BOOK REVIEW

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MONETARY POLICY

PARTHA RAY

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Review by

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The book titled ***Monetary Policy*** has been published under the Oxford India Short Introductions (OISI) series. The task of writing books under this series is a challenging one, as the authors are supposed to tell a story without compromising the academic rigour so that it benefits a spectrum of readers, ranging from the novice to the subject right up to the professionals and policy makers.

My first remark is that Partha Ray (currently Professor (Economics), Indian Institute of Management Calcutta) has been one of the most appropriate author to write such a book, given the fact that he has seen the task of formulation of monetary policy from close quarters (during his stint at Reserve Bank of India and also at International Monetary Fund) and has also has engaged himself in academic discourses in monetary theory.

The book contains: (i) an introductory chapter titled 'What is monetary policy?'; (ii) Indian Monetary policy during 1934 to 2011 (sub-divided into five phases of monetary policy which each of which constitutes a chapter) and an epilogue. These are followed by an Annexure giving details of duration and names of the RBI Governors, references, further readings and the index.

The introductory chapter neatly blends the theoretical aspects and issues pertaining to monetary theory and monetary policy in both global and the Indian contexts. The chapter includes the definition of money and monetary policy. It traces the evolution of Central banking in global context and lays down well researched historical facts as to the conditions that led to evolution of central banks in various countries, such as the need for: clearing house; purchase of government debt; controlling the chaotic monetary and financial conditions; injection of liquidity; banker to the commercial banks, etc. It is pertinent for the reader to know these historical facts that educate her to appreciate the role and functions of monetary policy in the Indian context. This chapter also traces the evolution of money from commodity money to paper money and while discussing the supply of money it takes into account the bank money or deposits which are included in the concepts of narrow and broad money. The author could have explained in this chapter the complications that arise in defining supply of money due to the existence of plastic money and internet banking.

Another theme that this chapter deals with is the theoretical approach to demand for money, wherein the author mainly deals with the Keynesian approach which identifies

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transactions and speculative motives for demanding money by an individual that depend on income and interest levels, respectively. Translated into the macro context, the demand for money in an economy depends on the level of national income and the interest rate (barring the liquidity trap situation). This is followed by the discussion on supply of money wherein the author explains the components of money supply, measures of narrow & broad money stock, reserve money. This equips the reader for understanding the concept of money-multiplier that follows later in the chapter.

The author then goes to unfold the various schools of thought of monetary policy, which differ mainly in respect to their views on the relationship between the monetary and real sectors. The author discusses Quantity Theory which regards that quantity of money can at best only lead to price changes and an anti-inflationary policy would constitute control of money supply. This is followed by discussion of: Keynes' analysis of monetary sector being crucial in influencing real sector under conditions of less than full employment; Phillips Curve (PC) that highlighted the choice between inflation (monetary variable) and unemployment (real variable); Milton Friedman's demonstration of the limits of monetary policy in influencing real variables through the construct of a vertical PC in the long run; Monetarism; revival of classical viewpoint on dichotomy between real and monetary sectors through by new classical economists through the construct of rational expectations; and revival of Keynesian ideology by the New Keynesians using the reasons such as menu costs, coordination failures, information asymmetry, etc. due to which inflexibilities and rigidities in prices and wages will prevail. The ease with which the author communicates these technical discussions with utmost simplicity without losing rigour of analysis is simply remarkable. The author concludes that the recent events of the global financial and economic crisis have demonstrated the need for activism of monetary policy by the central banks.

As historically, the genesis of Central Banks in various countries had different reasons and the fact that the economic problems witnessed by countries differed over time, the objectives of monetary policy of central banks need not be identical. However, world over, control of prices is regarded as a prime responsibility of Central Banks. In view of this, the author discusses inflation targeting (headline inflation) by select countries, issues pertaining to measurement of inflation, episodes of hyperinflation and the impossible trinity in an open economy. In brief, this section of the chapter is based on both theory and historical facts.

The author also introduces the reader to the various instruments of monetary Policy - direct and indirect. He discusses the analytics of reserve ratios, money-multiplier, Open Market Operations, Repo operations, direct credit control, prudential regulations (micro & macro) and the operating procedures of monetary policy. The reader is also provided with a neat summary at the end of the chapter.

