

Evolution of monetary policy approaches: A case study of Indian economy

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The monetary policy framework of India has undergone several transformations reflecting underlying macroeconomic and financial conditions as also the dominant socio-politico-economic paradigm. The present study makes pertinent commentary notes on different monetary policy approaches, including, for instance, the era of development planning, the era of monetarism, the era of multiple indicator approach, and the era of inflation targeting in India along with their respective advantages and disadvantages.

JEL CLASSIFICATION

E52; E58; E5

1 | INTRODUCTION

One of the important tasks of the central bank is to keep demand from either growing too rapidly with resulting inflation or too slowly with resulting high unemployment and slow economic growth. Hence, policy should be conducted in a way that leads to stable growth in aggregate demand. This ultimately helps to achieve different macroeconomic goal variables in the economy.¹ To this end, macroeconomic policymakers usually utilize a combination of fiscal policy and monetary policy to manage aggregate demand in any economy. However, as time passes, the policy regime keeps changing depending upon the needs at that time. Here, broadly speaking, the study focuses on four different eras of Indian monetary policy which have been followed by India's central banks—the Reserve Bank of India (RBI)—at different points in time.

To comprehend the Indian monetary policy better, one should look at the legal mandate of monetary policy in India. The RBI Act 1934 holds that RBI is legally mandated, “to regulate the issues of banknotes and 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 advantage, to have a modern monetary policy framework to meet the challenge of an increasingly complex economy, and to maintain price stability while keeping in mind the objective of growth” (RBI Act, 1934). Upon closer look, it is clear that it is a dual mandate. First, RBI has to keep inflation under control. Second, it has to meet the credit needs of the economy. Therefore, monetary policy thinking and practices in India have evolved based on

these two mandates, which are keeping inflation under control and providing credit to the economy. Two key issues are mentioned below which have remained in focus in almost every different era of Indian monetary policy.

- 1 How should the two objectives of price stability and economic growth be balanced?
- 2 What policy instruments should be used to meet these two objectives?

There are four distinct eras in terms of these two questions. Should RBI be focussed on price stability or on economic growth? This is the classic problem in the macroeconomic policy of matching economic policy goals with policy instruments. And this is where the current study focusses here on four distinct eras of monetary policy in India. The present study maintains the objective to focus on those four eras and their evolution at different points in time, including how monetary policy in India shifted over different eras since its inception.

1.1 | The era of development planning

India embarked on the road of development planning in 1951. Soon after independence was the time when the first 5-year plan was launched. Subsequently, 5-year plans were the centerpiece of India's development strategy. The question is what was the role envisaged for monetary policy in this entire development planning framework.

The most important thing to remember is that monetary policy was subservient to the needs of the 5-year plan. The whole idea was that the government of India would use fiscal policy and planning to raise growth rates and investment rates in the economy, and monetary policy had to accommodate the financing need of this economy. Some people have said monetary policy is a penumbra of fiscal policy that lived in the shadow of fiscal policy. Therefore, the RBI was expected to help funding budget deficits through money creation. Keep in mind at this point in time India wanted to ramp-up its investment rate to generate faster growth. However, it did not have enough domestic savings to fund that investment. One part of this savings gap was being met through foreign aid, while another part was being met through accommodation by the RBI, that is, money creation by Indian central banks. Hence, the RBI was expected to help funding budget deficits through money creation.

As is known in economic theory, when money is created in excess of the growth of the economy, inflation rears its ugly head. It is not that the planning authority or government of India were not aware of inflation risks inherent in the strategy. But at that point in time, the growth imperative was so strong that planning strategy or development strategy implicitly assumes that India could tolerate some inflation until growth was at the stage where India could escape from mass poverty. Within the RBI itself, there was a structuralist view of inflation as a supply-side challenge. Like any central bank, the RBI could never ignore the role of money supply or excess money supply in generating inflation. Consequently, significant research of the RBI showed that inflation in India was also sensitive to supply-side rigidities, for instance, food and production of intermediate goods. Even the RBI realizes that to crack the inflation problem, the supply-side constraint has to be eased. Hence, at one end, there were inflation risks but the gamble was that it would help to increase domestic supply and, in turn, put India on a path of low inflation and high economic growth. Thus, under the era of development planning, the goal was the development—inflation had an overall secondary role to play.

