Talking Points

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Central Banking in India: Retrospect and Prospects

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Dear Friends,

It is my privilege and great honour to be invited to deliver Kale Memorial Lecture. Shri R R Kale has done great service to the country by founding the Gokhale Institute of Politics and Economics in 1930. The Institute is a product of his vision, foresight and generosity. It is not a mere research or academic institution believing in excellence in scholarship. It is much more than that. It stands for service, courage and dedication to social and ethical values that are cherished in India. I have known and worked with some of its products. They believe in simplicity in personal lives also. I take this opportunity to pay a tribute to the founder, and to the institution.

There are several reasons for selecting the subject for today's lecture. Many Kale Memorial Lectures in the past related to central banking, and one of them is by Dr. C D Deshmukh in 1948 on "Central Banking in India – A Retrospect". It was delivered in the backdrop of differences between Government and RBI on nationalisation of Reserve Bank. I want to revisit the subject to trace developments since then and explore emerging issues, with special reference to current context.

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Current Context

The issue of governance in central banking is being widely debated globally. U.S. President Donald Trump has criticised the Federal Reserve for raising interest rates. European Central Bank president Mario Draghi recently raised the issue of the threat to central banks' independence from governments stating that the "ECB mandate does not involve financing government's deficit". President Erdogan accused the Central Bank of a "traitorous" reluctance to lower interest rates. In India, tensions between Government and the Reserve Bank of India (RBI) in the very recent past have been aired in public culminating in the resignation of Governor Urjit Patel.

Mr. Das who took over as Governor in December 2018 said: "I will try and uphold the professionalism, the core values, the credibility and the autonomy of Reserve Bank."

Fiscal deficit has been a concern for long in India, but current concerns have new dimensions. There are controversies about measurement of GDP. The Comptroller and Auditor General of India mentioned that the deficits are under-stated. The critics point out that the dividend from RBI to the Government already exceeds the dividends to Government from all public enterprises. Yet the Government has sought and obtained interim dividends recently, obviously to meet cash needs. While a Committee is examining Government's claim on the accumulated reserves of RBI, including those on account of revaluation, it has been reported two days ago that RBI is being asked to pay to Government as dividend the amounts that have been transferred to reserves in the previous two years. Cumulatively, these events are being interpreted by some critics as replacement of "automatic monetisation of pre-reform period" with what may be termed as "coercive monetisation of fiscal needs".

The critics also point out that the fiscal authorities are using the banking system to implement the Government's programmes on unprecedented scale. With the latest directions from the Government on lending to SMEs, the critics point out that "behest lending" of pre-reform period has been replaced with "lending on command".

Governor Patel had spoken about need for regulation being ownership neutral. The Government, however, countered with the statement that the Reserve Bank has adequate powers of regulation and supervision over public sector banks, though it did not deny that such regulation was not on par with other banks.

Of particular significance is the proposal in Oct. 2018 to invoke Section 7 of the RBI Act, an unprecedented move by Government. In many ways, this raises fundamental questions on governance.

My presentation today is in the nature of narration of flow of events and ideas that led us to the current context from the time Deshmukh delivered this lecture soon after independence.

Retrospect

Reserve Bank of India was set up originally as a private shareholder institution under the Reserve Bank of India Act, 1934. It commenced its operations on 1 April 1935.

The RBI was nationalised in 1949, despite RBI's protest. The Reserve Bank was also given the power to regulate commercial banks after the failure of several banks at that time. The RBI became accountable to the Union Government (Ministry of Finance) under the Constitution that launched the Republic of India on 26th January 1950. RBI became debt manager and banker also to almost all State Governments through agreement with each of them. Thus, RBI became a fully government owned full service central bank. RBI's role in Indian economy, in particular in relation to government, has been evolving responding to the needs of the day within the mandate set by government from time to time.

The retrospect can be divided, for purpose of convenience, into several phases roughly as a twenty year cycle: namely, 1950-1970; 1970-1990; 1990-2010, and post 2010.

Planned Fiscal Dominance: 1950-1970

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 to be in line with plan priorities.

Reserve Bank of India's development orientation was clear from the All India Rural Credit Survey ordered by RBI under directions of a Committee set up in 1951. Its report in 1954 forms the edifice for policy of RBI towards institutional credit.

The mid-fifties saw the beginnings of serious erosion of autonomy in the monetary policy function due to the emergence of the system of *ad hoc* Treasury Bills and automatic monetisation. Under the system it was agreed that RBI would replenish Government's cash balances by creation of *ad hoc* Treasury Bills in favour of the RBI. The *ad hoc* Treasury Bills, which were meant to be temporary, lasted for over four decades.

