similarly, with the inception of repos it has lost its relevance as a signalling tool. Moreover, these types of models are tested with yearly data and not much useful in predicting short-run dynamics.

\textsuperscript{30}Reddy (2002), RBI (2002) review of the performance of the model shows that forecasts are not efficient. However, as mentioned in the report, parameter instability is mainly caused by the data characteristics.

\textsuperscript{31}In the short run fluctuations in the foreign exchange and other financial markets are also very important. As a result RBI and its agencies intervene in these markets for maintaining stability.

\textsuperscript{32}However, the role mandated to the monetary authority in India can be interpreted in several ways. The Reserve Bank of India Act 1934 set the mandated tasks as “...to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.” Following the broad specification on credit availability and price stability in the system, policy frameworks of the RBI used to maintain targeted rates of output growth, monetary expansion and inflationary level.

\textsuperscript{33}In a macroeconomic context, liquidity refers to overall monetary conditions, reflecting the extent of mismatch between demand and supply of overall monetary resources. However, Central banks refer liquidity with respect to the monetary base (currency and reserves of the banking system) of which the central bank is the solitary supplier. Although central banks refer liquidity on a narrow basis, we follow the common reference. Moreover, as a conventional measure in macroeconomic analysis, we also use percentage change in broad money as a measure of liquidity growth in the system.
success in Indian case. The data available on targeted and achieved rates shows that the success rate was nearly 50 percent only (see table.3.1).

Compared to the monetary aggregate targeting, output growth targeting is preferred more in modern times. In a supply-constrained economy like India, price stability can be achieved only through achieving higher levels of economic growth. In this regard, the association between credit deployment and output growth was identified in the earlier decades itself. In the Indian economy, credit deployment schemes had played a major role in the monetary policy frameworks. However, credit aggregates were never considered as a prime targets in the policy frameworks. In the later years of the nineties, monetary targeting was replaced by a multiple indicator approach. The replacement was made in the light of changing monetary relationships in the economy.

In the earlier years, dominance of the fiscal formulations on the monetary policy framework also heavily contributed to its failure. Until the introduction of a new system of ‘ways and means of advances’ in 1997, monetisation of fiscal deficits through ad hoc treasury bills had heavily contributed to the liquidity in the system. Impact of the monetisation on the liquidity was more direct and the central bank was asked to contain it. Moreover, it was authorized to neutralize the impact of price distortions on the economy also.\textsuperscript{34} As a result of these policy dynamics, the central bank was under the pressure of fiscal imbalances for most of the years. Under such circumstances, any attempt to evaluate the performance of policy frameworks has to consider the absence of policy independence as a binding constraint that the monetary authority has faced during the period.

With the inception of the Liquidity Adjustment Facility (LAF) the Reserve Bank has been trying to control the liquidity through open market operations. However, it has been observe that other measures are also necessary to stabilise

\textsuperscript{34} Price distortions could have resulted from various shocks such as those generated by supply-demand imbalances in production as well as international oil prices and the like.
the liquidity in an open economy environment. Market Stabilisation Schemes (MSS) also play a significant role in sterilization. In order to control long-term liquidity growth, the Reserve bank revived the use of cash reserve ratio (CRR) along with the other short run measures.

3.4 Summary

Macroeconomic scenario during the early nineties uprooted the orthodoxy in macroeconomic thinking in India.\textsuperscript{35} Liberalisation, privatisation and globalisation were recognised as the basic ideology of macroeconomic policy making. In this line, the roles of institutions were redefined, which in turn led to fundamental changes in the institutional settings and policy frameworks. Two prominent developments in the institutional settings can be identified as the new system of ways and means of advances and the liquidity adjustment facility. Similar to the change in the institutional settings there is some significant development happened in the monetary policy frame work also. The new generation framework follows a multiple indicator approach and changes are more visible in its operational procedures. The new arrangement of ‘ways and means of advances’ gave higher levels of autonomy for the central bank. With the growth of alternative financial markets and inception of the liquidity adjustment facility, the Reserve Bank has been trying to pursue its goals mainly through open market operations. The dependency over direct policy measures had been reduced considerably under the new framework. Further growth of financial markets and higher levels of financial integrity will enable the Central Bank to succeed its goals through indirect measures.

\textsuperscript{35} Rangarajan (1999)
Figure 3.1 Policy Variables
Table 3.1 Performance of monetary targeting in India

<table>
<thead>
<tr>
<th>Year</th>
<th>M₃ ( % growth rate)</th>
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<th>Inflation rate (%)</th>
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<td></td>
<td>Target</td>
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<tr>
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<tr>
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Source: Compiled from various publications of RBI (Annual reports and circulars on monetary and credit policy)