What were the policy instruments used to maintain growth and inflation on a certain path? The RBI Act mentioned bank rate as the main policy instrument. That was fundamentally the most important instrument of monetary policy as envisaged in the original RBI Act of 1934. However, in practice, the bank rate did not have as much importance as the law may have suggested. Put it another way, the bank rate did not factor in very much. For example, the bank rate was changed only six times from 1951 to 1971. Now, compare it today when the repo rate changes frequently. If not every 3 months, it has changed dozens of times in the last 20 years. Hence, the bank rate was a policy instrument in the law but hardly ever used. Instead, the RBI used a direct instrument for credit control. Thus, it was not an indirect monetary policy through an investment rate channel, but rather it was a direct intervention through a credit channel.² The RBI did credit control for two reasons. First, to maintain the flow of credit in the economy. Second, to direct credit to a specific sector of the economy, which the planning authority thought needed focusing on.

In a nutshell, since the colonial past, the initial years following independence may be characterized by an exchange rate anchor.

This anchor was set by the proportional reserve system prescribed by the RBI Act of 1934, under which at least 40% of the total notes issued were to be backed by gold bullion and sterling. The proportional reserve system gave way to the minimum reserve system in 1957 and the use of credit aggregates as the nominal anchor for monetary policy (RBI, 2014). Thus, at the beginning of the planning period, the monetary policy framework could be best described as “controlled expansion” of the money supply and was determined mainly by a fiscal stance that was formulated against the backdrop of large budget deficits (Mishra & Mishra, 2012). During 1971–1985, the monetization of the fiscal deficit exerted a dominant influence on the conduct of monetary policy. Therefore, the main task of the RBI at that time was to contain the adverse effects of monetization. In short, monetary policy in India during that period was completely subservient to the fiscal stance of the central government (Bhattacharya, 2006).

This era of development planning obviously had its successes, for example, economic growth picked up and India developed a diversified industrial base. However, the limitations of this strategy were also evident. By the end of the 1960s, India was stuck with very high inflation. This was a bit like what happened in Western countries as well when the 1970s were known as the era of stagflation characterized by the combination of stagnant economic growth and high inflation. Consequently, the high inflation of the 1970s, as well as the fiscal dominance over monetary policy, led to a new wave of thinking that led to the era of monetarism in India. The whole criticism of monetary policy in the era of development planning was that the RBI and government had lost overall control over inflation and that the growth dividend was not as high as anticipated. These consequences ultimately led to an entire re-thinking about monetary policy and inauguration of the next stage of monetary policy thinking, which is the era of monetarism. This broadly is in line with what happened in the rest of the world as well.

1.2 | Era of monetarism

No economics student has done a course on monetary economics without coming across this fundamental idea put forward by Milton Friedman when he said: “inflation is always and everywhere is monetary phenomenon.” Keep in mind that the RBI had a structuralist view of inflation and that inflation was because of inadequate food and intermediate goods, that is, a supply-side problem. Basically, Friedman, Friedmanites, and monetarists were of the view that inflation, in the end, is explained by excess money supply and the central bank has to do something to control the growth of that money supply. Therefore, a re-think started in the late 1970s globally and in India as well. But monetarism really came into its own in India in the mid-1980s. In the year 1985, the committee to review the condition of the monetary system chaired by Dr. Sukhamoy Chakravarty released its landmark report in which he mentioned that “RBI should accord price stability a dominant position in the spectrum of objectives pursued by the monetary authority.”³

In 1985, the committee recommended a new monetary policy framework based on monetary targeting with feedback, drawing on empirical evidence of stable money demand function. Under this approach, a monetary projection was made consistent with the expected real gross domestic product (GDP) growth and a tolerable level of inflation. The committee also recommended limiting monetary expansion through the process of monetization of fiscal deficit by an agreement between the Reserve Bank and the government of India. Thus, during this regime, broad money (M3) was set as the intermediate target, while reserve money was one of the main operating instruments for achieving control on broad money growth.