The issue of relations between RBI and Government gained prominence in 1957, when Benegal Rama Rau resigned in response to a letter from Prime Minister. Governor Rau asserted his right to be consulted before a decision was taken by the Government on "technical and sometimes complicated monetary issues". Pandit Nehru maintained that RBI is "centrally autonomous but it is also subject to the central government's directions". Nehru's stand was that RBI is independent within the Government. There are similarities as well as dissimilarities in the events leading to Governor's resignation in 1957 and in 2018.

In mid sixties, India had to access funds from IMF. The initiatives continued to be with the Ministry with RBI playing a supporting role. In 1966, RBI took the drastic step of devaluing the Rupee by 57% in accordance with the decision of the Government duly advised by RBI. The action invited wide spread adverse reaction, but Government owned up the decision.

There is only one notable event that, perhaps, dented the reputation of RBI, namely, the collapse of Palai Bank in Kerala in 1960. However, the outcome of the scam is the birth of deposit insurance and the legislative empowerment of RBI to forcibly merge banks.

During this period, the RBI attracted professional talent and the officers of the Central Bank were held in high esteem, not only in global institutions like International Monetary Fund and the World Bank but also in other countries.

The subservience of RBI to Government in 1950s and 1960s was in alignment with global trends in general. The demands of Second World War had warranted subservience, but the compulsion of post war reconstruction and the socialist model of development also meant subordination of central bank to government control. No doubt, Central bank's advice was valued on policies, but it was also used by governments to administer controls and regulate or manage banks.

Fiscal and Financial Sector Dominance: Inward Looking (1970-1990):

The 70s was a period of confusion for central banks globally with collapse of Bretton woods System in 1972-73 and hyper inflation partly caused by oil shock in 1973. In India, the confusion was compounded by domestic political and economic events with an inward looking orientation.

The decision to nationalize fourteen private sector banks that controlled most of the country's deposits in 1970 was a milestone in the country's economic management by the Government, but it was not in consonance with RBI's stance, and was admittedly political. RBI thus became subject to, if not subservient to the dominance of both fiscal policy of government and its financial sector policy.

The Union Government which had no official functionaries in States except in regard to their constitutional obligations acquired through nationalisation of banks a network to implement its priorities. RBI became a partner of, if not an agent of the Union Government in its developmental activities in the States also.

States were encouraged by Planning Commission to have posts of Directors of institutional finance to interact with banks and facilitate flow of banks' funds to planned activities in the States. Branch Licensing by RBI took account of States' views. Pooling of central funds, state funds, bank's credit and RBI's finance / refinance and spending them as per national priorities decided by Governments, became an accepted national consensus.

RBI became a promoter of Development Financial Institutions in the area of agriculture, industry and mutual funds.

RBI became closely involved in deciding the cost and disbursal of bank credit among users in alignment with the plan priorities set by the Government.

The Oil Crisis of early 1970s impacted countries globally and infused inflationary pressures. RBI also had to take recourse to tight monetary policy to manage the inflationary impact of oil crisis of 1973. The Foreign Exchange Regulation Act was passed in 1973. 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 consistent with Plan priorities. RBI became an adjunct to the Government in its inward looking policies also.

National Emergency in 70s affected the functioning of RBI, especially with the appointment of a person not so well respected in RBI or by financial institutions as Governor RBI. Post emergency RBI, in 1978, reluctantly went along with the controversial decision to hold gold auctions on behalf of the Government. The objectives of the auctions, namely moderating price of gold and reducing smuggling were however not achieved. In the same year (1978) the Government resorted to demonetisation of very high denomination notes, despite the Governor I.G. Patel conveying to the Finance Minister the futility of the exercise. He wrote later that the gesture had to be made and produced much work and little gain.

The adverse effects of misallocation of resources were evident by late 1970s and early 1980s. Government recognised the problem and in 1981 successfully approached IMF for an Extended Fund Facility – the largest by IMF till then. The Extended Fund Facility is a good example of close and deep cooperation between the Government and the RBI.

By the early 1980s there was some consensus in the RBI that inflation was rising because of a surge in money supply. 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. As a follow up, RBI followed a range rather than a fixed target for the annual growth of money supply which was further subject to mid-year adjustments.

