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Future of Central Banking in India

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President Jajodia, Vice President Goenka, and friends,

I am grateful to Assocham for inviting me to deliver the prestigious J.R.D. Tata Memorial Lecture. J.R.D. Tata's contribution to our country and to society at large is legendary. We recognise that. But, we in India have also been guilty of not learning adequately from him in the conduct of public policy or standards of governance in private sector. In 1970s and in 1980s, we generalised the conduct of private sector as 'bad' and adopted anti-private sector policies. We summarily rejected the philosophy of Rajaji and example of Tatas. Less said the better about some of the private sector in recent years.

JRD was a global citizen, but that did not make him less of a patriotic Indian. But, in 70s and 80s we became inward looking and started invoking for "foreign hands" to deflect attention from our failures.

JRD Tata was futuristic in his thinking, a visionary in thought and deed. He should be an inspiration for millions of entrepreneurs and multitude of policy-makers to combine and balance public duty and private initiative; global outlook and national loyalties; and finally, the present with the future.

As a tribute to his philosophy of life described, and in recognition of his services as member of the Board of Reserve Bank of India, I will speak today on "Future of Central Banking in India".

There is another reason why I selected this subject. There is considerable discussion about the independence of central bank in India. At the same time, there are many who argue that RBI is the creation of the government and accountable to government. Hence, too much of independence cannot be justified. There is a basic philosophy behind the arrangement of central bank to be the guardian of money and finance. The idea is to convince people that they can have trust in money and finance irrespective of political changes since an independent institution, namely, central bank, has been entrusted with such matters. Further, the government has spending authority and, therefore, it wants to convince people that creating money is being handled by another institution. In other words, a central bank is an institution created by the government for its own purposes. The government would like to convince people that central banking is independent but would like the central bank to do what it wants. Central bank has to convince the people that it is independent if it wants to be effective. This is the tussle that has been happening for a long time and in all countries. The balance keeps changing depending on the context. I hope to add some clarity to the on-going debate on central banking in India.

It is useful to have a peep into the past, and assess the present in order to explore the future. I will be detailed on the past since I have comparative advantage; hesitating about the present since most of you know the present better than me and brief about the future that is largely unknown.

Let me begin, Mr. President, in a lighter vein. The RBI building is a landmark building on Parliament Street in Delhi. There are two huge statues – Yaksha and Yakshini at the entrance. This became controversial when a question was raised in the Rajya Sabha. It ran as follows: Why were statues of naked women put in front of the RBI Building? The origin of the statutes was a desire expressed by Pandit Nehru that we should encourage Art and Architecture in the capital. The RBI Board took the suggestion seriously. J.R.D. Tata who was a member of the RBI Board, suggested the name of Carl Khondanwala who was an active art critique and eminent architect. The statues were made on his recommendation. In some ways, JRD Tata contributed to the erection of the pieces of art in Delhi, which was mistakenly described as 'naked women'; and fortunately the incident was forgotten. Be it pieces of art or public policy in India, JRD's imprint can be found.

The Past

The Reserve Bank of India (RBI), set up originally as a private shareholder institution under the Reserve Bank of India Act, 1934 commenced its operations on 1 April 1935. Till independence, its coverage extended to British India. Its core objective as stated in the preamble to the Act at that time was "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 advantage."

On the eve of independence, RBI ceased to act as a banker to the Government of Burma but continued to provide central banking services to Pakistan until 1948. In

the following year (1949) the RBI was nationalised. The same year, the Reserve Bank was given the power to regulate commercial banks.

The RBI became accountable to the Union Government (Ministry of Finance) under the Constitution that launched the Republic of India on 26th January 1950. After the integration of princely states that preceded the adoption of the Constitution, RBI became debt manager and banker also to State Governments through agreement with each of them.

Subservience

With the establishment of Planning Commission in March 1950 and adoption of planning as the driving force for policy interventions in the economy, the RBI's policies had the toe in line with plan priorities. For instance, when deficit financing became an acceptable mode of financing development plans, the RBI agreed to finance the Central Government's budget deficits without any limit through issue of *ad hoc* Treasury Bills in 1957. This resulted in automatic monetisation of government deficit severely constraining monetary management by the RBI.

This is the beginning of the phase of overriding importance to funding of needs of Government.

In 1966, RBI took the drastic step of devaluing the Rupee by 57%. It faced criticism from the Parliament, media and the public. The decision was essentially that of the Government duly advised by RBI. RBI considered it necessary under the circumstances. It was difficult to keep the value of the currency stable due to the

increase in public debt and reduction in foreign aid flows in the context of the Indo-Pak and Indo-China wars.

