Historical Evolution of Monetary Policy and India's Standpoint

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Monetary policy refers to actions taken by central banks to affect monetary and other financial conditions in pursuit of the broader objectives of sustainable growth of real output, high employment, and a reasonable degree of price stability. It has emerged as an important tool of economic policy in the developed, developing developed and developing economies. And major reforms in monetary policy occurred in the last two decades of the 20th Century and, more or less, in the first two decades of the 21st centuries, augmenting in fact the globalization of monetary policy. It is clear now that the challenge for monetary policy have been changing over time, even though some basic issues have remained of perennial concern.

It is in this backdrop, the objective of the chapter is to report the historical evolution of the monetary policy across the globe within which we include classical monetary policy,monetary policy during the Great Depression, the goals of monetary policy, instruments of monetary policy, intermediate targets, theories of monetary policies, rules versus discretions as well as pinpoint thetrends of India's monetary policies over time.

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The conduct of monetary policy is complex. It has not only to be forward looking, but has to grapple with an uncertain future....The challenge facing a monetary authority is to balance the various choices into a coherent whole and to formulate a policy as an art of the possible.

–Y.V.. Reddy, Former Governor, RBI

I. Introduction

Monetary policy that refers to actions taken by central banks to affect monetary and other financial conditions in pursuit of the broader objectives of sustainable growth of real output, high employment, and a reasonable degree of price stability, has emerged as an important tool of economic policy in the developed, developing developed and developing economies. And major reforms in monetary policy occurred in the last two decades of the 20th Century and, more or less, in the first two decades of the 21st centuries. It is clear now that the challenge for monetary policy have been changing over time, even though some basic issues have remained of perennial concern. As the institutional environment—both domestic and global— changes, the tasks of monetary policy also undergo a change. Today's monetary and financial system is far more complex than it has been the past. The channels of financial intermediation have also changed. While only in 2009 most business flowed through the balance sheets of banks or insurance companies, or through a limited range of investment funds, the explosive increase in wealth held privately (partly as a result of greater dispersion of income) has led to the creation of a wide range of other investment vehicles, of which hedge funds and private equity are the most prominent. New instruments have emerged which make it possible to transfer risk of all kinds on a far larger scale and in more complex ways.Financial intermediationhas reached a level of sophisticationwhich has itself become a source of concern in recent days. The menu of financial products available has expanded enormously. Derivative products which were unknown till a few decades ago, have become common. All these changes have an important role to play in relation to the transmission mechanism. The impact of monetary policy action can be felt through a variety of channels some of which though recognized in the past have become more important. The speeds with which funds nowadays move across borders have raised issues regarding the coordination of monetary policies among countries. Prices and interest rates are no longer determined by domestic factors.

In the industrial advanced countries, after the World War II, there had been many changes in monetary policies in the fight against inflation and other matters. Also the relative importance of growth and price stability as the objectives of monetary policy as well as the appropriate intermediate target for monetary policy became the focus of attention. The recent churning of the financial system has raised several new questions not only with respect to objectives but also to the overall conduct of monetary policy itself.

A similar trend regarding monetary policy is discernable in developing economies as well. The importance of price stability and, therefore, the need to use monetary policy for that purpose assumed importance in developing economies. The impossible trinity[1] is now a reality and the countries have to make the relevant choice.

II. Objectives

It is in this backdrop, the objective of the chapter is to report the historicalevolution of the monetary policy across the globe within which we include classical monetary policy, monetary policy during the Great Depression,the goals of monetary policy, instruments of monetary policy, intermediate targets, theories of monetary policies, rules versus discretions as well as pinpoint thetrends of India's monetary policies over time.

III. Historical evolution of monetary policy

From the First World War onwards, central banks focused entirely on public objectives. Their objectives also changed towards shielding the domestic economy from external shocks and stabilizing real output and prices. The trend continued in the 1930s and after the Second World War.

Classical Monetary Policy

The true origin of the modern monetary policy occurred under the classical gold standard, which prevailed from 1880 to 1914. Under the gold standard all countries would define their currencies in terms of a fixed weight of gold and then all fiduciary money would be convertible into gold. The key role of the central bank was to maintain gold convertibility. Central banks were also supposed to use their discount rates to speed up the adjustment to external shocks to the balance of payments, that is, they were supposed to follow the 'rules' of the game (Keynes, 1930).There is considerable debate on whether the rules were actually followed (Bordo and MacDonald, 2005). There is evidence that central banks sterilized gold flows and prevented the adjustment mechanism.