Focussing on the objectives under this framework, the present study again refers to the RBI law. It was monetary stability and providing credit to the growing economy. What the report said was that inflation control should be the primary objective of monetary policy. Noting that it should not concentrate on growth but rather than the primary objective should be inflation control. This shift was because of the high inflation experience of the 1970s which led to political instability in India. It was also the result of the overall global rethinking about the nature of the monetary policy. So, the era of monetarism was a landmark era where monetary policy shifted from development planning toward monetarism.

Under a monetarism framework, the broad goals of monetary policy were to give a stronger focus on inflation, reduce the fiscal dominance of monetary policy, and step away from financial repression. Here, what does fiscal dominance mean? It means that the RBI's ability to control money supply to control inflation was severely restricted by its requirement to the growing fiscal deficit of the Indian Government. Therefore, monetary policy was subservient to fiscal policy. Another problem was financial repression, which meant that because of interest rate control most of the interest rates were lower than the inflation rate. In turn, the ability of the RBI to manage aggregate demand through changes in interest rates was restricted. The broad goals in this era of monetarism were to give a stronger focus on inflation, reduce fiscal dominance, and step away from financial repression. After all, in the era of development planning, credit control was the main policy instrument used. While in the era of monetarism, it was control of the money supply which became the main policy instrument of the RBI.

Now, how did the RBI come to its annual monetary target or the target for how fast the money supply should grow? There were three things that the RBI considered:

- 1 *The estimated rate of real GDP growth.* Because the money supply had to grow along with real GDP.
- 2 *An acceptable level of inflation.* The real GDP growth, as well as inflation, gave an accepted rate of *nominal* GDP growth which was used in the money supply calculation.
- 3 *Income elasticity of the demand for money.* The monetary target was derived from real GDP growth as well as inflation rate and income elasticity of the demand for money.

This framework was quite flexible in the sense that it allowed for various feedback effects (Mohanty, 2010). Moreover, the money

supply target was relatively well understood by the public at large (Rangarajan, 1997). The setting of monetary policy during the early 1980s, more often than not, used to be in the backdrop of uncomfortably high growth of liquidity (M3) and a higher than the desired rise in wholesale prices (Mohanty & Mitra, 1999). One of the biggest obstacles to monetary targeting was the lack of control over the RBI's credit to the central government, which accounted for the bulk of reserve money creation. The capital flows during the 1991 economic reform also created difficulty to control monetary aggregates. Undoubtedly, monetary aggregates had served the purpose better in terms of its nominal anchor until money demand became unstable. They had been undermined by instability and loss of predictability of the demand for money, discrediting accountability, and communication when targets were missed. The instability in the money demand was attributed to the financial innovations⁴ and external shocks emanating from swings in capital flows, volatility in the exchange rate, and global business cycles. Thus, the era of monetarism lasted about 10 or 12 years in India. It was a complete break away from the earlier era of development planning.

Also, it was in the middle of the economic reform process. As economic reforms progressed, interest rates were freed. More than just this occurred. "The considerable changes [were] dismantling administered interest rates, the unification of dual exchange rates by introducing a market-based exchange rate system and a phased move towards convertibility on the current account" (Ramachandran, 2004). Thus, international capital flows became more important and monetarism started losing its appeal not just in India but also abroad. In the end, the monetarist era eventually gave way to the next era of Indian monetary policy, which was the era of multiple indicators. The turning point was in 1998.

1.3 | The era of multiple indicator approach

After a severe balance of payment crisis in 1991, India adopted economic reforms which led to a distinct change in the early 1990s in its policy environment, framework, and strategies. The monetary policy then had to deal with traditional issues besides those new issues, which were brought about by changing the economic policy environment. Indeed, deregulation and liberalization of financial markets started casting doubt on the appropriateness of exclusive reliance on money as the only intermediate target in the late 1990s. Against this backdrop, the monetary policy framework in India changed from a "pure monetary targeting strategy" to a "multiple indicator approach" in April 1998 with a greater emphasis on rate channels for monetary policy formulation relative to quantity instruments.

