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EVOLUTION OF MONETARY POLICY FRAMEWORK IN INDIA SINCE INDEPENDENCE

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ABSTRACT
The monetary policy framework plays a major role in shaping the economic sphere of a country. The economic journey of India is self-evident due to the dynamic nature of monetary policy formulation and its implementation in response to the evolving economic conditions, internal and external to India. This paper gives a very comprehensive examination of the monetary policy framework evolution of India since the establishment of the RBI (Reserve Bank of India). Furthermore, the paper explores the pre-reform and post-reform characteristics of the monetary policy framework through pre-independence (1935 to 1947), after-independence & pre-reform periods (1947 to 1990) and post-reform period (1991 onwards). The paper also examines the various monetary policy frameworks including planned economic development, multiple indicator approach, flexible inflation targeting, and monetary targeting. In conclusion, the paper highlights the challenges that have been faced by the Indian economy and suggests enhancing the monetary policy's effectiveness and credibility in the era of dynamic domestic and global realities.

Keywords: Monetary Policy, Monetary Transmission Mechanism, Money Supply, Inflation etc

1. INTRODUCTION
Since the evolution of macroeconomics after Keynes, monetary policy becomes popular decade after decade in the macro management of an economy across the world. This fact is evident from the significance that has been achieved by monetary policy across the world whether it is developed nations or developing nations, in managing the business cycles or short-run fluctuations. The monetary policy came in to existence with the establishment of central banking systems in the world, for instance, Risks Bank (1668), Bank of England (1694), Bank of Japan (1882), Swiss National Bank (1906), Federal Reserve Bank (1913), RBI (1935) etc., However, it is important to observe that the establishment of central banks in different countries was not only for the operation of monetary policy but these were established for many reasons, for example:

1) To provide the financial support to the government,

2) To maintain harmony among the issue of currency,
3) To maintain reserves, and
4) To improve the payment system (Goodhart, C. 1988). And India is no exception to this.

It is highly essential to understand the monetary policy framework evolution of India, for determining the nature of monetary management in India.

There are four sections to the paper. The 2nd section presents the systematic analysis of the Indian monetary policy framework for the pre-reform period (1935 to 1990) for examining the monetary policy framework. The pre-reform period is further divided into the sub-periods like pre-independence period (1935 - 1947) and after independence and the pre-reform period (1947 – 1990) in accordance with the changing economic scenarios. Further, it is important to highlight here time period of monetary targeting spans from 1986 to 1998 which overlaps with both the pre-reform period and the post-reform period. Therefore, this period was further subdivided into monetary targeting (1986 – 1991) and monetary targeting (1991 – 1998) to provide a clear demarcation between the pre-reform period and the post-reform period.

The third Section describes the monetary policy framework in the post-reform period starting from the monetary targeting (1991 – 1998), the multiple indicator approach (1998 – 2016), and the flexible inflation targeting (2016 onwards).

The fourth Section provides a conclusion that highlights the challenges that have been faced by the Indian economy and it suggests enhancing the monetary policy effectiveness and credibility in the era of dynamic domestic and global realities.

2. PRE – REFORM PERIOD COVERING FROM 1935 TO 1990

India gained its independence on 15th August 1947, but the significance of monetary policy among the instruments of macroeconomic policy has been felt with the inception of RBI in the year 1935. Therefore, for the sake of better understanding and analysis of the monetary policy evolution in India, it is relevant to further divide the pre–reform period into two sub–categories i.e., pre–independence (1935 to 1947) and after independence & pre–reform period (1947 to 1990).

2.1. PRE – INDEPENDENCE AND AT THE EVE OF INDEPENDENCE (1935 TO 1947)

This period posed various challenges as well as numerous opportunities for the world in general and for India in particular since the World War – II, Great Depression, the Partition of India, and our independence that took place during the above period. Now one would like to know the process of monetary policy formulation and operation during this period, what were the primary tools which were used and what was primary targets which it needs to achieve?