While the limited and half hearted trade and industrial reforms brought about a jump in growth of GDP to over 5 per cent per annum in 1980s, the RBI was concerned that the high growth jump was with borrowed time and borrowed money. RBI formally expressed its concerns in regard to persistence of high fiscal deficits, large borrowing programme financed through monetization and weaknesses in external balance. Towards the end of the 1980s short term external financing also increased. The collapse of the USSR added to the imbalance in external sector and the RBI assisted the Government in concluding a 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 impending crisis, but to no avail. Domestic economic vulnerabilities built over the years led to the balance of payments crisis in early 1991, though the proximate trigger was the Gulf Crisis and political instability.

On account of Government policies relating to personnel in RBI in 1970s and in 80s, RBI witnessed a large increase in staff but a decline in quality of qualified professionals.

Without doubt, 80s were a turbulent period, but RBI, by and large, managed the price situation better than almost all countries in the developing world. But on the fiscal stability front, RBI's record was one of helplessness as economy was heading towards a crisis on the external fronts in 1991. To quote T.C.A. Srinivasa Raghavan:

"What was the RBI able to do about it? Precious little. It protested, cajoled, and even threatened the Finance Ministry. But in the end, the finance secretaries of the period – three or four in all – ignored it because they had the prime minister's backing. The reasons were political."

"Letter after letter from the governor about deficit and the coming crisis went unacknowledged."

Partnership in Crisis Management and Reform: 1990-2010:

In the late 1980s and early '90s, globally, the relationship between the central banks and the governments changed in many countries, with emphasis on independence of central banks and the genesis of inflation targeting framework. Induced by technological changes and ascendancy of market ideology in U.S.A., with emerging markets following suit, radical changes were taking place worldwide in several policy areas, in particular global trade and finance. India lagged behind these developments and believed that a closed economy kept the prospects of crisis low. RBI's series of warnings in late 1980s about impending crisis were ignored by Government. The Indian economy experienced a severe balance of payments crisis in 1991.

Irrespective of or because of political uncertainties, the government took the advice of the RBI on crisis management and strongly supported its actions in both financial and external sectors. It culminated in using gold belonging to the government and pledging the gold belonging to RBI to save the country from loss of reputation and defaulting from meeting external payments. Negotiations with the International Monetary Fund were held for obtaining its support in a period of political uncertainty. The apolitical stature of RBI won the support of the full spectrum of political leadership.

The reforms that commenced in 1991 following the crisis became a watershed in the economic development of the country. A dramatic shift in the relationship between the government and the RBI occurred. Beginning with the two-step devaluation of currency and the reform budget in 1991, a partnership began between the RBI and the Government in bringing about fundamental changes in several fronts. Perhaps, there was an agreed coherent intellectual framework that governed the policies of and relations between RBI and Government. Consistent with government policy, RBI became outward looking but with appropriate caution and calibration expected from a central bank.

Reforms undertaken during this period were based on recommendations of Committees led by former or extant Central bankers; as, for example, Narasimham Committee on financial sector and on banking, Rangarajan Committee on Balance of Payments, Malhotra Committee on insurance, and Tarapore Committee on capital account management. All the recommendations were accepted and many of them implemented smoothly with notable exceptions, namely, those relating to dual control over and restructuring of public sector banks and directed / priority sector lending.

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 supplemental agreement in September 1994 on the abolition of the *ad hoc* treasury bills to be made effective from April 1997 eliminated the automatic monetisation of Government deficits and resulted in considerable moderation of the monetised deficit and introduction of Ways and Means Advances system. At the same time, with gradual opening up of the economy and development of domestic financial markets, the operational framework of the monetary policy also changed considerably with clearer articulation of policy goals and more and more public dissemination of data and thinking relating to its operations.

To ensure that the monetary policy 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, it extended its supervision to Non-Banking Financial Companies (NBFCs) also in 1997

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.

There was, however, continuing dualism in reforms relating to public sector banking and credit allocation. The intellectual forces within the RBI advocated withdrawal from priority sector lending, focusing on regulations, ensuring competition and gearing up the financial sector to let the market play leading role. This was at variance with the practical view which recognised socio-political forces and their compulsions. Broader practical considerations ensured that the developmental financing role could not go out of RBI's radar. However, new private sector banks were issued Licences after decades and a liberal approach to approval of licensing for foreign banks to open branches was adopted. The public sector banks were recapitalised as needed, in accordance with global standards. Government ownership in public sector banks was diluted while government retained total management control bestowed on it in the relevant statutes.

In late 1999, the Foreign Exchange Management Act (FEMA) was passed replacing the Foreign Exchange Regulation Act (FERA) of 1973.

Fiscal transparency and some fiscal rules were introduced through the Fiscal Responsibility and Budget Management Act enacted in 2003 with appropriate technical support provided by the RBI.

