REVIEW OF MONETARY POLICY OF INDIA SINCE INDEPENDENCE

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ABSTRACT

Monetary Policy is the policy which looks after the supply of money into the economy, keeps record of inflation and takes into account the economy's growth. Central bank of a country conducts the monetary policy of that country. Reserve Bank of India (RBI) is the central bank of India hence regulates the monetary policy of the country. RBI formulates implements and supervises all the functions of monetary policy. Indian Monetary Policy has seen many structural changes since independence. During early 1990s, the major monetary policy measures were Cash Reserve Ratio (CRR) and Statutory Liquid Ratio (SLR). In case of India, it has been seen that the increase in inflationary pressure is mainly due to the money demanded by the central government to meet the budgetary deficit of the country. If we talk about the recent development in monetary policy of India, we see that Monetary Policy Committee (MPC) has been constituted after the recommendation of Urjit Patel Committee in the year 2016. Establishment of MPC is considered to be a revolutionary development in the area of monetary policy. This paper intends to take a review on the monetary policy of India, changes that have been made to tackle the economic instability in the past and the recent developments in monetary policy of the country. It also intends to test the monetary policy with respect to pressure on inflation. This research paper is entirely on the secondary data. Different journals, books and other research papers within the same context have been followed for this paper.

Key words: *Monetary policy, India, Inflation, WPI, CPI, Monetary Policy Committee*

Introduction

Money is a very vital aspect in any economy. The quantity of money is one of the major determinants of the level of overall economic activity. Money whether in digital form or physical form provides strength to an economy but if provided in excess, it can adversely affect the growth of an economy. Money is controlled to keep economic activity in a smooth course. Wrightsman (1983) explains that if money is not properly controlled, the economy will not be able to avoid fluctuation in prices. Therefore in order to have smooth economic growth, it is required to have proper regulation of money supply into the economy. This is what monetary policy does, to check the money supply into the economy and adjust it whenever is needed so as to avoid the undesirable situation such as inflation and deflation. These two situations occur due to the frequent fluctuation in the price of goods and services. Hence, maintaining price stability is the main aim of monetary policy of a country without hampering the growth of the country. Inflation and deflation are two extreme situations which drag down the economy to slower growth.

In India, monetary policies are being formulated and regulated by RBI. Under Reserve Bank of India Act 1934, RBI is the apex body which is responsible for any change in such policy of the country. Since 1952, monetary policy has been putting much emphasis on following two aims of the economic policy. i) To speed up country's economic development, to increase national income and to increase living standard of the people, ii) Adapting measures so as to control and to reduce inflation in the economy. RBI through its various instruments of monetary policy regulates the supply of money into the economy. The flow of credit is controlled by RBI by implementing quantitative and qualitative measures.

Before 1991, monetary policy was mainly anti- inflationary. From 1991onwards, RBI had made many changes in the monetary policy of the country like, earlier RBI had adopted a controlled policy but when globalization came it has changed it from controlled to decontrolled policy. The present paper intends to take a review on the monetary policy of India, changes that have been made to tackle the economic instability in the past and the recent developments in monetary policy of the country.

Inflation and Measures of Monetary Policy

Inflation is a situation which occurs when the normal price of the goods and services increases which results in decreasing in the real value of money and therefore leads to decrease in the purchasing power of the currency. In order to ensure the smooth running of the economy RBI adopts various measures so as to prevent the economy from both the extreme situations of inflation and deflation. Earlier in India the prime indicator of inflation was Wholesale Price Index (WPI) but recently the indicator has been changed to

Consumer Price Index (CPI). Both the WPI as well as CPI measures the average changes in the prices of basket commodities but the difference is the former reflects the prices for bulk sale at wholesale level of transaction whereas the latter reflects the changes in prices at retail level. Let us discuss the trend of inflation in India and the monetary policy measures taken by RBI to contain inflation in some detail.

Since 1955-56 prices have been continuously rising putting an inflationary pressure on to the economy of the country. During the period of 1956-64, the prices were rising heavily although the inflation rate was not the same throughout the period. During this period price rises at an annual rate of 5.1 %. During the year 1964-1981, the level of price increases averagely at 9.5 % p.a. Later on wholesale prices also increases at an annual rate of 8.2 % during the year 1981-1994. One of the major reasons for such inflationary pressure may be viewed as the money demanded by the central government to meet the budgetary deficit. When prices rise and appeared to be out of control, RBI intervene and took decision with regard to change in monetary policy so as to control the rising prices.

