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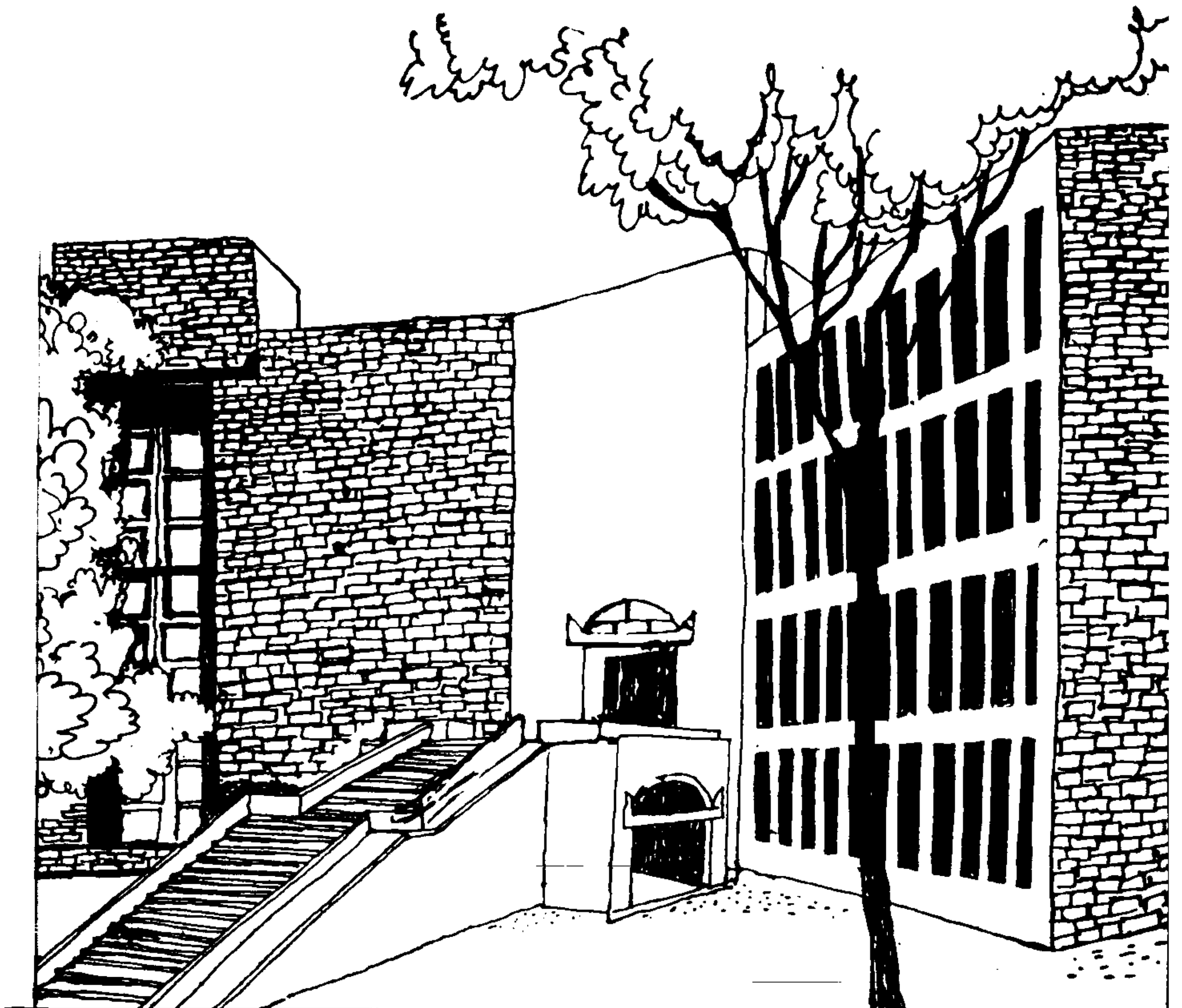

ROLE AND CONDUCT OF MONETARY POLICY

By

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<u>Role and Conduct of Monetary Policy*</u>

G.S. Gupta

1. It is a matter of great privilege to have this opportunity to address this distinguished gathering of policy economists on a subject of high significance in the present day India. I am grateful to Prof. Kothari and his colleagues for their generous invitation. Although Monetary theory and policy has been a subject of my interest but being placed in an Institute of Management, it has been a bit hard for me to keep up with the pace of ever increasing literature. It is in this background that I begin my talk and crave for your indulgence if you do find some shortcomings.