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

Innovative policy initiatives such as the Market Stabilisation Scheme involving close and continuous collaboration between government and RBI for cash liquidity management in government and markets were put in place.

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.

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.

In parallel, in 1990s 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.

Institute for Development and Research in Banking Technology was established in late 1990. RBI became a pioneer in setting world class market infrastructure like Clearing Corporation of India, with world class payment system.

There were several policy challenges that had to be met during 1990s and 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 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. RBI also became a fiscal adviser to States and transformed itself into a national institution. RBI also acquired greater visibility in the global community of Central banking. By becoming an active member of the Bank for International Settlements and of the G20 group, and participating in the development of International Standards and Codes, RBI reinforced its national stature and helped improve Indian presence in the global economy.

There were, however, some major scams during this period which put RBI on the defensive.

RBI had to face considerable criticism due to Harshad Mehta scam in early 1990s. The brokers were using the cheaper finance of the formal money market to finance their deals in the stock market. They diverted money from the banking system by taking money out of the inter-bank market for government securities for use in speculating in the stock market. It was clear that there was corruption in the banks concerned, and negligence by the RBI in several capacities, viz., as a regulator of the banks and of government securities market, and above all, as an institution in-charge of payments and settlements system. RBI learnt its lessons and successfully installed a most modern payments and settlements system and improved its control systems. Unfortunately for RBI, two of the major institutions that contributed most to the scam, namely, State Bank of India and National Housing Bank, were owned by Reserve Bank of India.

The second scam related to issue of a licence to an NBFC (CRB Capita) which collapsed in the process of setting up a bank. This resulted in strengthening regulation of NBFCs.

The third scam in which RBI faced embarrassment happened toward the end of 2000 and early 2001. Ketan Parekh used bank money to finance his activities in the stock market. In this case, it was sudden relaxation in the regulatory restrictions on the exposure of banks to stock markets that enabled them to finance the broker. The two banks involved were, Madhapura Mercantile Cooperative Bank and Global Trust Bank. As a consequence of this experience, the RBI followed up with several regulatory measures in particular those relating to governance, and introduction of fit and proper criteria.

Financial sector assessment was made in 2002 and again in 2006 which provided an opportunity for the RBI to get a comprehensive appreciation of the global trends in International Standards and Codes. They provided an opportunity for officers in the RBI to work with outside experts. Around this time, BIS, IMF and World Bank drew upon the professional skills of RBI in their work globally.

Between 1990 and 2010, the skills in RBI were expanded through several measures including exposure to academia and financial market participants. While the quality of RBI professionals improved, the total staff dropped dramatically: for example from 31,275 in the year 2000, to 20,295 in 2009, and 14,785 by 2017. Class I Officers during the corresponding years were 7881, 9,430 and 6,958.

Divergence from global thinking

From 2004, the government and the RBI had to face unfamiliar challenges. 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 differences between the government and the RBI in the areas of monetary management and external sector. The regulatory actions of a prudential and counter-cyclical nature were undertaken by the RBI despite some initial resistance from government and financial markets. The private sector banks were consolidated and weaknesses eliminated due to joint efforts while public sector banks remained unreformed.

Government in a rare case of bipartisan support decided to open private banking sectors to foreign banks but its implementation was postponed at the persuasion of RBI by adopting a prolonged road map. Fit and proper criteria for ownership of banks were announced after consultation.

A notable initiative of RBI which gained full support of Government was financial inclusion which went beyond micro credit with a focus on universal access to financial services and credit at affordable rates. In the process, micro finance institutions became a new channel of credit dispensation.

This was also the time when India firmly joined the league of high growth major economies in the world. The foreign exchange constraints introduced in 1957, ended in 2004; and soon thereafter, the forex reserves were built to inspire confidence. But, inflationary pressures emerged on the eve of the crisis, mainly attributable to huge increase in oil prices.

The global thinking on finance and money was appealing and euphoric during early part of 21st century till the financial crisis hit in 2008. There were clear signs of divergence in thinking between RBI's caution and global preference for market based finance leading the development. RBI was out of alignment with practice of central banking globally in terms of inflation targetting, independence of central banks, counter-cyclical regulation, financial innovations and capital account management. In fact, in pursuing Market Stabilisation Scheme, RBI surrendered its independence in favour of effectiveness in market operations relating to exchange rate management. Government in general, was in agreement with global thinking, but eventually tilted in favour of trust in RBI's policy advice in these areas.

However, RBI became an unwilling party to a nationwide bank loan waiver programme in 2007 and partly funded it.