Abandonment of the monetary targeting framework implied the loss of broad money (M3) as the nominal anchor. By changing the policy framework, the RBI has not categorically mentioned its nominal anchor. However, under this framework, broad money remained an informative variable with a host of quantity variables (such as money, credit, output, trade, capital flows, and fiscal position) as well as rate variables (such as rate of return in different markets, inflation rate and

exchange rate). These quantity variables are examined for the trajectory of monetary policy perspectives. The multiple indicator approach is informed by forward-looking indicators since the early 2000s drawn from the RBI's surveys of industrial outlook, credit conditions, capacity utilization, professional forecasters, inflation expectations, and consumer confidence (RBI, 2014).

A multiple indicator approach was not just looking at money supply but at a more eclectic group of economic variables including money supply, inflation, the interest rate in money markets, exchange rate, credit growth, fiscal deficit, and capital inflows. These variables became quite pertinent after the 1991 economic reforms. For instance, until 1991, the money market interest rate was controlled tightly by the RBI. The money market became market-determined only after 1991. Likewise, the exchange rate was fixed. Once India became fully convertible on the current account that exchange rate became important input into economic policy. Similarly, India did not get too many capital inflows until 1991. It is only after that money started flowing to the stock market as a foreign direct investment (FDI). Therefore, the switch from a single parameter like money supply to the range of parameters like inflation, exchange rate, credit growth, interest rate, and capital inflows (called multiple indicators) is actually considered the core of the shift from monetarism to multiple indicator approach.

A particular noteworthy step during this period was the historic accord between the government and the RBI for phasing out the issuing of ad-hoc treasury bills, thereby eliminating automatic monetization of the budget deficit. This, in turn, reinforced monetary policy autonomy and enhanced the credibility of the central bank. Although the basic objectives of monetary policy of ensuring price stability and availability of credit to productive sectors remained intact, the underlying operating procedures underwent significant changes. Also, the emphasis shifted from direct instruments of monetary policy (interest rate regulations, selective credit controls, and cash reserve ratio [CRR]) to indirect instruments (repo operations under liquidity adjustment facility [LAF] and open market operations [OMO]). Therefore, from 1998–99 until 2014–15, much emphasis is given on inflation and growth with multiple intermediate targets. Of course, the question arises as to why the RBI made this shift. There were two important reasons for this shift.

- 1 The demand for money function became unstable because of financial liberalization.⁵
- 2 Interest rates became a more important policy variable than either money supply or credit aggregates.

The first issue was that the demand for money function became unstable because of financial liberalization. What do we mean by unstable money demand function? Focussing on the stability of money demand, as mentioned by Laidler (1982): "When we say that the demand for money function is stable we mean at the very least that money holdings, as observed in the real world, can be explained, to conventionally acceptable levels of statistical significance, by functional relationships which include a relatively small number of

arguments. We also mean, or should mean, that the same equation is capable of being fitted to samples of data drawn from different times and places, without it being necessary to change the arguments of the relationship in order to achieve satisfactory results, and also without the estimated quantitative values of the parameters changing too much."⁶

It is known by the fact that money supply targeting makes sense as long as the demand for money is forecasted well. Therefore, the demand for money which is forecastable and the money supply target will give some sense of what the interest rate would be in the economy. After financial liberalization with the explosion of financial product, people started switching between bank deposits, cash, and mutual funds, etc. It became very difficult to forecast the demand for money precisely and the demand for money function became unstable. The second issue was that the interest rate became an important policy instrument. Because just like the RBI shifted away from monetarism, a lot of other central banks globally shifted away from monetarism or monetary targeting. In light of this monetary policy strategy, Gerald Buoe, former governor of Bank of Canada, noted: "We did not abandon monetary aggregates; they abandoned us."