2. The subject I havechosen, the role and conduct of Monetary Policy, with particular reference to India, is vast, for it would include all that Monetary Policy could do and the methods of practising that. As James Tobin has said "We are in the easy profession of advising" but I trust our prescriptions are not impractical. What I propose to do is to provide you with, in brief, "the state of the art" on the theoretical development of the subject, which I would later use to infer my views on the efficacy of monetary policy in India and to venture concrete recommendations for the conduct of Indian Monetary Policy for your kind deliberations.

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3. Let us remember that economics is an inexact science, which deals with functional relationships among/between variables, which we try to quantity with the aid of historical data and tools of econometrics. In this connection, it will be useful to recall the Saving-Tinbergen fou: fold classification of variables into high level goals, proximate (intermediate) targets, indicators and policy instruments. The learned audience does not need elaboration and examples. The Monetary Policy like any other policy tool, affect high level goals through its effect on financial or intermediate variables.

4. There is unanimity among economists and policy makers across the globe with regard to the ultimate objectives, viz. economic growth (high and growing GNP), price stability, self-reliance and social justice (alleviation of unemployment, poverty and inequalities—both personal and regional). There is also probably some degree of consensus with regard to the consistency or otherwise among and between these goals, though we do have the famous Phillips' curve, Kuznets' curve and now the Laffer curve. Wrose still, we have serious differences among ourselves with regard to the priorities which we attach to various goals, when we find they are in conflict. But I guess we don't have to offer applogies, for ours is an inexact science and we do have severe constraints of poor raw-materials, i.e. data, which particularly in our country comes reluctantly with a long lag and serious doubts on their accuracy. I say all this, for if economics were an exact science like mathematics, and we had reliable data, we could have

produced, on the basis of the Tinbergen-Theil policy models, the deterministic alternative policy packages, and our bureaucrats and politicians could choose the one on their objective or/and subjective considerations, to exactly hit their targets.

5. The policy variables are conveniently classified into direct and indirect. We are here concerned with indirect instruments only, and my talk covers only on such instrument, i.e. monetary policy. The reason I have recalled this is that Monetary Policy cannot be framed without reference to the fiscal policy, for as my own Professor, Dr. Carl Christ, has pointed out, long back (1968) xxxx xxxxxxxxxx the two policies are interdependent through the government budget constraint and very often the RBI is obliged to purchase government bonds, which leads to increase in money supply when the govt. is unable to secure needed funds from alternative sources. For the sake of explicity, let us note that we consier the effectiveness of any policy with respect to its contribution towards high level goals, whch in surrogative terms is understood with reference to Nominal GNP, real GNP/employment or unemployment, and the price level.

6. To provide a brief review of the literature and policy actions, we could name something life seven schools, which, chronologically speaking, include by their most familiar names, the classicalists, Keynesians,

monetarism, Neo-classical-neo-Keynesians, New Classical Economics, supply-side economics, and the Reagonomics or Rajivo-Singh[illegible]ics, in our case. The first school which dominated our beliefs until mid-thirtees argues that monetary policy is very effective with regard to nominal income and the price level,but not with regard to real income and employment which were always at their full employment level. The Keynesians which raised their heads, beginning 1936 and dominated the scene for almost three decades until the mid-sixties, discovered some limitations of monetary policy, including the ones caused by liquidity trap, abd brought out the efficacy of fiscal policy through the ingenious tools of the IS-LM curves. Both these demand management policies were throught to be of significance and with regard not only to the nominal GNP and price level, but also with respect to real GNP and unemployment. The Pigou-Patinkin-Haberler Real Balance effect was discovered to rescue the effectiveness of Monetary Policy in the presence of liquidity-trap and the Phillips curve became the subject of serious talks. Under the Phillips curve hypothesis, all that the policy makers are required to do, is to opt for any combination of inflation and unemployment rates deem fit by them. The two nobel laurates, James Tobin and Franco Modigliani, are still behind this Keynesian or non-monetarists school.