During the period 1961-1991, inflation was rising and to control such inflationary pressure RBI adopted both quantitative and qualitative monetary measures. In order to induce private investment it had adopted cheap money policy till 1961 but this was given up by RBI as the inflation rises during the period. To contain the inflation, bank rate remained at 9 % in July, 1974. It was further increased to 10 % in July, 1981 to curb inflation. During 1980s, RBI used another monetary policy measure called Cash Reserve Ratio (CRR) to take back the excess capacity of lending money by commercial banks. In the year 1984 CRR was raised to 9 % from 7 % in 1983. Later on Statutory Liquid Ratio (SLR) also raised by RBI to 35.5 % in July, 1984. SLR was again increased up to 37.5 % in the month of April, 1987. Cash Reserve Ratio was increased up to 15 % in month of July, 1989. The Statutory Liquid Ratio rises to the tune of 38.5% in September month of 1990. To curb down excess liquidity with the commercial banks, Bank rate again revised at 12 % in October month of 1991 by RBI. After this the government decided not to rely only on CRR and SLR to curb inflation as per the recommendation of Narsimham Committee. Accordingly RBI reduced the Cash Reserve Ratio and Statutory Liquid Ratio. Statutory Liquid Ratio was reduced till 25 % in the month of October, 1997.

During late 90s, Indian economy had seen a little monetary change as the foreign exchange reserve rise sharply with RBI since 1992-93. This had impacted on the composition of reserve money. As RBI feared that this will create domestic monetary expansion and will lead to inflationary pressure, it decided to control the monetary expansion by selling out the accumulated reserve by the way of open market operation. RBI sold the government securities worth [1] 27,782 crore during 1993-1998. In the year 1995-96 inflation came down to 5.50 %. But again during September, 1998 rate of inflation rose to 8.8 %. In the year 1998-99 net sales alone on account of the open market operation generated by RBI was worth [1] 29,669 crore. Open market operation steeply rose to [1] 53,402 crore during 2002-2003. Therefore we can say that the open market operation come out as one of the very important tool of monetary policy.

During the year 2005-06, inflation rate averagely stood at 4.4 %. It goes up to 5.5 % during the year of 2006-07. It further increased to 12.6 % in August month of 2008. However government managed to pull it down to 2.43 % in February, 2009. But the average rate of inflation in 2010 again rose to 12.11 %. The CPI inflation rate has increased since June 2008, the main cause for increasing the inflation were rising in the prices of food articles, fuel and services. This had reached a range of 16.2 – 17.6 % during the month of January 2010. RBI continued to tighten the monetary policy in order to contain inflation since 2010. Repo rate was increased by 50 bps in the month of July 2011 and again by 25 bps in September month of 2011 by RBI. The main cause of inflation was due to the supply constraint. In order to regulate and control the money supply, RBI has always been criticized that the regulatory framework is anti-inflationary as well as anti-growth. Therefore the major challenge before RBI is to control inflation without hampering the growth of the economy. Beside this, the main challenges to effective monetary policy management were fiscal pressures and global uncertainty.

During November 2012, headline inflation decreased to 7.2 % resulted in declining in the prices of vegetables, minerals and fuel. However, in contrast to the development of WPI inflation, CPI inflation was on the higher side. The new combined (rural and urban) CPI (Base: 2010=100) inflation rose in the month of November, reflecting an increase in food inflation pressures, particularly the price of vegetables, cereals, pulses, oils and fats gone up. The non-food component of the index also reflected inflationary pressures. In order to curb down the liquidity deficit at reasonable levels, open market operations (OMOs) was conducted by the central bank on December 4 and 11, injecting primary liquidity of two thirty two billion. Repo rate was kept unchanged at 8.0 %.

Recent developments in Indian Monetary Policy

Indian monetary policy has gone into various changes during the recent years. During September, 2013 Raghuram G. Rajan took over the charge and became the 23rd governor of RBI. During his tenure of 3 years Indian Monetary Policy has gone into very unusual changes. When he joined the office, the Indian economy was struggling with an alarming rate of inflation.

At this point of time the retail inflation stood at 9.49 %. As a governor, the primary concern of Rajan was to curb down the inflation. He was able to contain inflation at 3.78 % in the month of July, 2015- the lowest since 1990s. Headline inflation also declined from 5.98 % in September, 2013 to its lowest which is at -4.05 %. Earlier the key indicator of inflation was Wholesale Price Index (WPI) but during Rajan's tenure, as per the global norm RBI adopted Consumer Price Index (CPI) as the key indicator of inflation. Let us see in some detail the performance of monetary policy measure during his tenure.