Thus, monetary aggregates became unstable and could no longer be used as a policy instrument. Now, the era of multiple indicator approach had its run with a lot of changes in this time. The liquidity adjustment facility (LAF) under which the repo and reverse repo systems are in place came into being. The RBI also started deepening the financial market in this country. The multiple indicator approach seemed to work fairly well from 1998–99 to 2008–09, as evident by an average real GDP growth rate of 7.1% associated with average inflation of about 5.5%. However, on the one hand, persistently high inflation and weakening growth have come to co-exist over a period of time. On the other hand, since the late 1980s, several advanced and emerging economies have adopted inflation as a nominal anchor for monetary policy, drawing upon the strong theoretical and empirical support for low and stable inflation as a necessary precondition for sustainable high growth (RBI, 2014).

Consequently, on the eve of the global financial crisis, some observers questioned this multiple indicator approach strategy. They suggested a gradual move toward an inflation-targeting framework as it is adopted in other emerging economies (Rajan, 2008). Thus, it came under attack from many critics who said that a multiple indicator approach was too vague and monetary policy needed a nominal anchor that should have a single target. The target could be inflation, exchange rate, money supply, and nominal domestic GDP; all these are credible nominal anchors which would help to anchor the expectations of private economic agents. This was the time when many central banks, first in advanced and then emerging economies,⁷ shifted to an inflation-targeting framework. Similarly, it was the time when global monetary thinking started moving to the idea that the task of a central bank is not just to meet inflation target but to anchor long-term inflation expectation. And there was a view that RBI with its multiple goals and multiple instruments could not give credible signaling to the market and the private sectors so that it could help them to stabilize the inflation expectation.

Importantly, since 2007, there were several high-level committees in India which have mentioned in their report that the RBI must consider inflation targeting framework rather multiple indicator approach. For instance, “The Report of the High Powered Expert Committee on Making an International Financial Centre,” 2007 (Chairman: Percy S. Mistry); “The Report of the Committee on Financial Sector Reforms,” 2009 (Chairman: Raghuram G. Rajan); and The Financial Sector Legislative Reforms Commission (FSLRC), 2013 (Chairman: B.N. Srikrishna). All of them argued that the RBI must abandon a multiple indicator approach and move toward a single nominal anchor for its monetary policy. And in all reports, the preferred anchor was the inflation target. The RBI did not necessarily agree with this because it is thought that in a complex economy such as India, it is important to have various options open. For example, the RBI should have a full-service central bank rather than just an inflation-targeting central bank. But the consensus in the world had by then shifted very strongly to the idea that central bank should have a single target that is, inflation and the single policy instrument to meet that target which is the short term interest rate. Therefore, by the then many central banks first in advanced and then emerging economies had shifted to an inflation-targeting framework. Noting that through the first decade of the 21 century, there was a general drift globally that central bank after central bank started moving toward inflation targeting, although there were some important exceptions including the RBI and the Bank of China. Therefore, this criticism and the experiences of the Indian government led to the shift to the latest era of monetary policy in India, which is the era of inflation targeting.

1.4 | The era of inflation targeting

In the year 2015, under the governorship of Dr. Raghuram Rajan, former governor of the RBI, a “flexible inflation targeting framework” was adopted as its monetary policy strategy, particularly after the “Report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework” under the chairmanship of Dr. Urjit R. Patel in January 2014. Under this framework, a new nominal anchor was announced by the RBI: inflation.

Before going into details of this framework, firstly, it is important to know what a nominal anchor is. A nominal anchor is a constraint on the value of domestic money, and in some form, it is a necessary element in the conduct of successful monetary policy regimes (Mishkin, 1999). Mishkin further mentions that a nominal anchor can be thought of more broadly as a constraint on a discretionary policy that helps weaken the time-inconsistency problem so that in the long-run, price stability is a more likely to be achieved. In addition to the above, a nominal anchor may also be needed to limit the political pressures to pursue overly expansionary and time-inconsistent monetary policies. Thus, a nominal anchor or an indicator for monetary policy is a single variable or device that the central bank uses to pin down the expectations of private agents about the nominal price level or its path (or about what the bank might do with respect to achieve that path). In different monetary policy regimes, nominal variables used as

anchors specifically include exchange rate targets, money supply targets, and inflation targets.