The nationalization of fourteen private sector banks that controlled 70% of the country's deposits in 1969 was a milestone in the country's economic management by the Government. The decision was not in consonance with RBI's stance, and was admittedly political. Six more banks were nationalised in 1980. The implicit signal to the private sector banks was that, if it grows big, it will be nationalised. This stifled growth of private sector banking. Inevitably RBI became not merely a regulator but also a junior partner with the government in the banking system. Consequently, monetary management by RBI became subject to, if not subservient to, both the financial sector policy and fiscal policy of government.

In 1972, National Credit Council (NCC) emphasized that commercial banks should play a larger role in extending credit to rural and other sectors considered to be a priority both from social and economic points of view. The following year, regional rural banks (RRBs), a new set of banks marrying cooperative and commercial principles, were started. With these policy actions, RBI became closely involved in deciding the cost and disposition of bank credit among users, in alignment with the plan priorities set by the Government.

In 1973, the Foreign Exchange Regulation Act was passed repealing the earlier Act of 1947. The Act expanded the administering 'controls' over availability and use of foreign exchange. RBI ensured that the remittances out of the country were severely constrained and closely monitored.

Was Indian Central banking alone in the subservience?

The subservience of RBI to Government up to 1960s was in alignment with global trends (barring, perhaps, Germany and Swtizerland). Great Depression and collapse of the Gold standard, represented failure of prevalent models of central banking. The demands of Second World War warranted subservience. The socialist model of development and the compulsion of post war reconstruction also meant subordination of central bank to government control. Central bank's advice was valued on policies, but was used by governments to administer controls and regulate or manage banks.

The 70s was a period of confusion for central banks with collapse of Bretton woods System in 1972-73 and hyper inflation partly caused by oil shock in 1973. RBI also shared the confusion but the economy was also affected by domestic political development in 1970s. Emergency period witnessed subordination of RBI to Government.

The success of Paul Volcker in USA in containing inflation shifted attention to clarity. The clarity evolved during the dominance of market ideology in 1980s through inflation targetting. This was first formalised by New Zealand in 1988 and adopted by Bank of England in 1997.

By the early 1980s there was some consensus in the RBI that inflation was rising because of a surge in money supply. This concern coincided with global concerns about inflation, and rise to prominence of Paul Volcker in USA. In 1985, the Sukhamoy Chakravarthy Committee recommended a clear framework for the country's monetary policy in the form of monetary targeting to ensure price stability. The Committee recommended control of inflation within acceptable levels and

monetization of government deficit within limits consistent with money supply growth targets. The emphasis on restraining the automatic monetisation reflected the global preference for greater weight than before for inflation or price stability.

In practice, RBI had to recourse to regulatory actions, stipulation of high Statutory Liquidity Rate and Cash Reserve Ratio to manage the growth in money supply. The era of self accelerating financial repression began. RBI followed a range rather than a fixed target for the annual growth of money supply which was further subject to mid-year adjustments. Administered interest rate regime also had undergone a change ostensibly more in favour of promoting long term savings.

For most of the 1980s, there was a quantum jump in growth, thanks to early industrial and trade liberalization measures and some financial market reforms. RBI became concerned with higher fiscal deficits and large borrowing programme financed through monetization. Towards the end of the 1980s, short term external financing also increased. The collapse of the USSR added to the imbalance in external sector. RBI negotiated the transition of rupee trade agreement with Russia. Added to political uncertainties, the Gulf crisis triggered high oil prices further tightening the balance of payments situation. NRI deposits and remittances were adversely affected. RBI repeatedly warned the government about the possible crisis because of large deficits in fiscal and external sectors. The political instability during this period of domestic vulnerabilities coupled with gulf crisis led to the balance of payments crisis in early 1991.

The RBI successfully avoided hyper inflation and also ensured that banking system retained the confidence of the people at large. Part of the credit should go to

Government because the political pressures in a functioning democracy helped contain inflation. Further, public sector banking itself provided the necessary comfort to people at large. The balance of payments was on a different footing. RBI conveyed its concerns as the situation was deteriorating and warned the Government of impending payments crisis.

Crisis Management

The RBI became the first line of defence as the stress in balance of payments became acute in 1991. However, management of a full-blown crisis required the total involvement of the government. Despite political uncertainties, the government took the advice of the RBI and strongly supported its emergency actions in both financial and external sectors. It culminated in using gold belonging to the government and pledging the gold belonging to the RBI to save the country from loss of reputation and defaulting from meeting external payments. Negotiations with the International Monetary Fund were held in order to obtain the support in climate of political uncertainty. The RBI and the Government drew upon their professional skills and clout both within and outside the country to device strategies and actions. The apolitical stature of RBI won the support of the full spectrum of political leadership.