After the First World War, the gold standard was restored, but in the face of a changing political economy

— greater emphasis was placed by central banks on the domestic objectives of price stability and stable output and employment than on external convertibility.

The Federal Reserve followed the flawed real bills doctrine, which exacerbated the downturn, and the gold sterilization policies followed by the Fed and the Banque de France weakened the adjustment mechanism of the gold standard.

Monetary policy during the Great Depression

Monetary policy during the Great Depression had four phases. The first phase is the Great Contraction.1929-33 is referred to as the contraction or downturn phase of the Depression.The second phase of the Depression is a brave recovery from 1933 through 1939. Monetary policy during this period was dominated by President Roosevelt's decision to devalue the dollar in terms of gold. Besides, numerous pieces of legislation were enacted increasing and altering Federal Reserve's powers. The third phase was another depression that occurred in 1937.The final phase was to some extent a recovery. In fact,monetary policy during the Great Depression is largely a study of failure: a lack of leadership, an incorrect theory of policy, the constraint of the gold standard and a lack of understanding. But the failure gives the pillar offuture success in the pursuit of price stability and maximum sustainable growth.

Monetary policy was restored to the central banks in the 1950s and 1960s. But inflation was broken in the early 1980s by concerted tight monetary policies in the United States, the UK and other countries and a new emphasis was placed on the importance of low inflation. Central banks in many countries were granted goal independence and were given a mandate to keep inflation low.

The Goals of Monetary Policy

Until 1914, the dominant monetary regime was the gold standard. Since then, the world has gradually shifted to a fiat money regime. Under the classical gold standard the key goal was gold convertibility with limited focused on domestic economy. By the interwar period convertibility was being overshadowed by emphasis on domestic price level and output stability, and the regime shifted towards fiat money. This continued after the Second World War. Under the 1944 Bretton woods Articles of Agreement, member countries were to maintain pegged exchange rate and central banks were to intervene in the foreign exchange market to do this, but the goal of domestic full employment was also given predominant. The Bretton Woods evolved into a dollar gold exchange standard in which members currencies were convertible on a current account basis into dollar and the dollar was convertible into gold (Bordo, 1993). A continued conflict between the dictates of internal and external balance was a dominant theme from 1959 to 1971 as it was the concern over gold imbalance.

The collapse of Bretton woods between 1971 and 1973 was brought about largely because the United States followed an inflationary policy to finance both the Vietnam War and expanded social welfare programmes. There was abelief that the Phillips' Curve trade-off between inflation and unemployment existed: this led to a focus on maintaining full employment at the expense of inflation.

Since the end of the World War II, the countries across the globe have had witnessed relatively stable inflation and a high growth regime. But the happy mirror soon faded out. That period of "stable inflation and high growth" came to a halt during the oil price spike in the 1970s — the period known as the period of 'stagflation'.

The resulting 'great inflation' of the 1970s finally came to an end in the early 1980s by central banks following tight monetary policies. Since then the pendulum has again swung towards the goal of low inflation.(Friedman, 1968; Phelps, 1968). From the late 1980s the inflation came down to a stable level and the growth again picked up in the countries. This period is sometimes called period of 'great moderation'. Significantly, during this period the US Federal Reserve was chaired by Paul Volker and Alan Greenspan (the latter became Chair of the Fed in 1987), two legendary central bankers. That is why thios period is sometimes referred to Volker- Greenspanera.

This period continued upto the time of global financial crisis 2007-08. One significant aspect of this period is that the central banks across the world assumed a kind importance which was never observed before.

Instruments of Monetary Policy

The original policy instrument was the use of the discount rate and rediscounting. Open market operations (the buying and selling of government securities) was first developed in the 1870s and 1880s by the Bank of England in order to make bank rate effective, that is to force financial institutions to borrow.

In the interwar period the newly established Federal Reserve initially used the discount rate as its principal tool, but heavy criticism for its use, the Fed shifted to open market policy, its principle tool ever since.