Crisis and Recovery

On the eve of crisis of 2008, India had reasonable external sector balance and moderated vulnerability in the fiscal sector, but the financial sector remained robust. However, India was affected mainly due to the contagion through sentiment, cross country financial flows and the deceleration in global economic activity. India recovered quickly not only because it did not have serious initial vulnerabilities, but also because as a response to the crisis, three sets of important measures were taken, namely, fiscal stimulus, monetary stimulus and regulatory forbearance. Coordination between Government and central banks to manage the crisis was global and India was no exception.

In retrospect, however, it appears that the fiscal stimulus was, in fact, fiscal deterioration (since the increase was in recurring revenue expenditures); the monetary stimulus lasted longer than needed; the regulatory forbearance was taken undue advantage of by the banks and industry resulting in restructured loans and large NPAs. The spur in lending to infrastructure at this time also led to large

NPAs. All indications are that RBI was constrained by Government in timely withdrawal of stimulus.

It is interesting that globally, tensions between central banks and governments arose in the process of withdrawal of stimulus and India was no exception. In some countries, especially USA, U.K. and Euro zone, crisis induced reforms took place. In India, reform process after the crisis had no observable link with Crisis, but it differed from the past.

Rebalancing and New framework: 2010 -

Since the financial sector reforms commenced in early 1990, the Government shed some of its authority in regard to financial and external sector to the RBI, regulators, and markets. Often as in the case of end to automatic monetisation and exchange controls, practice preceded legal mandate. RBI gained operational autonomy, aligned the policies with Government and worked closely with Government on structural changes. Developments since 2010 point to a review of the balances between government, financial markets, and RBI. Government took direct responsibility for coordination in financial sector, and sought inputs from financial institutions and markets, especially global financial giants directly rather than through RBI, as was the practice previously.

Government reduced its dependence on RBI for the intellectual framework for financial sector reforms since 2008. Raghuram Rajan Committee on Financial Sector Reforms (2008) and Justice Sri Krishna Commission on Financial Sector

Legislative Reforms (2013) provided the intellectual framework. Assistance to these Committees was sourced from outside government and RBI. The technical work relating to G20 was also outsourced to a research Institute by Government replacing dependence on RBI inputs. Recently, a Committee on Digital Payments headed by a former finance secretary, Ratan Watal (2013), gave a report on payments system, a core function of central bank. The Committee's recommendations included the controversial one to set up an independent regulator to regulate payment and settlements in the country.

The coordination function in regard to financial sector at an operational level was assigned by the Government in 1993 to a Committee on Capital Markets headed by the Governor, with regulators as members and the Joint Secretary, Ministry of Finance, as Convener. With the establishment of Financial Stability and Development Council (FSDC) in December 2010, all coordination functions are directly with the Ministry. The Union Finance Minister is the chair person of the Council. The members include the Governor, four Secretaries to Government, a Chief Economic Adviser and four Heads of Regulatory bodies. The Council has been made responsible for financial development, financial stability, financial literacy, financial inclusion, and most important, inter regulatory coordination.

RBI resumed its task of implementing reforms in money and finance once the process of crisis management and recovery were completed, and after it had effectively handled the aftershocks of the dollar tantrums in 2013.

The initiatives regarding Financial Inclusion which in the past were led by RBI with strong support from the Government changed in terms of the emphasis and scope. The financial inclusion movement from 2014 was led by the Government under Prime Minister's Program (PMJDY) with full support from the Reserve Bank of India. As part of the Program and, consistent with Raghuram Rajan Committee's recommendations, guidelines were issued for payments bank and small finance banks in the same year. Approvals for setting up such banks were given in principle promptly in 2015. The concept of differentiated bank licensing was introduced in India. In 2016, guidelines for on-tap licensing of universal banks for private sectors were also released.

The legislative mandate for new monetary policy framework came into force in June 2016 through amendments to Reserve Bank of India Act. The primary objective of the monetary policy now is to maintain price stability while keeping in mind the objective of growth. The monetary policy framework in India has to be operated by the Reserve Bank of India, and the regime is described as flexible inflation targetting. The central government under the new framework determines the inflation target in terms of consumer price index once in five years. It appoints a Monetary Policy Committee consisting of three members including the Governor from the RBI, and three outside experts nominated by the government through a procedure prescribed under the law.

In the reform process there was one case of difference between the RBI and the Government that came into the open, namely, the establishment of an independent public debt management agency. The Finance Minister made an announcement in the budget of 2015 that such a unit will be established, but later it was watered down, on a plea from RBI, to public debt management unit to be located in the RBI pending detailed formulation of implementation of plan.