The reforms that commenced in 1991 following the crisis of 1991 became a watershed in the economic development of the country. Beginning with the two-step devaluation of currency and the reform budget, the post 1991 period ushered in a dramatic shift in the relationship between the government and the RBI. Thus began a partnership between the RBI and the Government in bringing about fundamental changes on several fronts.

Reforms with Indian characteristics

The Reforms that commenced in 1991 were in some ways a belated effort to catch up with changing contours of central banking globally. The process was, however, remarkably smooth and non-disruptive, and in some ways, reform of financial and external sectors with Indian characteristics. RBI rejected inflation targetting and single objective, unequivocally. It did not share the enthusiasm for capital account and decided to manage impossible trinity. These were points of departure from global practice.

The Budget 1993-94 announced a move towards a unified exchange rate or a market-determined management system, marking the transition to convertibility on the current account soon afterward.

The RBI entered into agreements with the Central Government beginning 1993-94, to phase out issuance of ad hoc Treasury Bills and eliminate it altogether from April 1997 substituted by Ways and Means Advances (WMA) within limits putting an end to the era of automatic monetization of budget deficits (explain). This provided greater manoeuvrability to RBI in monetary management. The monetary targeting framework was refined and implemented as part of the reform with the initiatives from Governor and approvals of the Finance Minister.

In April 1998, RBI decided to switch over to multiple indicators approach as a new framework for the conduct of monetary management which looked at a variety of financial market and economic indicators to evolve appropriate stance of monetary policy.

The fiscal transparency and some fiscal rules were ensured through the Fiscal Responsibility and Budget Management Act enacted in 2003 with appropriate technical support from a working group of RBI.

RBI strengthened its advisory and debt and cash management roles for State governments since the late 1990s, with the institution of regular meetings with Finance Secretaries and Committee of Finance Secretaries.

These were some steps towards evolving global best practices.

The full convertibility on current account as per the government policy and management of capital account by RBI were the two corner-stones of liberalised external sector management. The current account convertibility and market determined exchange rate since the early 1990s made provisions of FERA redundant. In late 1999, the Foreign Exchange Management Act (FEMA) was passed replacing the Foreign Exchange Regulation Act (FERA) of 1973.

These mark a departure from the generally advocated, if not fully implemented thrust towards simultaneous liberalisation of external and financial sectors.

Besides the implementation of the monetary policy, RBI also has the function of financial regulation and supervision to ensure that the country does not get into an economic crisis. To ensure that this function is carried out in the best possible way without any conflict of interest with regulatory functions, the Board for Financial Supervision (BFS) was set up in 1994 as an autonomous body under the RBI. Although the Board was meant to regulate commercial banks, 1997 witnessed strengthening of supervision over Non-Banking Financial Companies (NBFCs). In

2005, RBI set up the Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) to oversee the payment and settlement system. Under the Payment and Settlement Systems Act, the Board is empowered to authorise, prescribes policies and set standards for regulating and supervising all payment and settlement systems in the country.

In parallel, several new institutional arrangements were put in place by the government. These included establishment of securities market, pension, and insurance regulators. The Governor, Reserve Bank, as the head of High Level Committee on Financial Markets virtually assumed the responsibility for coordination in matters relating to money and finance while being accountable to the government.

There were several policy challenges that had to be met during the 1990s and the early part of the millennium such as the contagion effects of Asian crisis, the Russian and the Mexican crisis, the fall out of US sanctions as a reaction to our nuclear program, Kargil war, and Y2K problem. These were successfully managed thanks to decisions taken by the government to empower the Reserve Bank of India and enhance the role of financial markets.

During this period, several statutory amendments took place regarding RBI Act, Banking Regulation Act, Payments and Settlements System, Financial Markets, etc., to clarify and enhance the role and effectiveness of Reserve Bank of India in conduct of monetary policy and managing financial system. Innovative policy initiatives such as the Market Stabilisation Scheme involving close and continuous collaboration between government and RBI for liquidity management were put in place.

Divergence from global thinking

From 2004, the government and the RBI had to face unfamiliar challenges on account of marketisation and its integration with global economy. These related to large capital inflows, high economic growth, unprecedented expansion in credit, asset bubbles and absorption of a highly elevated oil prices. These resulted in some tensions between the government and the RBI in the areas of monetary management and external sector. While concerted action was possible for strengthening the private sector banking system, the regulatory actions of a prudential and counter-cyclical nature by the RBI were undertaken despite some resistance from government and financial markets.