Intermediate Targets

Traditionally, central banks altered interest rate as the mechanism to influence aggregate spending, prices and output. In the 1950s, the monetarist revived the Quantity Theory of Money and posited the case for using money supply as the intermediate target. But this process generated the great inflation of the 1970s.

By the 1970s most central banks had monetary aggregate targets. However, the rise of inflation in the 1970s as well as continuous financial innovation made the demand for money functionless. This meant that central banks had difficulty in meeting their money growth target. In addition the issue was raised as to which monetary aggregate to target (Goodhart, 1984). By the late 1980s most countries had abandoned monetary aggregates and returned to interest rates.

In sum and in addition, monetary policy has had its ups and downs in the post-Second World War period. In industrially advanced countries, after decades of eclipse, monetary policy re-emerged as a potent instrument of economic policy, in the fight against inflation in the 1980s. Issues relating to the conduct of monetary policy came to the forefront of policy debates at that time. The relative importance of growth and price stability as the objective of monetary policy as well as the appropriate intermediate target of monetary policy became the focus of attention. Over the years, a consensus has emerged among the industrially advanced countries that the dominant objective of monetary policy should be price stability. Differences, however, exist among central banks even in these countries as regards the appropriate intermediate target. While some central banks consider monetary aggregates and, therefore, monetary targeting as operationally meaningful, some others focus on the interest rate. There is also the more recent practice to ignore intermediate targets and focus on the final goal such as inflation targeting.

But since early 1990s monetary policy in many countries had been based on pursuing an inflation target (implicit or explicit) with the policy rate set to allow inflation to hit the target, a policy which seems to be successful.

Theories of Monetary Policies

The development of practice of monetary policy described above was embedded in major advances in monetary theory that began in the first quarter of the 19th century.

Two principles became embedded in central banking lore — gold standard and the real bill doctrine. Adherence to the two pillars led to disaster in 1930. The depression was spread globally by the fixed exchange rate gold standard. In addition, the gold standard served as 'golden fetters' for most countries because they could not use monetary policy to allay banking panics or stimulate the economy lest it triggers a speculative attack (Eichengreen, 1992)

The Great Depression gave rise to the Keynesian view that monetary policy was impotent. This led to the dominance of fiscal policy over monetary policy for the next two decades. The return to traditional monetary policy in the 1950s was influenced by Keynesian monetary theory. According to this approach monetary policy should influence short-term rates. This money market approach dominated policy until the 1960.

Rules versus Discretion

A key theme in the monetary policy debate is the issue of rules versus discretion. The theoretical literature suggests that a rule-based monetary policy is preferable to discretionary monetary policy. Taylor votes for rule based policy. Taylor(2012) aregues that the monetary policy in the United States can be divided into two periods— while 1985- 2003 is marked by rule based period , the period thereafter culminating in the global financial crisis is characterized by discretionary policy.

A more recent approach focuses on the role or time inconsistency. According to this approach, a rule is a credible commitment mechanism that ties the hands of policymakers and prevents them from following time–inconsistent policies — policies that take past policy commitments as given and react to the present circumstances by changing policy. (Kydland and Prescott, 1977; Barro and Gordon, 1983).

Today's central bank, dedicated to low inflation, can be viewed as following the Taylor rule (Taylor, 1999). The chief merit of Taylor's rule is its transparency. It clearly provides a formula how to set the policy interest rate in keeping with the inflation and output gap in the economy. That is why it has become very popular with the policy makers at the central banks. This rule talks about inflation target. The countries adopted inflation targeting based on this rule.

In this vein, today's central bankers place great emphasis on accountability and transparency to support the credibility of their commitments to maintain interest rate geared towards low inflation (Svensson, 1999).

Though the central banks acroos the globe have embraced the Taylor rule as the major plank of their policy making, the global financial crisis put a big question mark on the efficacy of such rule. Many economists believe that Taylor rule should consider many other variables like asset markets parameters etc. in addition to inflation and output gap.

IV. Trends in india's monetary policy

Though the RBI played a major role during first three decades after Independence, it ought to abide by the guideline of the government. And so long as inflation was moderate, this approach worked well. But in keeping abreast of the world- wide inflation broken in the early 1970s and continued to the whole decade by the whirl of tight monetary policy in the United States, the UK and other countries, India only saw inflation at that period and it, in the 1970s, touched unacceptable levels and as a result,growth of the money supply had to be tamed and reigned in.