According to the RBI Act, 1934 (before amendment through the Finance Act, 2022) the spirit of the establishment of RBI was expressed in its preamble as follows:

“Whereas it is expedient to constitute a Reserve Bank for India to regulate the issue of Bank notes and the 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 advantages”

In the early years of the RBI's establishment, there was no formal provision for monetary policy formulation. However, the prime function for which the RBI was established was confined to the issue of currency along with acting as the banker of the government. Hence, during this period the RBI was supposed to maintain credit availability in the economy (Ray, P., 2013). The main instruments used were the Bank rate, Open Market Operations, and the Cash Reserve Ratio. The RBI functioning during this period mainly reflects the nature of colonial economic policies of British-ruled India. For instance, this period witnessed the outbreak of World War – II leads to the expenditure on war was financed by the RBI through currency issues which led to high monetary expansion and high inflation (and a slow or negative growth rate of GDP. During the years 1941 to 1943, the money supply increased from 32.6 percent to 68.0 percent, the wholesale price index inflation rises from 22.6 percent to 51.0 percent and the GDP growth rate decreased from 3.3 percent to -0.5 percent.

During the period from 01st April 1935 till India got Independence i.e., 15th August 1947, the RBI's working jurisdiction included both India and Pakistan. But after the partition of India and the independence of India, the working territory of the RBI was changed and it started to act as the Indian central bank. The RBI was nationalized in 1949 (Ray, P. 2013). During this period the functioning of the RBI and the monetary policy actions were influenced by the major economic and political events which took place, for example, the partition of India and the freedom of India from British rule. On account of the division of resources between India and Pakistan, low agricultural and low industrial production, the RBI was supposed to undertake the monetary expansion through open market operations which led to high inflation during this period. Therefore, in this period the monetary policy was basically a balance of payment driven because of the colonial nature of the economy and accordingly, the main objective was to stabilize the exchange rate the other primary objectives like Inflation control and stabilization of output seemed to be ignored.

2.2. INITIAL PERIOD OF PLANNED ECONOMY (1951 TO 1968)

After India gained independence in 1947 and the nationalization of the RBI in 1949, the next main event which influenced the monetary management in the country took place in the year 1950 as Planning Commission was established. The planning commission was established with the objective of evaluating the country's resources (natural, financial as well as human) and formulating a plan for the most efficient and equitable use of these resources. Thereafter the 5-year plans formulated by the planning commission determined the further path of development which was aspired by the then leaders and policy makers. The first five-year plan was launched in the year 1951. The conduct of the central banking and the monetary policy of the country was influenced by central planning. It was emphasized that the country's central bank was required to formulate and establish the institutional framework for enabling the economic development in the country. India being an underdeveloped country aspiring to be a developed nation, naturally had an expansionist monetary policy, which was required to provide resources for the financial needs of development. The primary tools that were used during this period, were the Bank rate, Cash Reserve Ratio, Ad – hoc treasury bills, and selective controls like marginal reserve requirement. This period was full of major developments and disturbances in India and the world like (i) the Korean War in 1950, which caused the inflationary tendency around the world, (ii) India's war with China in 1962 and with Pakistan in 1965 led to raising the proportion of expenditure on defense, (iii) The devaluation of India rupee took place since the foreign aid was stopped during the war time. On account of the above developments, the RBI had to undertake the monetary expansion by providing credit to the government through ad-hoc treasury bills, bank rates, and marginal reserve requirements.

The monetary policy effectiveness depends upon the banking habits of the country. As far as India is concerned, during this period, the proportion of currency deposits was high i.e., above 55 percent as a percentage of M3 relative to demand deposits which were around 40 percent of M3 which indicates that the people preferred to undertake transactions through cash and consequently the transactions through banks were less preferred. Hence, the main cause of less effective monetary policy at the time of this period was the existence of a high proportion of currency in relation to demand deposits as a component of broad money (M3) (RBI, 2006).