The global thinking on finance and money was appealing and euphoric during early part of 21st century. There were clear signs of divergence between RBI's caution and global preference for market based finance leading the development as well as relying on market mechanisms more than regulation. RBI did not, perhaps, could not oppose the combination of marketisation, financial safety and globalisation that was advocated, but insisted on gradual, slow, calibrated approach to reforms in that direction. RBI was out of alignment with central banking globally in terms of inflation targetting and independence of central banks. But they were moving in that direction on a voluntary basis. But, India was not alone in resisting the global trends but the pressure to join the trend was noticeably excessive. The global financial crisis put an end in many ways, to the misalignment of RBI with global central banking.

Present

Globally, central banking had its pride in achieving high growth, low inflation and low volatility in both. But, the crisis put an end to it. Yet, they were on the foremost to manage the crisis. In the task, central banks had to play a major role, especially when they were the problem. There are three features of central banks response to crisis, namely, (a) unconventional monetary measures; (b) closer coordination with government and regulation; and (c) review of approach to central banking

Global approach to central banking came under intense scrutiny with the occurrence of Global Financial Crisis (GFC) in 2008. There are many who ascribe the crisis to the poor regulation of financial sector and global imbalances rather than inappropriate monetary policy. There is, however, general agreement, if not unanimity, on the infirmities in the policies that contributed to the crisis.

The nuanced approach on which there is broad agreement, though not unanimity, may be summarised as follows:

First, price stability remains primary objective but not the sole objective. Financial stability, and in particular, the movement in asset prices has to be factored in.

Second, inflation targetting is still appropriate, except that preference is for flexible inflation targetting.

Third, the focus of the models on the role of money should not ignore several important relevant developments. For instance, while taking credit for "Great

Moderation", the impact of globalisation of trade and the consequent beneficial impact on inflation globally was under-estimated.

Fourth, technological changes have contributed to a disconnect between output, employment and inflation. A simple co-relation between output and employment did not represent the evolving reality.

Fifth, there is a need to supplement counter-cyclical monetary policies with counter-cyclical macro prudential regulation.

Sixth, capital controls may be warranted in some circumstances. Thus there is greater convergence.

Finally, there is need for coordination of monetary policies with other policies. The coordination has to be at two levels, namely, (a) coordination with fiscal policy and financial sector policies within the country and (b) coordination at global level, with the counter-parts in other countries.

The central banks in AEs are facing new challenges in terms of effectiveness of their policies.

Crisis and Recovery

Both fiscal and monetary stimulus in India were undertaken and supplemented by regulatory forbearance by RBI. After some time, it became evident to RBI that withdrawal of stimulus should be commenced. The fiscal authorities, however, did not seem to be on board. This proved to be stressful. However, it must be recognised that coordination becomes difficult during extraordinary situations and this was no

exception. However, these developments led to the questioning the monetary policy framework that was in place.

The conduct of monetary policy in India underwent a transformation since 2014, transiting to a flexible inflation targeting framework. During 2014-15, a formal architecture for flexible inflation targeting was put in place through an agreement between the RBI and Government. The liquidity management framework was also revised in the write-up of the new monetary policy framework. Recent amendment to the RBI Act, 1934 came into force in June, 2016. The amendment explicitly provided the legislative mandate on the monetary policy framework of the country. The primary objective has been defined explicitly which is "to maintain price stability while keeping in mind the objective of growth". The Constitution of MPC was mandated and entrusted with the responsibility to determine the policy rate required to achieve inflation target.

The new formal fiscal and monetary framework for the interface in India provides greater clarity than ever before on the respective role of monetary and fiscal authorities. We now have a rule-based fiscal policy mandated by FRBM Act and a rule-based monetary policy through the amended RBI Act.

There are elements of continuity. The monetary policy committee is in some ways a formalization of an improvement over the Technical Advisory Committee appointed by RBI over ten years ago. RBI had also articulated the concept of self-imposed inflation target. Inflation expectations survey had already been taken up. However, the institutional changes are significant for formalizing them.

There is one open issue. Is RBI identity as a full service bank under threat? Only future can tell.

The pre-occupation of both Government and RBI with crisis management meant that structural issues remained unaddressed. But, Government continued with a policy of seeking advice on money and finance beyond RBI – the culmination being appointment of Justice Sri Krishna Commission.

The Approach Paper of 'Financial Sector Legislative Reforms Commission' stated, 'After the global financial crisis of 2007 / 2008, a new literature has emerged asking whether some countries have a financial system that is too large. There is possibly a cause for caution in the financial development in such situations. However, the present state of the Indian financial system lies far below the thresholds that are tentatively identified where difficulties can arise. For a few decades, these considerations will not be a constraint in India' (Financial Sector Legislative Reforms Commission 2012: 6).