Thus, on February 20, 2015, the RBI and government of India signed a Monetary Policy Framework which focussed on inflation as a nominal anchor under an inflation-targeting framework. Under this pact, it was agreed upon that the RBI will maintain the monetary policy framework while considering the objective of growth, the objective of inflation targeting would be primarily to maintain price stability. The introduction of a new consumer price index in 2011, the all India CPI-Combined (CPI-Rural and CPI-Urban) was used as a representative measure of inflation. Henceforth, the monetary policy committee's exclusive mandate was, and continues to be, to ensure that headline inflation consumer price index (CPI) is within a band of 2–6%. That is why India's monetary policy framework is called “flexible inflation targeting”: it does not focus on a single target number, such as 2% in the case of the European Central Bank. Rather, its approach is “point with tolerance” target. In addition, under a flexible inflation target umbrella, the inflation target is aimed to be achieved on average over the business cycle while accommodating growth concerns in the short-run (RBI, 2014 quoted Ito, 2013).⁸

The central goal of a central bank is to meet an inflation target given to it by the government. But the more technical way to look at it as follows: “The objective of inflation targeting can be approximated by a quadratic loss function consisting of the sum of the squares of inflation deviations from its formal target and a weight times the square of the output gap. The central bank seeks to minimize this loss function through its monetary policy.”⁹

Meaning that the central bank had to see how far inflation was from the target and how far growth was from potential growth. Therefore, deviations from inflation and deviations from growth determine the nature of monetary policy and the central bank has to minimize this loss function. The Urjit Patel Committee report actually brought all these criticisms together and it led the way forward for the Indian monetary policy. Here is one illustrative excerpt from the 2014 report of Urjit Patel Committee: “Stabilising and anchoring inflation expectations—whether they are rational or adaptive—is critical for ensuring price stability on an enduring basis, so that monetary policy re-establishes credibility visibly and transparently, that deviations from desirable levels of inflation on a persistent basis will not be tolerated. In doing so, the monetary policy provides a common set of expectations to all economic agents which, in turn, influences their behavior and thereby aggregate demand.”¹⁰

Focussing on certain key issues of the claim, the goals of the current inflation-targeting framework are as follows: it is to anchor inflation expectation; to re-establish the credibility of monetary policy; to keep deviation from inflation target minimum; to keep the expectations of all economic agents in line with the monetary policy and eventually; and to influence aggregate demand. Therefore, the goal eventually of all monetary and fiscal policy or macroeconomic policy is to affect or manage aggregate demand. But the way it is done is through policy credibility and stable inflation expectations. This is the entire goal of the inflation-targeting framework. Therefore, after the submission of the Urjit Patel Committee report, India instituted a new