According to Milton Friedman, who visited India in the year 1955, the monetary authorities in India should have focused relatively more on the money supply rather than on the other parameters (Partha Ray, 2013). During this period the monetary policy was attributed to be in subordination to economic planning and the deficit financing through ad-hoc treasury bills was the main basis for the monetary expansion.

During this period, the RBI changed its view towards the monetary policy to be more in accordance with its obligations that had been assigned to it as a banking institution and enhancement in the economy's financial sector. This brought the most essential variation in the monetary policy conduct.

2.3. PERIOD AFTER THE NATIONALIZATION OF THE COMMERCIAL BANKS (1969 TO 1985)

The functioning of any institution is greatly influenced by the nature of its ownership because the objectives of the individuals or groups which own the institution try to conduct the affairs of the institution in compliance with its objectives. The free and fair functioning of the institutions which have concerns and essential role in the public policy formulation, is pre-requisite for the successful implementation of the policy. The commercial banks play a key role not only as an institution that provides finances to the public but it has a broader role as the catalytic institution in the procedure of development of an economy. After independence, the banking sector of India had various limitations and drawbacks. The commercial banks were owned by individual industrial groups. This caused the bad performance of the commercial banks as instead of serving the interest of their customers, they were more concerned about serving the interest of industrial groups which owned them. This period also witnessed the failures of quite a large number of the commercial banks. i.e., the number of commercial banks fell from 566 in 1951 to 90 in 1968. There has been a sharp decrease in the number of banks (Commercial banks) since the inception of central planning in India (RBI, 2006). These are the developments which paved the way for the nationalization of commercial banks. After in-depth analysis, discussion with the major stakeholders, and detailed deliberations, the Indian government nationalized the fourteen private sector banks in July 1969.

Now one may ask how the nationalization of the banks affected the environment for the conduct of monetary policy during this period? The nationalization of the banks in India led to the increased control of monetary resources in the hands of the government (Manavendra, 1969). The RBI was supposed to fulfill the credit requirement of the business houses, individuals, and the GOI as per the development planning. The RBI was supposed to work as the credit planner of the economy and the monetary policy was just like an act of credit planning during this period (Kharkhate, 1990). The credit planning requirement of the RBI were mainly determined by the fund requirements of the government i.e., deficit financing. The monetary policy main instruments used during this period were “bank rate, statutory liquidity ratio, and cash reserve ratio. The period after the nationalization of the commercial banks” witnessed a sudden rise in the money supply due to the strategic development plans of the country.

There were many external adverse effects felt by the Indian economy like the oil shocks of 1973 – 75 and later during 1979 – 81, this led to the deterioration of the balance of payments situation of the county and India had to borrow from the International Monetary Fund for absorbing the above mentioned two oil shocks basically the second one. As India experienced these two external shocks and also the balance of payment crisis, the monetary policy was contractionary mainly based on the subsequent rise in the cash reserve ratio (Joshi, and Little, 1994). Despite the fact that India had borrowed from the International Monetary Fund the inflationary situation was dominant due to funding of the fiscal deficit through 91–day treasury bills. To bring the economy out of this crisis and ensure the independence of monetary policy from the fiscal policy, Dr. Manmohan Singh the then governor of RBI appointed a committee in 1982 under the chairmanship of Dr. Sukhamoy Chakravarty to examine and review the monetary system in India.

2.4. MONETARY TARGETING (1986 – 1998)

Now one may want to know the process of the monetary policy formulation during this period? The monetary targeting period is the period that contains the transition period of the Indian economy from the pre-reform period to and post-reform period. However, the Monetary Targeting approach period spans from 1986 to 1998 but for the sake of simplification and analyses of the monetary policy framework during the pre-reform and post-reform period, this period was further divided into 2 sub-periods (i) monetary targeting (1986 – 1990) and monetary targeting (1991 – 1998) i.e., post-reform period

2.4.1. MONETARY TARGETING (1986 – 1990)

The oil shocks of 1973 – 75 and 1979 – 81 had its far-reaching implications not only on Indian economy but on the entire world at large. On the global platform the main adverse implication of same can be observed in breakdown of Bretton Woods System which led to the change in monetary policy approach at the global level. In the backdrop of the crisis which was felt in the economy in context of lower growth and higher inflation during the 1970s. During the first half of the 1970s, the inflation rate was double-digit i.e., to the tune of 20 percent, and in mid – the 1980s. It was around 10 percent which started declining gradually. The Chakravarty committee appointed by Dr. Manmohan Singh the then governor of RBI submitted its report in April 1985 (Chakravarty, S., 1986).