The Financial Resolution and Deposit Insurance Bill, a comprehensive code for speedy and efficient resolution of financial firms, introduced in Lok Sabha by Government in 2017 invited stringent public criticism. The proposal therefore had to be withdrawn, with some embarrassment to the new thinking on reform.

An important issue that came up during this period relates to the large non performing assets that belatedly came to the fore after RBI revised its Prompt Corrective Action (PCA) norms for banks. The issue got complicated because of the reluctance of the Government to promptly inject capital in public sector banks without putting in place corrective mechanisms, and consequent impact on credit flow. There was also an effort to apportion the blame between the mismanagement of public sector banks by the government and inadequate regulation and supervision by the RBI. The Government, in 2017 responded with two measures, namely, introducing Insolvency Bankruptcy Code and amendments to Banking Regulation Act in relation to NPA issue. The former is a historic step with enormous positive consequences for the financial system. The latter, however, could be considered superfluous since the powers that were conferred to RBI by the ordinance already existed implicitly under the prevailing Act. However, the amendment empowered the Government to give directions to RBI on this purely operational matter.

The RBI was on the defensive not only on the delayed recognition of NPA problem, but also on account of large frauds committed by the borrowers. Three high profile cases related to Punjab National Bank, in case of Nirav Modi and IDBI/SBI in case of Vijay Mallya, while it was ICICI Bank in case of Videocon. All these were essentially in the nature of frauds committed for which the responsibility rests with the management of the respective Boards. The owners should be most concerned though. Overall, the series of events led to an unusual and public expression of the prevailing inadequacy of powers of the RBI in supervising public sector banks.

The monetary management as well as reputation of the RBI has been affected by the demonetisation announced in November 2016 and implemented subsequently by RBI. Demonetisation, announced by the Prime Minister on November 2016 came as a surprise. Reserve Bank of India seems to have reluctantly acquiesced after Governor Raghuram Rajan had orally expressed reservations before he vacated the position at the end of his term. The decision was implemented during Dr. Urjit Patel's tenure. RBI had to take the blame for the significant pain that was caused to the general public during the period of implementation.

In 2018, the initiation of consultations with the Governor under Article 7 of the RBI Act for the first time in the history of the RBI, gave rise to a number of issues. These continue to dominate the relationship between the RBI and the Government even after the exit of Governor Urjit Patel for 'personal reasons'.

<u>Current Issues – 2019</u>:

In October 2018, it transpired that Government had sought the opinions of the Governor under Section 7 in order to give directions to the

RBI in public interest. This is unprecedented and virtually meant that the channels of normal communication for reaching agreed position between Government and Governor RBI had broken down. The Board of RBI appeared to have differences with Governor on the same issues. These differences came into public domain after a speech by a Deputy Governor.

The Central Bank's Deputy Governor, Viral Acharya gave a landmark speech in October 2018, in which he virtually warned the Government that undermining RBI's independence would attract the wrath of the markets. The speech provoked strong response from the government which interpreted the Deputy Governor's speech – a speech that was admittedly authorised by the Governor, and represents institutional position, as an act defiance rather than as an expression of disagreement with the Government. It triggered a prolonged war of words between the Deputy Governor RBI and Secretary Economic Affairs, Ministry of Finance, but this subsided with the departure of Urjit Patel in December. The resolution of issues originally flagged for consideration under Section 7 are likely to impact the future role of RBI as evident from debates nationwide on autonomy of Reserve bank of India. It is interesting that the market reactions to the proposals of RBI have not been as severe or as depressing as it was made out in Acharya's speech presumably because both financial market and Governments have a short term bias.

First and foremost contentious issue relates to the use of excess reserves in the balance sheet of RBI. This is not the first attempt by the Government in this regard. In 1986, Government demanded RBI's profits in the Government's quest for fiscal relief. Governor Malhotra explained how the profits of RBI were different from the normal profits of other public sector companies, and added that they were notional. He explained that higher transfers would impact the economy adversely and made it clear that the profits of RBI should not be considered as an avenue for augmenting the resources of the Government.

During the reform period till 2013, the Government took several steps to strengthen the balance sheet of Reserve Bank of India and added to the reserves. For instance, the excessive cost of sterilisation which normally is borne by the Central bank was shared by the Government to keep the Central bank strong to be able to serve the Government better in times of difficulties. In recent years, the Government has reviewed this approach. Further, by taking recourse to unprecedented practice of interim dividend, the spirit of limit on Ways and Means arrangement under fiscal management legislation has been compromised. The immediate fiscal needs seem to take precedence over a renewed assessment of the capital needs of RBI.