The strong monetarists, Milton Friedman, challenged the Phillips curve hypothesis, by distinguishing between the two types of this curve, which are now known as the short-run and long-run Phillips curve. The former is based on the constant expectations model while the latter is the Inflation Expectations Augmented Phillips curve. According to this approach, the output (real GNP) depends not on the inflation rate, as in the Phillips curve, but on the difference between the actual and expected inflation rates. Through this device, the Monetarists advanced two hypotheses: the Neutrality or the Natural Rate Hypothesis and Non-neutraility hypothesis. Under the former, the demand management (monetary and fiscal) policies are ineffective with respect to real income (employment) (though they are effective with respect to nominal income and the price level) in the long-run; and under the latter hypothesis, such policies are effective even with respect to real income in the short-run. These economists which include, besides their chief proponent Milton Friedman, Karl Brunner, Phillip Cagan, Allan Meltzer, Thomas Mayor, David Laidler, among others, argue that since there is lag, which is long and variable, the monetary policy must be conducted through Rule rather than Discretion to ensure its maximum effectiveness. To the credit of this school of thought, there is a near consensus that inflation is a monetary phenomemon and to quote one of the strong Fiscalists, Franco Modigliani, "we are all monetarists now...... in the sense that all (or most) macroeconomists believe in the importance of money" (American Economic Review, March 1977).

8. The Hicksian IS-LM paradigm provided good scope for the demonstaration of the views of both monetarists and Non-monetarists economists, and this, in turn, is also useful to analyse the views of neo-classicalists and neo-Keynesians (the so called New Economics) which provide a synthesis of the two schools. Time does not permit me to go into details of this minor matter.

9. The Keynesian revolution, which survived the attack of early Monetarists, has been followed by still stronger Monetarists, known as the Rational Expectations (RE) revolution, also known as the Newclassical Economics (NCE). Introduced by J.F. Muth in 1963, and popularised later by Robert Lucas, Thomas Sargent, Neil Walice and Robert Barro, this school has revived the classicalists Neutrality Hypothesis in a slightly different context. According to them, while the non-systematic or non-expected (surprised) changes in demand management policies do exert influence on real magnitudes, the systematic changes in them are insignificant with regard to real income and real interest rate even in the short-run. Such a strong conclusion is, ofcourse, based on their two assumptions, one of which is hard to challenge but the other is equally hard to believe. The first one is that people form their expectations rationally, meaning that they are optimal in their use of information and its cost and that they don't make systematic errors. The other is with regard to the market clearing, that there is no involuntary unemployment and even all other markets are totally clear.

10. The critics of the RE school, which include Stainley Fischer, Robert Gorden, E.S. Phelps, J.B. Taylor, A.A. Blinder, and O.J. Blanchard, have refuted, on the basis of their empirical work, the neutrality hypothesis, even for the short-run. Their main basis for arguments include three factors (a) that there is less than perfect information and that information is quite costly, (b) that markets are not clear and that (c) people substitute leisure inter-temporarily, which means that even anticipated changes in money supply affect real interest rate, through their effects on expected inflation rate, which in turn, affect output, among other things (Lucas Supply Function).

11. The ingenious incomplete information model that could comprate both the neutrality as well as the non-neutrality hypotheses is sound and preferable to any other model, but alas, the academicians and policy makers have yet to come out with one such model.

12. The sup ly-side economics which came into limelight only in 1980s was inspired by the disease of stagflation which plagued many countries during 1970s. This is an important side, for it attacks on supply bottlenecks through enhanced savings and productivity, and it alone could safeguard us from the twin evils of stagnation and inflation. Tax cuts, encouragements to saving and investment, etc. are the components of such a policy.

13. The Reaganomics, or Rajivo-Singho-nomics in our case, is basically the practice of the prescriptions of the supply-siders, without ignoring demand considerations. These policies are of recent origin and have produced mixed results. Time alone would establish the credibility or otherwise of this hybrid policy action.

14. Coming to my own views, I do believe that money matters, and it matters not only in the long-run and with respect to the price level only as suggested by Prof. Modi, but also in the short-run and with regard to most high level goals, including real GNP and the inflation rate. I do not need to prove this through recourse to data, but simply by underscoring some of the salient features of our economy vis-a-vis the theoretical debate I have just presented to you. We have an econom where

a. the information set is late and yet incomplete

b. markets are rarely clear and there are wage-price rigidities- including the administered prices, which have a 15.8% weight in the wholesale price index;

c. People do substitute leisure inter-temporarily

d. decision-making is slow and undependable with respect to time it takes

e. there exists considerable immobility of labour and market imperfections

f. the capital market is still developing

g. the government is unstable and subject to less monitoring and criticisms than the Western world, and

h. the Central Bank (RBI) has big arms, which include the Bank rate, open market operations, cash reserve requirements, statutory liquidity ratio, moral suasion, selective credit

controls, interest rate structure, refinance schemes, foreign exchange rate determination, etc.