A continuous 'battle' between the RBI and the MoF on the control of inflation and the need to contain fiscal deficit came to the fore in the 1980s.The period was marked by uneven growth though accompanied by even an average growthof little over 5 per cent. The average inflation was close to 7 per cent.The annual M_3 growth was 17 per cent. Submitting its report in 1985,theChakravarty Committee recommended that in a need to regulate the money supply, the money supply growth ought to be consistent with real growth and acceptable level of inflation. It also stressed for close co-ordination between monetary policy and fiscal policy. Thus Committee's vision converted into a scheme what came to be described as flexible monetary targeting. But in the latter of the 1980s the Indian economy still saw a higher fiscal deficit and higher money supply growth, in spite of the acceptance of the recommendations. All these propelled us to dip into the crisis of 1991.

The 1990s saw a sea change in the contour of monetary policy. For example, (i) the issue of ad-hoc treasury bills was done away with. It was replaced by a system of Ways and Means Advances which had a fixed ceiling. The Reserve Bank of India continued to subscribe to the dated securities at its discretion. (ii) During 1993 and 1994, for the first time monetary policy had to deal with the monetary impact of capital inflows with the foreign exchange reserves increasing sharply from $ 9.2 billion in March 1992 to $ 25.1 billion in March 1995. As a result, the automatic monetization of fiscal deficit came to an end.(iii) Besides, by moving to market –determined rate of interest, government securities became marketable and it has enabled the emergence of open market operations(i.e., selling and buying of government securities) as an instrument of credit control. The dismantling of the administered structure of interest rate enabled the rate of interest to emerge as a policy variable. The RBI was deeply concerned withprice stability as a dominant objective of monetary policy and therefore, regardedregulation of money supply as a key factor in monetary policy.

Monetary policy has begun to operate within a changed institutional framework brought about by thefinancial sector reforms. It is this change in the institutional framework that has given a new dimension to monetary policy. New transmission channels have opened up. Indirect monetary controls have gradually assumed importance. With the progressive dismantling of the administered interest rate structure and the evolution of a regime of market determined interest rate on government securities, open market operations including 'repo' and 'reverse repo' operations emerged for the first time as an instrument of monetary control.

Post-1997 was earmarked by a series of approaches of multiple indicators. For example, the Liquidity Adjustment Facility introduced first in 1999 and refined later is emerging as a principal operative instrument to manage market liquidity on a daily basis. Bank Rate acquired a new role in the changed context. So too the repo and reverse repo rates. The Nineties have paved the way for the emergence of monetary policy as an independent instrument of economic policy (Rangarajan, 2002). But the issue connected with multiple objectives such as to (i) maintain a reasonable degree of price stability and (ii) to help accelerating the rate of economicgrowth) remained the same.

Financial Crisis, 2007-08

After the onset of financial crisis, monetary policymakers faced significant challenges. Financial markets were in trouble, normal credit flows were significantly disrupted, and economies moved into recession. Central banks sharply reduced their policy rates and tried to improve the functioning of financial markets. As "lender of the last resort" central banks provided liquidity to financial market participants.A number of other important measures were also initiated to quell the situation. The actions of the central bank mitigated the effects of the crisis and fostered recovery. As a result the size of the balance sheets of major central banks, reserves and the monetary base rose after Septemmber2008. Over time, balance sheets came to a normal level.

The 2007-08 crisis and central bank responses have stimulated discussion of the appropriate way to implement monetary policy and the role of the central banks in both micro-prudential and macro – prudential regulation (Table). It is worth-mentioning that based on the 1988 Basle accord, prudential norms were introduced in India in 1992. Since then there has been a progressive move towards international norms. An important lesson from the 2007-08 crisis is that central banks, whether they are ultimate micro- or macro-prudential regulator or not, must pay more attention to the level of systemic risk in formulating policy and to how their monetary policies might affect the degree of systemic risk. Accordingly, central banks have begun the task ofidentifying indicators of the level of systemic risk[2] and have begun the discussion of how this information will be used in monetary policy decisions. It is well recognized that in a globalization context, policy conducted with data of poor quality could be very inefficient.