As mentioned earlier, the five phases of monetary policy in India, ranging from the conception idea of a central bank for India to 2011 has been provided in Chapters 2 to 6.

Chapter 2 describes the initiatives to establish a central bank (during 1927-34) for India and provides a historical account of the birth of Reserve Bank of India. The unfolding of monetary policy during the colonial era (1934 to 1950) has been described in this chapter. It also puts forth the critical viewpoints of monetary policy operation during this era in terms of it being playing a subservient role to the needs of colonial power. In brief, the author acquaints the reader with a historical perspective of monetary policy and central banking in India during the colonial era.

Chapter 3 discusses the conduct of monetary policy in India during 1951 to 1968 and calls this as the Foundation Stage. The author highlights that during this period, the centralized planning and resource allocation made the monetary policy subservient to overall economic policy. Monetary policy attempted to smoothen the fluctuations in prices and output that were caused by dislocations in the real sector for which it was criticised even by Milton Friedman. The author could have brought in political dimensions also in this chapter, as India had fought two wars during this period. The nexus between monetary and fiscal policy could have been empirically demonstrated in this context by adding a column on the data on deficit financing in Table 7 on economic indicators. During this period, there were also strains on foreign exchange reserves which culminated in a major devaluation of the Indian rupee. In brief, political upheavals, natural calamities and unduly controlled regime of the Indian economy provided hardly any major role to monetary policy.

Chapter 4 encompasses the period between 1969 and 1985 during which nationalization of major commercial banks was undertaken with a view to snap the link between ownership of banks and firms. The objective of monetary/credit policy was to provide credit not only to the large corporations but to smaller firms as well, in line with the overall developmental objectives. The chapter is well spiced with anecdotes and the reader will enjoy reading the political economy of nationalization of banks presented in this chapter. The author gives examples (priority sector lending, pre-emption of resources through CRR and SLR, administered interest rates, etc.) of how monetary/credit policy assumed the character of socialist planning which had both positive and negative impacts on the Indian economy. The response of monetary policy to the two economic crises, 1973-75 and 1979-81, during which the oil-price shocks and overall inflation rates shot up. The author could have also emphasized the impact of droughts which aggravated the inflation witnessed during these episodes. The difference between the two oil-shocks was that the foreign exchange reserve position in the aftermath of the first oil-shock was reversed due to the remittances from the Gulf countries, whereas, no such cushion was available to overcome balance of payments position after the second oil crisis. Inflation which could be controlled after the first oil crisis attained an upward structural shift after the second oil crisis. This is well documented in the data provided in the Chapter.

Chapter 5 discusses the period 1986 to 1997-98 during which monetary targeting was experimented in the Indian economy. End of the eighties was characterized by a repressed financial system, high inflation, a precarious balance of payments position and widening fiscal deficit. In view of this, monetary targeting with feedback was suggested by Chakaravarty Committee Report (CCR, 1985), though it was not exactly same as experimented by other developed countries. The Chapter acquaints the reader with the major recommendations of CCR and the basic tenets of monetary targeting. This chapter also outlines the several reforms in the arena of financial sector, coordination between monetary and fiscal policy, external sector policies and critiques the experiment of monetary targeting.

Chapter 6 presents the developments in Monetary Policy during 1998 to 2011 period. This period begins with adoption of Multiple Indicator Approach (MIA). This approach monitors through multiple indicators besides money supply, such as interest rates, fiscal deficits, balance of payments, GDP, etc. Moreover, it also captures the expectations of various macroeconomic fundaments. It also highlights the transition from direct to indirect and market oriented instruments of monetary policy. The Chapter meticulously explains the operations of Open Market Operations (OMOs), Repo transactions, Liquidity Adjustment Facility, other new instruments/institutions and the manner in which these instruments are used for dealing with volatile capital inflows/global financial crisis. The reader finds in one place recent developments pertaining to monetary policy and also their operational analytics.

The chapters are followed by an epilogue which concludes the book with the key issues confronting the conduct of monetary policy in India.

The book is highly readable, with an optimum combination of data, history, information and analytics. It is indeed a welcome addition to literature on monetary policy, especially in the Indian context. In fact, such a book was highly required to update the readers after the publication of Vasudevan (2003).

References:

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Vasudevan, A. (2003), Central Banking for Emerging Market Economies, Academic Foundation, New Delhi.

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