However, the committee had made various recommendations related to the monetary policy and financial sector in accordance with the terms of reference of the committee. The committee recommended adopting the ‘monetary targeting with feedback’ as “the monetary policy structure to be adopted in India. The monetary targeting rule recommendation is the monetary policy framework on the basis of the assumption of the stable money demand function along with the predictable money supply” function (Adil, H. M. & Rajadhyaksha, 2020). This is the period that fits into the formal framework of the monetary policy approach for the first time in India. During this period the monetary policy instruments which have been utilized, include the open market operations, cash reserve ratio, reserve money (M0 as operating target), and broad money (M3 as intermediate target).

3. POST–REFORM PERIOD (1991 ONWARDS)

3.1. MONETARY TARGETING (1991 – 1998) I.E., POST-REFORM PERIOD

The economic condition of India witnessed a deterioration and further worsening in terms of rising inflation, greater current account deficit, greater fiscal deficit, and political uncertainty during the late 1980s through 1990. In this crisis scenario the then Government of India led by P.V. Narasimha Rao as Prime Minister and Dr. Manmohan Singh as Finance Minister in July 1991, introduced New Economic Policy 1991 popularly known as LPG policy i.e., Liberalization, Privatization, and Globalization policy for undertaking stabilization and structural adjustment in the Indian economy.

Following the New Economic Policy 1991 various financial and fiscal sector reforms were undertaken based on the committee recommendations on the Banking sector reforms constituted in August 1991 under the chairmanship of Maidavolu Narasimham popularly called the Narasimham Committee-I. However, the committee made various financial and banking sector reforms but the following were the main recommendations that shaped the monetary policy framework during this period:

1) The Statutory Liquidity Ratio reduction from 38.5%- 25% by 1996.
2) The gradual reduction in the Cash Reserve Ratio from 15% to 3 to 5 percent.
3) The removal of regulation on lending and the deposit rates.
4) The ways and means advances (WMA) system introduction as a result of the elimination of ad-hoc treasury bills according to the agreement between RBI and the GOI.

The implementation of the above recommendations and the reforms, the monetary policy got greater autonomy.

3.2. MULTIPLE INDICATOR APPROACH (1998 TO 2016)

The monetary targeting approach of the monetary policy framework had a very disappointing performance. During the span of thirteen years i.e., 1985 to 1998 only four episodes of success were noticed. The monetary targeting approach achieved its targets in the years 1985-86, 1987-88, 1990-91, and 1995-96. The main reason behind archiving the targets was the new economic reforms implementation introduced in 1991 which brought the new issues along with the conventional issues that a monetary policy has to settle (Mohanty, D. & Mitra, K.A., 1999). Therefore, in light of the above environment, the monetary policy framework reformulation was required. Therefore, the RBI adopted a new method to the monetary policy called the 'multiple indicator approach' in April 1998.

The multiple indicator approach adopted different data sets for variables to be considered including inflation rate, exchange rate, interest rate, money, output, credit, capital flows, trade, and fiscal indicators. During this period various indirect instruments were used and introduced to perform the monetary policy like LAF (Liquidity Adjustment Facility) operating through repo as well as reverse repo and OMO (open market operations) on the recommendation of Narasimham Committee II in the year 1998. The cause of the same was the growing imbalance in the money demand function with the advent of new financial products as a outcome of financial liberalization and the interest rate gained popularity as a better transmitter of the monetary policy. The initiation of the Fiscal Responsibility and Budget Management Act 2003 had put constraints on the government for the direct borrowing from the RBI apart from the borrowing through ways and mean advances (Mohanty, D. 2010).