Table : Micro and Macro Approach

	Macro-prudential	**Micro-prudential**
Objective	Limiting systemic risk of the financial system: Mitigating the failure of a large segment of the financial system	Limiting idiosyncratic risk of individual institutions: Protection of depositors and investors
Implementation of supervisory controls	Top-down: setting prudential control in terms of the probability and costs of systemic distress	Bottom-up: Setting and aggregating prudential control in relation to the risk of each institution
Characteristics of risk	**Endogenous:** Originating in the collective behaviour of and interactions between institutions	**Exogenous**: Given to individual institutions and the disregard of feedback of collective actions
Common exposure to systemic risk	Relevant and important: Causes of the fallacy of composition	Irrelevant

Use of instruments	Standard prudential tools plus linking provisioning and pricing of risk to the volume of loan	Uniform solvency standards and codes of conduct
Focus of supervision	(i) A greater weight given to banks and larger and more complex institutions; (ii) Market monitoring; and (iii) Countercyclical orientation	Protection of individual institutions

Sources: Crockett (2000), Borio (2003)

India's Standpoint

In the years before and after the 2008 global crisis, RBI focused on financial stability that applies to both institutions and markets and that implies ability of the institutions to meet their obligations on their own without interruption or outside assistance. And markets are said to be stable when prices in financial markets are not volatile and participants can confidently transact in them at prices that reflect fundamental forces.In 2016, RBI moved to a new monetary policy framework which may be described as one of flexible inflation targeting. The interest rate (Repo Rate) became the operating target. Moving to the new policy framework, clarified the objective of monetary policy. But RBI has to contend with many other issues with respect to monetary policy. The question of when to raise or lower the interest rate will always be a contentious issue.

Changes in the exchange rate and foreign trade regimes have added an additional dimension to India's monetary policy. External considerations have now to be taken into account in the conduct of monetary policy. Central Bank has also expanded hands inexternal sector management, whether it was meeting the balance of payment crisis in 1991, or managing the transition to a liberalized exchange rate, unified exchange rate, current account convertibility and capital account liberalization. There have been years in which the Reserve Bank had to fight the impact of capital outflows and there have also been years in which the major concern is how to deal with the large capital inflows.

V. Conclusion

A policy is said to be monetary if relevant actions are those generally undertaken by a central bank. They may include the size of the monetary injections, reserve requirements, the discount rate, or the scale of intervention in local or foreign exchange market.

Today monetary policy is the principle way in which governments influence the macro economy. To implement monetary policy the monetary authority uses its policy instruments (short-term interest rate or the monetary base) to achieve its desired goals of low inflation and real output close to potential. It is widely accepted that well-developed monetary policy can counteract macroeconomic disturbances and dampen cyclical fluctuations in prices and employment thereby improving overall economic activity and welfare. In other words,central banks conduct monetary policy with the ultimate aim of promoting sound economic performance and thereby ensuring the well-being of people. While there is a rich diversity in the way monetary policy is formulated and conducted across the world, the success of central banking in India lies in steering the economy to a higher growth path without generating inflationary pressures which themselves may hinder growth.

Note:

1. Impossible trinity disallows the simultaneous achievement of exchange rate stability, monetary independence and capital market integration. Any

two of these goals may be attained but never all three. The combination of managed flexibility and partial capital account controls has allowed India, to a large extent, the trilemma of the famed Impossible trinity. India never took three as with the case of East Asian Countries in 1997.

2. Systemic risk is nothing but the risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy.

Systemic risk(*Karmakar and Jana,2019*) occurs from the following sources:

a) Exposure to asset price (real estate) bubbles resulting from loose monetary policy due to the presence of global imbalances that led to excessive credit availability;

b) Multiple equilibria and panics— the latter that deserve some attention as one of the macroeconomic aspects of systemic risk ;

c) Inefficient liquidity provision and the mispricing of assts;

d) Contagion (possibility that the distress of one financial institution spreads to others in the financial system, thus leading ultimately to a systemic risk);

e) Sovereign default— a serious problem occurred in Europe in the spring of 2010 in its own right because of its effect on the stability of the banking system; and

f) Currency mismatches in the banking system.

To tame the systemic risk is the most important task of the RBI as a central

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