TABLE 1 Advantages and disadvantages of monetary policy approaches

Nominal anchors – Pros and cons		
Anchor	Advantages	Disadvantages
Monetary targeting	<p>Some monetary aggregates can be quickly and easily controlled by the central bank.</p> <p>Monetary aggregates can be accurately measured (with short lags).</p> <p>Increases the transparency of monetary policy, thereby avoiding the time-inconsistency trap.</p>	<p>Depends on a well-defined and stable relationship between monetary aggregates and nominal income. With financial innovations, this stability often breaks down.</p> <p>Greater stress on making policy transparent (clear, simple and understandable) and on regular communication with the public may undermine credibility in the face of deviations.</p>
Nominal income targeting	<p>It could be superior to monetary targeting, since it avoids the problem of velocity shocks and time inconsistency.</p> <p>Allows a country to maintain the independent monetary policy.</p>	<p>Compels a central bank to announce a potential GDP growth number, over which it has limited control.</p> <p>Concept of nominal GDP is not clearly understood by the public, lowering transparency.</p> <p>Could engender time inconsistency if the central bank announces too low or too high a number, which subsequently is found to be different from the announced one.</p>
Exchange rate targeting	<p>The nominal anchor of the exchange rate fixes the inflation rate for internationally traded goods and thus, contributes directly to keeping inflation in check.</p> <p>If the exchange rate target is credible, it anchors inflation expectations to the inflation rate in the anchor country to whose currency it is pegged.</p> <p>Has the advantage of simplicity and clarity; well understood by the public.</p>	<p>The central bank has limited control over its monetary policy.</p> <p>The country becomes vulnerable to shocks emanating from the country to which its currency is pegged.</p> <p>Speculative attacks on the exchange rate might force the central bank to substantially raise its interest rates, with significant economic costs.</p>
Inflation targeting	<p>Preserves independence of monetary policy.</p> <p>Provides a nominal anchor for the path of the price level.</p> <p>Clear and simple; hence, well-understood by the public.</p> <p>Transparency increases the potential for promoting low inflation expectations, which helps to produce a desirable inflation outcome.</p>	<p>Too much focus on inflation often at the cost of output stabilization.</p> <p>Long and variable lags in monetary transmission mean that a substantial amount of time must elapse before the success of monetary policy can be ascertained.</p> <p>Efficacy could be compromised if interest rates hit a zero lower bound.</p> <p>A right rule does not allow enough headroom (discretion) to respond flexibly to unforeseen contingencies.</p>
Price level targeting	<p>Lowers uncertainty about prices that would prevail in the near future.</p> <p>Allows economic agents to form forward-looking expectations based on current price levels.</p> <p>Can prove effective when the nominal interest rates hit the zero lower bound.</p>	<p>Poses communication challenges. Under this approach, the central bank, at a minimum, needs to specify both an intercept (level of target in the base period) and a slope (rate of increase in target price path over time), over and above a time period.</p> <p>Not practical experience on the success or failure of its implementation across countries in modern times.</p> <p>The transition costs of moving to this practice (for countries already on inflation targeting) could be large and uncertain.</p>
Just-do-it strategy	<p>Constructive ambiguity in policymaking often helps the central bank achieve its long-term goal (price stability).</p> <p>Demonstrated success.</p>	<p>Nontransparent; not clear to the public what the central bank intends to do (or, is doing).</p> <p>Strongly dependent on skills and performances of individuals in charge of the central bank.</p>

Source: Adopted from RBI (2014).

monetary policy framework, its fourth framework, inflation targeting. This new monetary policy framework has several important components which are as follows:

- 1 The government has given the RBI an inflation target of 4%. It is no longer a vague goal, that is, inflation is to be kept under control. Rather inflation is supposed to be kept at 4% on a medium-term. Although there will be some fluctuations here and there, in the medium-term, inflation will be around 4%, i.e., the nominal anchor of monetary policy.
- 2 There is a formal monetary policy agreement between the government of India and the RBI. Hence, it is not just a wish list but there is a legal document to back this inflation target.
- 3 The policy instrument to be used to meet this inflation target is the repo rate or interest rates in general; interest rates are no longer just decided by the RBI governor or just by RBI on its own but by the six members of the monetary policy committee. Three are from the RBI and three are out of the RBI. The three outside members may be either academicians or market experts.

Thus, the entire way the monetary policy has been done in India completely changed after adopting inflation targeting. The monetary policy framework has changed from a simple era of development planning to the era of the monetary targeting framework in the mid-1980s to the era of multiple indicator approach in the late 1990s, and then the current era of inflation targeting framework since 2015. In addition to the above, there are several other approaches to conduct monetary policy. However, costs and benefits were involved behind every single monetary policy approach. Some of the important pros and cons are mentioned below by the present study in Table 1:

2 | CONCLUSION

As mentioned earlier, one of the important tasks of the central bank is to keep demand from either growing too rapidly with resulting inflation or too slowly with resulting high unemployment and slow economic growth. Hence, the policy should be conducted in a way that leads to stable growth in aggregate demand. Thus, the final goal of a short-term macroeconomic policy is to manage aggregate demand to ensure that the economy grows rapidly while keeping inflation under control. Now, the Indian monetary policy is mandated by the RBI Act of 1934 to maintain price stability without hurting growth. That is the ultimate goal. To this end, at different point of time, there were four different eras of monetary policy: first, the era of development planning; second, the era of monetarism; third, the era of multiple indicator approach; and fourth, the current era of inflation targeting has been adopted. These four eras have been defined by the relative importance given to these two goals, which are price stability and growth. To achieve them, several policy instruments, both conventional and unconventional,¹¹ have been used.