During 2013-14, WPI inflation moderated at 5.98 % whereas CPI also moderated to 9.49 % from 10.21 % in 2012-13. In order to contain inflation, the monetary policy of RBI remained tight throughout the year. During the year RBI changed the repo rate four times with the rate standing at 8 % at the end of March, 2014 which was 50 bps higher than the rate standing at the end of March, 2013.

In April, 2014 RBI published its first bi-monthly monetary policy report. During the year 2014-15, headline inflation in terms of WPI moderated to an average of 3.4 %. It was high during the first quarter due to increased prices of food and fuel but gradually declined in the second and third quarter to 3.9 % and 0.5 % respectively. Inflation in terms of CPI which was around 9-10 % during 2012-2014 also came down significantly since the second quarter of 2014-15. The CPI inflation stood at 5.1 % (base year 2012) in January, 2015. The negative slope in inflation was more quick than expected. This was due to the declining in the prices of crude oil, coal and global tradable which positively contributed to the declining of inflation much faster. The tight monetary policy helped in containing inflation, kept check on the volatility of rupee. In January, 2015 with the softening inflationary condition repo rate was also decreased by 25 bps to 7.75 %. RBI also reduced SLR to 21.5 % from 22 %. As recommended by Dr. Urjit R. Patel Committee, CPI (Combined) inflation is adapted by RBI as the key measure of inflation.

During 2015-16, Indian economy continued to experience a moderate inflation. Headline CPI (Combined for rural and urban area) stood at 4.9 % which was lower than that of 5.9 % in 2014-15. The decline in CPI (Combined) inflation was mainly due to decrease in the prices of food articles and non-food non-fuel category. Headline WPI inflation remained negative since November, 2014 and was at -2.8 % in 2015-16. With the ease of inflation, RBI decreased the repo rate by 100 bps to 6.75 % in September, 2015 and kept it unchanged in February, 2016.

Monetary Policy Committee (MPC)

In the Union Budget for 2016-17, upon the agreement between government and RBI, the government proposed to amend the Reserve Bank of India (RBI) Act, 1934 for giving statutory backing to the Monetary Policy Framework Agreement and setting up a Monetary Policy

Committee (MPC). MPC has been constituted for maintaining price stability, inflation targeting while keeping in mind the growth objective. MPC has been entrusted with the task of fixing the benchmark policy rate (repo rate) required to curb inflation within the specified target level. It came into force on June 27, 2016 and it is mentioned under the amended Act that government of India after consulting the central bank (RBI) would decide the inflation target once in every five years and the amended Act further provides for a statutory basis for the constitution of an empowered Monetary Policy Committee (MPC). The inflation target has been fixed by the government at the rate of 4 per cent with tolerance level of +/- 2 per cent for the period beginning from August 5, 2016 to March 31, 2021.

The government notified the constitution of MPC on September 29, 2016. Meanwhile on September 5, 2016, Dr. Urjit R. Patel took over the charge as 24th RBI governor. RBI in its fourth bi-monthly monetary policy statement published in October 4, 2016 the MPC has reduced the policy repo rate from 6.5 % to 6.25 %. Bank rate stood at 6.75 %. The headline CPI (Combined) inflation has been reduced to 4.5 % during 2016-17. Earlier there was a huge gap between the WPI and CPI inflation in about 10 %ages during September, 2015 but now in May, 2017 there is no gap between the two as both stands at 2.2 %. CPI inflation has been below to 4 % since last eight months and reached at its lowest to 1.5 % in June, 2017.The MPC held three meetings during the year 2016-17. MPC in its latest meeting held at August 2, 2017 have cut the repo rate by 25 bps to 6 %. The reverse repo rate stands at 5.75 %.

Conclusion

Price stability, ensuring adequate flow of credit into the economy and simultaneously controlling the inflation keeping in mind the growth prospect of the economy are the main objective of monetary policy. RBI is the regulator of the monetary policy in India. RBI is the supervisor of the financial system of the country. Monetary policy has gone to the tremendous change since independence and has helped the economy to contain inflation. Earlier the main measures of monetary policy used by RBI were CRR and SLR but later on focused slowly shifted to other measures after the recommendation of Narsimham Committee. The RBI Act, 1939 has been amended; it has given RBI a statutory mandate where there was no such provision earlier. Recent development in the area of monetary policy also includes changing the indicator of inflation from WPI to CPI (Combined) and setting up Monetary Policy Committee (MPC) after the recommendation of Urjit Patel Committee during the year 2016. . Establishment of MPC is considered to be a revolutionary development in the area of monetary policy.

At present the inflation is fluctuating within the range of 1 to 4 % which is a good sign as the inflation is within the acceptable limit.

Now the major challenge before RBI is to maintain inflation within this range keeping in the mind the growth of the economy.

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