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Monetary Policy in India – The Current Conjuncture

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The Reserve Bank of India (RBI) released its Annual Monetary Policy Statement for 2007-08 on April 24, 2007 in which it clearly laid out its dominant objectives – to manage the surging capital inflows and contain inflation. On both counts there is a confrontation between the RBI and the Ministry of Finance and monetary policy is compromised as a result.

By February this year inflation as measured by wholesale prices had touched 7.3 per cent. It came down in subsequent weeks but was well above the RBI's threshold inflation rate of 5 to 5.5 per cent. The RBI accordingly tightened liquidity by increasing the repo rate to 7.75 per cent and the cash reserve ratio to 6.5 per cent. These were left unchanged in the Annual Policy of April when the RBI took the view that inflation cannot be managed merely by monetary measures. To quote from the Annual Policy – "Managing the supply situation is emerging as a formidable challenge, especially as constraints on the supply response to the momentum of growth have become more binding than before". More than 50 per cent of inflation is due to a rise in the price of manufactures as a result of capacity constraints in basic and intermediate goods. These constraints cannot be relaxed by monetary policy alone.

The Finance Minister on the other hand has been of the view that India's strong growth of over 9 per cent is sustainable and that this can be maintained the next few years without unduly affecting inflation. This opinion is mainly based on the increase in investment that has risen from 23% of GDP in 2001 to 29.5% in 2006-07. This does not recognize that investment does not automatically increase speed limits for the economy as with capacity constraints operating investment activity adds to demand driven inflationary pressure in the short run and the disinflationary benefits of additional capacity comes only in the longer term after inflationary pressure has taken its toll. The Finance Ministry is unwilling to recognize that the economy is overheating – in fact much more so than China with a higher inflation rate, twice as faster growth in bank lending and swifter rises in share prices.

The constraints on the economy as the RBI implicitly recognizes is in terms of infrastructure inclusive of power generation – electricity capacity increases in the past few years have been just over half of targeted levels – and skill shortages. Before inflation gets out of control and there is a hard landing for the economy it is better to control inflation and thereby sustain

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growth. With inflation high, real interest rates are low compared to the current rapid economic growth. The RBI may need to continue tightening monetary policy as a result and keep in mind the longer lead times required to keep inflationary pressure in check as inflation is not purely a monetary phenomenon.

The other leg of policy – managing capital inflows – is also the subject of controversy between the central bank and the Ministry of Finance. Despite the surging domestic demand the current account deficit at 1.2% of GDP has not deteriorated significantly due to high receipts from software exports and remittances from Indians working overseas. Meanwhile capital inflows have surged to 5.1% of GDP in 2006-07. This has put tremendous pressure on the rupee to appreciate which the RBI had traditionally been resisting via absorbing the inflows through reserve accumulation. However, from March onwards the RBI has reversed its stance and allowed the rupee to appreciate which has dampened import prices and has added to the initial tightening measures of raising the repo rate and banks' cash reserve ratios in furthering the credibility of its anti-inflationary stance.

The high capital inflows in the recent past have not been due to the traditional FDI or portfolio investment but due to a policy emanating from the Ministry of Finance which is being sought to be offset by the RBI. The Ministry has in the past two years raised the ceiling on external commercial borrowings (ECBs) to US $ 22 billion. Today ECB and NRI deposits constitute 44% of capital account surpluses – up from 12% in 2002-03. The Ministry increased the limit when the economy was already subject to demand driven inflationary pressure and as a result encouraged borrowing (often unhedged) by Indian companies from flush international capital markets. As a result to sterilize increased intervention in foreign exchange markets the RBI was forced to raise the banks' required cash reserve ratio. Finance Ministry policy induced capital inflows which added to inflationary pressure were therefore neutralized by the central bank increasing monetary tightening and raising interest rates which in turn made it more attractive to borrow abroad and this exacerbated the underlying problem.

Balance of Payments (US $ billion) for Fiscal Years

	2002-03	**2003-04**	**2004-05**	**2005-06**	**2006-07**
Current Account Balance	6.3 (1.2)	14.1 (2.3)	-2.5 (-0.4)	-9.2 (-1.1)	-10.5 (-1.2)
Capital Account Balance	10.8	16.7	28.0	23.4	46.5
Of which					
FDI	3.2	2.4	3.7	4.7	10.0
Portfolio	0.9	11.4	9.3	12.5	8.0
Loans	-3.9	-4.4	10.9	4.5 ♠	20.0
Overall Balance	17.0	31.4	26.2	15.1	36.0

♠ : 2005-06 affected by redemption of US $ 5 billion India Millennium Deposits
N.B.: Figures in brackets are percentages to GDP.

The RBI has also recently made deposits by non-resident Indians (NRIs) less attractive in its recent policy statement by cutting the interest rates on these deposits by NRIs – a welcome move as in today's surplus forex economy there is little reason to give preferential returns to

NRIs. However, the government needs to cut the ceiling on ECBs so as to check monetary expansion. Monetary expansion can be checked by cutting policy induced inflows – not encouraging outflows as the government seems to think. The government for instance has recently announced that individuals can take funds out of the country up to US $ 100,000. However, there is little incentive to do so when local assets are generating high returns and the currency is appreciating.

On balance considering the current direction of monetary policy it is reasonable to expect that the rupee will appreciate in the near term of the next six months as appreciation of the currency is used as an anti-inflation device. However, as the infrastructure improves and productivity grows there will emerge larger current account deficits and as a result the economy's capacity to digest capital inflows will improve. The medium term forecast of the exchange rate is therefore towards a depreciation of the rupee from about the INR 40 to 41 level per US $ today to about INR 43 to 44 in another couple of years. Also, the current growth rate of the economy is not sustainable without generating high inflation and this requires that the economy will have to be managed at a more moderate and sustainable growth rate of 7.5 to 8 per cent.

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