The assumption appears to be that lessons of Global Crisis do not apply to Indian conditions. In practice, however, there is sensitivity in the Government to the lessons learnt from the crisis.

I fully endorse what Raghuram Rajan says in his book titled "I do what I do".

"Is there a reason we need more checks and balances, or are we trying to solve a problem that does not exist. As the Chinese would say, let us recognize the value of crossing the river by feeling each stone before we put our weight on it. Let us not take a blind jump hoping that a stone will be there to support us when we land."

Lessons

What are the lessons from the past?

First, the idea of independence of central bank as central to monetary policy is a more recent phenomenon. It is not as universal as it is believed.

Second, central banks had been for most part, performing multiple functions: towards (a) price stability; (b) output and employment; (c) financial sector development and stability and support government borrowing program when appropriate, and restraining use of such papers when necessary. The relative emphasis depended on the context.

Third, there is not a single model of a central banking that is universally valid though with increasing global integration, coordination across the countries is useful. But diversity may moderate risks.

Fourth, some universal rules like Taylor rules were introduced in monetary management as universally valid rules for scientific management of monetary policy. But some countries like India did not subscribe to this.

Fifth, India has been in alignment with globally preferred model, but did not hesitate to deviate when needed.

Sixth, RBI has been among more successful Central banks.

Finally, there are periods in history when there was confusion about the optional model for a central bank. Currently, we may be in one of such periods.

Future

What will be the future of central banking?

I can do no better than quote Professor Goodhart from BIS Working Paper 326, November, 2010.

"Now there is a good chance – but not a certainty – that we are entering a fourth epoch, in the aftermath of the financial crisis of 2007-10.

This is likely to involve some return towards the second epoch, with more intrusive regulation, greater government involvement and less reliance on market mechanisms. I would hope that we only go part way back. Instead of central bank subservience, perhaps we could have a more even-handed partnership. But the range and scope of interaction with government, on the bank tax, on regulation and sanctions, on debt management and on bank resolution, is likely to increase. The idea of the central bank as an independent *institution* will be put aside."

Rebalancing

As I see it, the central banks will have to cope with two sets of issues, those relating to rebalancing in several policy fronts and mega trends.

Simultaneous rebalancing on several policy fronts characterises the future and central banking will also be rebalanced, in alignment with changing balances.

First, national governments are seeking greater policy-space to address the concerns of their citizens: thus, redefining the role of national policies in the global

economy. What are the implications of USA (the global currency) moving in that direction?

Second, due to inequalities and environmental concerns, the roles of state and market in public policy are being redefined.

Third, the risks and rewards of globalisation of finance are being re-evaluated.

Fourth, the disconnect between financial markets, especially stock markets and real activity such as output and employment, has to end, sometime or the other.

Fifth, diversity in central banking practices on the run-up-to-the crisis helped countries like Canada, China and India, to maintain global growth momentum when the advanced economies were stalled. A rebalance between usefulness of diversity and advantage of coordination will be needed.

Mega trends

There are discernible mega trends which cannot but impact the role of central banking in future.

First, since the crisis, there has been only marginal change in the international monetary system, governance of multilateral institutions and regulatory frameworks.

Second, titanic changes in demography especially China / Japan / Europe will influence macros such as Savings and consumptions. Impact of migration on wage levels and, thus, inflation is already evident.

Third, Varied impacts of technology and migration on macro balances and public policies across the global economy are unclear.

Fourth, globally, economic activity is shifting from West to East. Real activity may shift but finance may take longer time. Currently, most disputes can be settled only in the West because of the legal frameworks and stipulation in the contracts.

Fifth, the growing diversity in the structures and relative positions of AEs and EEs with blurring of distinction between AEs and EEs.

Concluding Remarks

In conclusion, the RBI has been serving the nation since Independence to the best of its capacities and acquired a reputation for high integrity and professional competence. Over a period, it has won the trust of people at large and the financial system, particularly the banking system. The extent to which and the way it could serve the nation has been dictated by the demands from the government and evolving economic compulsions. In doing so, it wore different caps, sometimes an agent, often an adviser, and to the extent feasible, an operationally independent central bank. Over a period of 70 years, RBI has earned the respect of people at large, domestically, and admiration of many, globally.

I have confidence that RBI, our central bank, will manage the future creditably. Let me end in a lighter vein: A long standing Finance Minister of India said: "No matter who we send to RBI as Governor, the technocracy in RBI captures him."

It is the professionalism in RBI that earns its autonomy, to serve the nation, as it should.

Thank you.