In fact, in last few years, RBI has restricted the rate of growth in M1/M3 and we have witnessed a low inflation rate.

15. Notwithstanding the above, we are unable to quantity the exact effect of monetary policy and the time lag which it takes to exert the influence, for

a. our economy's structure is far more unknown and unstable than those of the developed countries,

b. the theoretical debate has not indicated clearly as to which values of, which parameters, in which behavioural equations, imply which policy conclusions

c. there is long and variable lag

d. there is political cost to certain decisions, which may otherwise be desirable, and

e. very often the decision-makers have pseudo objectives, such as tax cuts/income tax raids/rural developments/weaker section programmes for their own sake, to influence the voters.

16. To conclude the role part, the monetary policy has a significant role to play in our economy, which ofcourse, is constrained by the deficit financing decisions of the government. What we need to do is to insulate the Monetary Policy from this menace to the extent it is possible. We have discucssed this point enough in other sessions so I do not take time to repeat my position.

17. At this point, I should like to respond to Prof. Sandesara's general question to all the experts, viz. what would explain the improvement in our growth rate in the last one decade over the earlier decades? The main answer I would like to offer is that the monetary policy is but one indirect policy tool and it would thus be too much for it alone to provide the needed explanation. However, should the delegates desire and time permit, we can discuss this question through recourse to all policy tools and the economic-political-climatic conditions in the country.

18. Coming to the conduct part of our monetary policy, I fully endorse some important recommendations of the Chakravarty Committee, which follows:

18.1 Resort to monetary targetting, where RBI announces it target for M_3, for, say, next 5 years and make all efforts to adhere to it just as in the case of our five year plans. The target should be in terms of a range rather than a number. I have examined the rationale and effectiveness of such a target in considerable detail in my work elsewhere, and I don't propose to report that here. Suffice it to point out here that our empirical work has demonstrated that M_3 (broad money concept) meets the tests of controllability, separability, closeness with the high level goals and its stability, and the exogenity reasonably well. Should the learned audience wish, I would be delighted to go into this detail. Furthermore, I should like to stress that targetting is neither policy by Rule nor by Discretion but perhaps somewhere in between the two.

As regards the method of fixing the target, I suggest we depend on three approaches, viz. (a) consistency with high level goals [could be seen through St. Louis (Jordan-Anderson) type of model] (b) consistency with genuine credit needs of the priority sector, (c) consistency with money demand function, that is the one which depends on the growth rates in money demand determinants and the various money demand elasticities. I do not mean that these three approaches would generate the same number for the target, but some compromise among them could be achieved in the presence of differences.

18.2 Use all (or most) monetar tools simultaneously. This is necessary, for ours is a vast economy and there is a considerable degree of the unorganized sector and the parallel economy component in our economy.

18.3 Make sure that the real interest rates on bank deposits and government bonds is positive and the size of it is commensurate with the maturity of financial assets. In particular, the real interest rate on fixed deposits of less than one year duration and on short-term treasury bills should be marginally positive, on deposits of five years or more should be around 2% and that on long-term government bonds must be about 3%. To ensure this, the RBI would need reasonably accurate forecasts for the inflation rate, which it should systematically make. Incidentally, I do not believe that these recommended rates are too

high or that they would require an increase in the current nominal interest rates in the economy. In fact, the inflation rate is already within one digit number now for several years in a row and do not see any difficulty in atleast maintaining it within that limit. Nevertheless, I do support Prof. V.M. Dandekar and refute Prof. RJ Modi (EPW debate) in that if the interest rate is raised still further, the debt servicing would pose serious threat to our economy, for while a lot of government assets are non-income (interest) earners, all liabilities (barring currency) are interest-bearing.

18.4 Curb concessional finance to the priority sector, public sector undertakings and to the sectors where there is no excess demand. We believe that because ours is an economy of multi-class and we have been having special programmes and concessions for weaker sections (regions) of the community (India), our policy makers are constrained to continue these. We feel that the country cannot afford to have them indefinitely and particularly to the same or increasing extent over tim Further, the public sector undertakings must prove their efficiency and profitability if they have to survive.

19. Unlike some of you, I feel that quite a few of the recommendations of the Chakravarty Committee, which include the ones I have just mentioned, have already been implemented. This I say on the basis of my understanding of the economic environment of our economy, xxx though I have no experience of working with the government which some of you do.

20. Due to the constraint on time, I have been rather brief in my talk. However, I would be delighted to elaborate any of my observations and recommendations, should you so desire.

21. I thank you for providing me with a patient hearing.

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