

Challenges for Monetary Policy*

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It is a great honour and privilege to be invited to deliver the Kale Memorial Lecture. Rao Bahadur R.R. Kale was a well-known leader who played a notable role not only in the political but also in the social and economic life of Maharashtra. His contributions to the development of education are well known. His generous contribution helped to establish the Gokhale Institute of Politics & Economics at Pune, which has emerged as a leading research institution in the country in the field of economics, politics and sociology. Professor D. R. Gadgil and Professor V. M. Dandekar, to name only a few, who were associated with this Institute, have made landmark contributions to the development of economic policy in post-Independent India. Kale Memorial Lecture is a prestigious lecture series, which includes contributions by many distinguished and outstanding personalities of our country. I, therefore, feel greatly honoured to deliver this year's lecture.

I want to speak to you this morning on the challenges for monetary policy in general and in particular for India. These challenges have been changing over time, even though some basic issues have remained to be perennial concern. As the institutional environment (both domestic and global) changes, the tasks of monetary policy also undergo a change. The monetary and financial system is far more complex today than it has been in the past. Financial intermediation has reached a high level of sophistication. 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 speed with which funds can move across borders has raised issues regarding coordination of monetary policies among countries. Prices and interest rates are no longer determined by domestic factors. While traditional issues such as the objectives of monetary policy, the possible trade-off among them and appropriate intermediate targets remain relevant, they need to be related to the changing institutional environment at home and abroad.

At a theoretical level, in the classical tradition strict neutrality of money ruled out monetary influence on real output. The formal enunciation of money and price relationship was made in the form of the famous Quantity Theory of Money under which money influenced only price. The neutrality proposition underwent a change in the Keynesian analysis. The neutrality view was abandoned and money was seen to have an influence on output through a variety of channels. The Phillip's Curve depicting the inverse relationship between unemployment and wage inflation provided the empirical basis for the non-neutrality proposition. While several economists (Friedman, 1968 and

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