In 2018 the Government took the stand that the existing levels of reserves are in excess of the requirement and, therefore, the excess of reserves could be legitimately claimed for use by the Government. Government was laying claim to stock and not merely flow. In its calculation, the government took into account the revaluation gains on forex assets on account of depreciation of the rupee over the years. RBI, on the other hand, took the view that the reserves are not in excess and that, even if they were in excess, the purpose will be served over the years by sticking to the legal requirement of transferring to its reserves a portion of the current surplus of income over expenditure till the reserves need to be augmented. The Chief Economic Adviser had already proposed that the excess of reserves should be made available for injecting capital to the public sector banks which are currently under-capitalised.

The law and the current practice are for the Board to determine on a yearly basis the excess of income over expenditure, the amount required for addition to its reserves and then the residual is transferred to the Government as dividends. This surplus thus flows to the Consolidated Fund of India for use as it deems fit. As part of the reforms, a formula was approved by the Board for transfer of such reserves and remained in force till 2014. However, the Government took the position that the level of reserves of RBI are in excess of needs and that the entire surplus of income over expenditure should be transferred to the Government. This was done in the year 2015.

There is no doubt that in the ultimate analysis, the Government as the owner has a claim over the reserves, but the way it exercises gives signals to the market and influences public opinion. In law, the Board will have to decide on this, and the Board members are nominated by the government. There are two substantive issues. One is determination of excess reserves and whether this should only be confined to realised gains or can apply to revaluation gains as well, and the second issue is the immediate use of excess reserves, as determined.

There are different approaches to the level of capital of a central bank. One view is that Government will provide support to it when needed and hence issue of adequacy does not arise. All income over expenditure every year could get transferred to Government. Alternatively the government may like to assure the markets that its Central bank has the Capital to meet contingencies that may arise without depending on governments. There is merit in keeping at least central bank's balance sheet strong if the Government's fiscal balance sheet is weak. But substantively, it is the judgement of Government that prevails on the adequacy issues though procedurally that of Board.

Use of reserves accumulated in the past will have to consider three factors, namely, a) the macroeconomic implications of such transfers, in particular, the monetary implications which are likely to be expansive; b) the issues of inter generational equity since the reserves have been accumulated as an Insurance for the future; c) the constitutional propriety of using the reserves directly to fund capital of the banks instead of crediting it to Consolidated Fund of India and then using it as considered necessary by the Government, and d) the incongruity of the banking regulator being asked to use its resources to fund banks that are in need of the capital. A Committee has been appointed to advise the RBI on the capital framework and related matters.

Secondly, the Government demands that RBI should relax the norms of Prompt Corrective Action. The Government's contention is that the growth is affected by such stringent measures. This is certainly an operational matter and a matter on which the Government owned institutions could make representations to the RBI for consideration. There can be genuine concerns of Government, but governments generally persuade the regulator but not direct it in such matters. Obviously, the Government is tilting in favour of their own regulated entities who failed to convince the regulator in the matter, though RBI is the agent of government fully equipped to take a view on the matter. In a manner, this dilutes both the autonomy and accountability of RBI.

Thirdly, the Government is also seeking the dilution of the Basel III norms for India on the ground that these are more stringent than the global standards. In general, the Basel III norms assume a particular level of realisable value of the assets in case it becomes non-performing. In India, the transactions cost and the liquidity in relevant markets, in particular in real estates, make the realisable value generally far less than the declared value. There is, thus, a case for the Indian norms to be more stringent than global ones. But the scope, coverage and deviation from global standards are a regulatory and operational matter.

Fourthly, the extent of RBI response to the liquidity conditions being faced by the non-banking financial companies is another point of friction between the Government and the RBI. If ILFS faced a liquidity problem it would have been the responsibility of RBI. Obviously it is an insolvency issue since the Government intervened. Perhaps, Government intervened since both LIC and SBI owned by it are large stake holders in ILFS, and also because many infrastructure projects are involved. In any case, RBI should be concerned at the risk assessment capabilities of public sector giants like LIC and SBI that allowed this to happen while having large stake in ILFS.

Fifthly, the government seeks a policy and a procedure from RBI to facilitate lending liberally primarily to small and medium industries. The SMEs problem is not new, nor is it unique to India. However, any extra-ordinary push will jeopardise depositors' interest or induce systemic instability. This is a matter again in which Government and the industry could raise the issues and convince the RBI, but should ideally respect the final judgement of RBI. To implement any support beyond what RBI considers it to be prudent, Government should ideally draw upon its budgetary resources as is being done in case of waiver of farmers loans.