Thus, in the backdrop of the above discussion, it has been shown that Indian monetary policy has changed in its relative

focus on inflation versus growth and on types of policy instruments that are used whether its either money supply/credit aggregate or interest rate to meet these policy goals. The key point is that the monetary policy framework keeps on changing along with the fiscal policy framework. Therefore, while economic theory gives a general view of macroeconomic policy, it is crucial to link it to historical and institutional factors in order to see how monetary policy or fiscal policy is actually carried out in the real world.¹²¹³

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ENDNOTES

- ¹ Most of the central banks focus on six basic goals when they discuss the objectives of monetary policy: (a) high employment (b) economic growth (c) price stability (d) interest-rate stability (e) stability of financial markets and (f) stability in foreign exchange markets (Mishkin, 2007).
- ² Credit channels operate by affecting the external finance premium through both the bank lending channel and the balance sheet channel (RBI, 2014).
- ³ RBI (1985)
- ⁴ As Arnaboldi and Rossignoli (2015) quote the definition of European Central Bank (ECB 2003), "Financial innovation is primarily a product and organisational innovation, which allows cost or risk reduction for banks and/or a service improvement for the financial industry as a whole." In another definition, by Lewis and Mizen (2000), "... financial innovation can be categorized in the form of a new product, or a new process for supplying an already existing product, or be in terms of market arrangements."
- ⁵ In the present study, financial liberalization is broadly defined to encompass financial innovations and institutional/regulatory changes (following James, 2005).
- ⁶ Laidler (1982, pp. 39–40)
- ⁷ As mentioned in the report of Reserve Bank of India (RBI, 2014)—Inflation-targeting countries in advanced economies including Australia since 1993, Canada since 1990–91, Japan since 2013, New Zealand since 1989–90, and Norway since 2001 are few among others. In the emerging-market economies, some countries have started focussing their monetary policy approach as an inflation targeting, for instance, Chile since 1999, Brazil since 1999, Hungary since 2001, Indonesia since 2005, and South Africa since 2000 are few among others.
- ⁸ Ito, T. (2013, November). We are All FIT-ers Now: Is flexible inflation targeting fit to a new financial environment. In *Bank of Thailand and IMF Conference* (pp. 1–2).
- ⁹ RBI (2014)
- ¹⁰ RBI (2014, p. 11)
- ¹¹ Mohanty (2013) defines, "Conventional monetary policy is understood as central banks operating with a short-term policy interest rate in the money market to signal the stance of monetary policy and in the process influence the term structure of market interest rates to achieve the objectives of price stability with sustainable growth." However, it becomes ineffective at the "zero lower bound". Therefore, central banks go for unconventional monetary policies. Furthermore, Mohanty (2013) rightly mentions about unconventional monetary policy: "When central banks look beyond their traditional instrument of policy interest rate, monetary policy takes an unconventional character." It may consists of several instruments, for instance quantitative easing, credit easing, forward guidance, and helicopter money.

- ¹² Time inconsistency trap or dynamic inconsistency is a situation in which a decision maker's preferences change over time in such a way that a preference can become inconsistent at another point in time (footnote added).
- ¹³ In 1931, Sweden went off the gold standard and adopted a price-level target in order to counter deflationary pressures associated with the Great Depression (C. Berg and L. Jonung, 1999. Pioneering Price Level Targeting: The Swedish Experience 1931–1937, *Journal of Monetary Economics* 43, 525–51).

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