The multiple indicator technique worked satisfactorily from 1998-2008 as rate of the economic growth improved and inflation was moderated. However, after the global financial crisis of 2008, this approach performance was not satisfactory as the economy growth rate started declining and the inflation started accelerating (Das, S. 2020).

The multiple indicator approach was criticized and moving toward inflation targeting was advocated by many higher-level expert committees constituted by GOI during this period. A few examples of the same are High-Powered Expert Committee on Making an International Financial Centre 2007 under the chairmanship of Percy S. Mistry (Mohan, R. T. T. 2007), the High–Level Committee on Financial Sector Reforms in 2009 under the chairmanship of Dr. Raghuram Rajan (Rajan, R. 2009) and The Financial Sector Legislative Reforms Commission in 2013 under the Chairmanship of Dr. B.N. Srikrishna (Srikrishna, B.N. 2013). At the global level also some sort of agreement among various scholars and researchers had developed in Favor of the inflation targeting framework and as a result, many developed and emerging economies have adopted inflation targeting framework (Adil, H. M. & Rajadhyaksha, 2020). In light of the changed economic perspectives, India had to think towards the same line to cope with the dynamic economic environment domestically and internationally.

3.3. FLEXIBLE INFLATION TARGETING (2016 ONWARDS)

As economic perspectives backdrop discussed in above section, an Expert Committee has been appointed by the RBI to Review and "Strengthen the Monetary Policy Framework in 2013 under the chairmanship of Dr. Urjit Patel which submitted its report in 2014. Nonetheless, the expert committee suggested that India's monetary policy framework has inflation as its nominal foundation. As a result, the RBI and the GOI signed a Monetary Policy Framework Agreement in February 2015, officially adopting Flexible Inflation Targeting as the country's new monetary policy" framework (Dua, P. 2020). Accordingly, the RBI Act, of 1934 was amended to give statutory status to "Flexible Inflation Targeting as a new monetary policy structure which has the provision of the consumer price index" combined (CPI – Rural and CPI – Urban) acts as the basis for the determination of the inflation target once in every 5yrs. The Central Government announced the inflation target to be at 4 percent with ± 2 percent as its tolerance band for the period from 2016 to 2021. If the RBI fails to maintain the inflation within the limits, then it needs to give the reasons for the same along with the estimated time for the solution of the same.

The statutory provision was made for a Monetary Policy Committee which should be appointed by the GOI. This committee has six members that needs to meet at least 4 times a year that have the responsibility of determination of benchmark policy rate i.e., repo rate. Accordingly, the monetary policy operating framework has to manage the liquidity on a day-to-day basis with the operating target of WACR (Weighted Average Call Rate). So far two monetary policy committees have been appointed by the GOI first in September 2016 and second in October 2020.

4. CONCLUSION

As far as India is concerned, the monetary policy framework evolution is the result of the time-to-time changes in the global and domestic economic environment both in terms of theory and practices. However, the Indian economy has seen four monetary policy frameworks which were improved versions in accordance with the economic dynamics that prevailed during the period, to name them, Planned Economic Development, Monetary Targeting, Multiple Indicator Approach, and now Flexible inflation targeting. But still, there are certain issues and challenges that still need to be addressed for the smooth and consistent working of monetary policy structure like an assessment of prevalent economic conditions, rigidities and lags in monetary policy transmission, understanding the dynamics of inflation, the lack of autonomy with Reserve Bank of India from political and fiscal authorities, etc., Therefore, for improving the monetary policy framework functioning the Indian monetary authorities should consider to develop a mechanism for collecting the high-frequency data so that accurate assessment of the economic scenario can be done, the coordination should be maintained among the various policies (monetary, fiscal and others) to cop up with the dynamics of global economic environment in general and domestically in particular.

CONFLICT OF INTERESTS

None.

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