Finally, the issue of governance and the role of Board have been raised. This certainly is a matter which requires to be considered keeping in view both the global practices and changing domestic circumstances. In any case, if the role of the Board is being reviewed, it should encompass the composition of the Board and relations between the Board and Government as well as Governor. The current composition of the Board in India is unique and is appropriate to a full service central bank. Currently, the Board focuses on house-keeping and renders advice and guidance on policy, and is active in Committees of the Board. Committees of the Board are constituted on advice of the Governor and they provide fora for detailed scrutiny and guidance by the Board Members.

The issues relating to capital framework, the regulatory relaxations and the role and composition of Board, will have a lasting impact on RBI.

Prospects:

What will be the future of central banking in general, and in India, in particular? We can start answering the question by looking at the past, as Professor Goodhart did in BIS Working Paper 326, November, 2010. He identifies three main stable epochs from the past, with short periods of confusion between them. These three periods are: (i) the Victorian era, say from the 1840 until 1914; (ii) the decades of government control: the 1930s until the end of the 1960s; and (iii) the triumph of the markets: from the 1980s to 2007. The period from 1914 to 1931-33 was a confused interregnum with World War I, and failed attempt to re-establish the gold standard; the 1970s was another interregnum between the subservience of monetary policies to government control, and the establishment of a free market system, with the central bank following a regime of inflation targetting.

He adds: "Following the ongoing financial crisis, there is probably an interregnum in search of a new consensus." His expectation of the future is: "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."

In my view, there are three inter-related issues that are being globally deliberated now. First, in regard to operational independence there is increasing realisation that monetary policies, fiscal policies and financial sector policies have more significant spill-over effects than was realised before the global financial crisis. What institutional arrangements and processes ensure that spill-over effects are taken into account? Second, in regard to the choice between a full service central bank and a monetary authority, it is necessary to examine the advantage of coordination recognising spill-over effects vis-a-vis the risks of conflict of interests in performing multiple functions. Third, in the context of institutional independence question raised is how independent the independent agencies can be without encroaching on the larger public policy function of the State. Paul Tucker, for instance, in his book "Unelected Power" compares military and judiciary with central bank and raises the question which public policy decision should be made by politicians, technocrats or judges. Treating central bank as an institution exercising unelected power, Tucker writes in Preface: "The book argues that power, welfare, incentives, and values have to be considered together if the institution of delegated unelected power is to be sustainable in our democracies." There are no easy answers, but search for meaningful answers to these for practical application in our country is complicated by heightened global uncertainties.

The global uncertainties due to geo-political pressures, trade wars and threat of digital currency, cumulatively pose severe problems for the central banks. It is unclear how they will evolve, especially in view of the serious current infirmities in regard to global monetary system, global financial architecture, and regulation of global financial conglomerates by national regulators.

Redefining the role of central banking has to take place in the context of a historic rebalancing that is underway globally between role of State and markets, between national and global approaches, and relative emphasis on finance and real sectors, and role of Asia and West (USA and Europe).

Perhaps, in regard to India also, we are going through confusion in search of a new ideal for a central bank and it has to be ideal for our circumstances. There is one lesson from the past to guide us. RBI has done well whenever it has the liberty to think globally, advise independently and act in the domestic context.

India has to very closely watch the global developments and chart the future of our central banking, more than ever before in history for several reasons. Firstly, future will be more globally integrated. Secondly, India will be increasingly important to the world. Third, we have more opportunities than ever before in the area of financial sector for our dominance with our strengths in technology and skilled manpower. To take advantage of it, Government of India in partnership with Reserve Bank of India should address the root causes of the recent standoff between them.

Conclusion:

The future of central banking everywhere depends on when and how the confusing era in regard to central banking ends. Further, the immediate future of central banking in India depends not only on how it equips itself to face the complex unclear challenges but also on the manner in which the current concerns relating to fiscal management, public sector ownership, external sector balance and coordination functions are resolved by the Government.

I will conclude by repeating the concluding part of Dr. C D Deshmukh's Kale Memorial Lecture on Central Banking in 1948:

"After all, it is not the theoretical constitution of the Institution that matters, but the spirit in which the partnership between the Ministry of Finance and the Bank is worked. The success of the partnership will, in the ultimate analysis, depend on the manner in which Government desires to be served and provides opportunities accordingly. No country can have better public institutions than it deserves."

Thank you.