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India's Annual Policy Statement for FY2008-09: Achieving a 'Neither Tight, Nor Liberal' Monetary Policy

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The Reserve Bank of India (RBI) announced its Annual Policy Statement for FY2008-09 on 29 April 2008. Given the high headline inflation in India, many had felt that the RBI would tighten monetary policy by increasing interest rates. It was, therefore, surprising to note that all the key policy rates (that is, bank rate, repo rate and reverse repo rate) were kept unchanged. Only the cash reserve ratio (CRR) has been increased for arresting growth in liquidity.

It must have been difficult for the RBI to work out an appropriate monetary policy, given the complexities in the current macroeconomic environment. Price management, undoubtedly, is one of the biggest policy challenges facing the RBI now. With headline inflation based on the point-to-point wholesale price index at more than seven percent, maintaining price stability is of utmost importance. With elections to the Indian parliament drawing closer, much of the overall policy focus in the coming months will be on reducing prices. It was, therefore, imperative for the RBI to accord 'high' priority to price stability.

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It is not only the RBI that is worried about maintaining prices. Price stability has emerged as the top priority for central banks in practically all major emerging market economies (EMEs). High food and energy prices produced by wide demand-supply imbalances have led to sharp increase in headline inflations in EMEs. Central banks in these economies are implementing a variety of measures to contain inflation. Some, such as the People's Bank of China and the Banco Central do Brasil, have tightened monetary policies by increasing interest rates. Other central banks, such as those in Mexico, Malaysia, and Thailand, however, have kept interest rates and the broader stance of their monetary policies unchanged. The specific monetary policies being adopted by different EMEs central banks across the world are being determined by several factors. These include the levels of capital inflows, liquidity positions, conditions of domestic financial markets, exchange rate movements, overall macroeconomic fundamentals and the current state of domestic prices.

In preparing its latest policy, the RBI has had to accommodate conflicting concerns and major trade-offs. On one hand, it had to ensure that the monetary policy is strongly anti-inflationary. Anti-inflationary monetary policies are usually tight having relatively high interest rates. However, increasing interest rates at this juncture could have created other problems. The RBI has already come in for sharp criticism for increasing interest rates during 2007-08, which, many felt were not only unnecessary, but were also responsible for adversely affecting growth in industrial output.

With industrial growth during April-February 2007-08 coming down to 8.7 percent, compared with 11.2 percent in the corresponding period of 2006-07, concerns over moderation in industrial growth couldn't have been overlooked. Such concerns look graver if one takes into account the current performance of infrastructure industries. The six core infrastructure industries (electricity, coal, steel, cement, crude oil and finished petroleum products) show an overall growth of only 5.6 percent in April-February 2007-08. This is more than three percentage points lower than the growth of 8.7 percent recorded by infrastructure industries in April-February 2006-07.

The challenge before the RBI was to prepare a monetary policy that would ensure price stability without affecting industrial and overall growth. It also had to take note of the emerging concerns over a possible slowdown in industrial investment. This is reflected in the lower growth of non-food credit disbursed by scheduled commercial banks during 2007-08. Till the end of March 2008, non-food credit, which is essentially meant for industrial and commercial purposes, grew at a lower rate of 22.3 percent, compared with 28.5 percent in the previous year. Critics of the RBI's policies are quick to point out that lower credit flow to industry is a natural outcome of higher interest rates. Any further increase in interest rates might have worsened the industrial investment outlook for the coming months.

In developing the latest policy, the RBI has clearly refrained from adopting any measure that might adversely affect industrial performance and sentiments. However, by increasing the CRR, it has indicated its concern over the liquidity levels in the economy. The reserve money growth in the economy at around 30.9 percent is probably much higher than what the RBI would like it to be. Such growth has taken place despite an increase earlier round of increase in the CRR. Much of the growth in reserve money is being contributed by net foreign exchange assets. As on 18 April 2008, India's foreign exchange reserves were US$313.5 billion, showing the continuing high rate of accumulation of foreign assets. Indeed, such accumulation during 2007-08 was around US$110.5 billion.

It is evident that despite the occasional setbacks suffered by the stock market in recent months, capital flows continue to come in. Such flows, if left 'unsterilised', affect the exchange rate. This is again another critical issue that the RBI could have hardly overlooked. A stronger rupee will erode export margins, particularly for textile and information technology exporters. After faltering during the first half of 2007-08, merchandise exports have recovered in the later months to record an overall growth of 22.8 percent during April-February 2007-08. This is, however, still lower than the growth rate of 23.2 percent achieved during the corresponding period of 2006-07.

Thus, the RBI cannot afford to leave the capital inflows unsterilised. It would intervene in the market for picking up the foreign currency denominated inflows and releasing an equivalent amount of domestic currency in the process. Unless it does so, the exchange rate might move against the interests of exporters. However, 'sterilisation' increases the money supply in the economy. In an economy, where despite high prices, the propensity to consume is yet to show signs of reducing, thanks mostly to higher middle-class disposable incomes, higher money supply can push up prices with a time lag. Inflationary concerns, therefore, call for reducing money supply and liquid balances at the disposal of the general public. In addition to usual open market operations involving buying and selling of government securities for mopping up liquidity, the RBI has also decided to force commercial banks to hold on to larger cash balances by upping the CRR.

The main objective that the RBI aims to achieve through the current policy is to bring down headline inflation from its current level of 7.14 percent to around 5.5 percent and closer to five percent. It takes note of the monetary overhang in the system and emphasises the reduction of monetary expansion. At the same time, it is wary of the signals emanating from the industry and would like to maintain growth of non-food credit to at least around 20 percent during the year. It must be noted that these objectives are conceived in the backdrop of a somewhat lower gross domestic product (GDP) growth during 2008-09. While the advance estimates for 2007-08 prepared by the Central Statistical Organisation show a real GDP growth of 8.7 percent for the year, the projections for 2008-09 are range bound marginally lower between 8-8.5 percent.

Only time will tell whether the RBI will be able to achieve its objectives or not. However, like almost all other EMEs central banks, it is evident that the RBI is also caught in a policy dilemma. The dilemma is a result of its trying to manage several conflicting policy goals. Maintaining price stability is definitely its foremost objective. However, it cannot afford to engage in too much monetary tightening for curbing prices as that will have adverse impacts elsewhere in the economy. Industrial production in the short term and investment growth in the long term are likely to suffer from tight monetary policies and high interest rates. On the other hand, it cannot afford to liberalise the monetary policy too much. That will increase money supply and add to inflationary pressures. Thus, it needs to discover a ‘neither tight, nor liberal’ monetary policy. That is not an easy task. And to further compound its woes, it has to contend with jerky levels of capital flows, exchange rate fluctuations and problems of sterilisation. The latest policy has tried to address all these concerns with minimum fuss. It is time to wait for the results.

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