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Evolution of Reserve Bank of India as a Full-Service National Institution

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Governor Tariq Bajwa and Respected Dr. Ishrat Hussain, distinguished Bankers, and friends,

I am thankful to the Governor for giving me the opportunity to address the gathering. I was in Karachi in May, 2005. I had addressed the Institute of Bankers of Pakistan on "Banking Sector Reforms: An Overview." It is ten years since I left Reserve Bank of India. So, I cannot say much on contemporary issues, but can look back, introspect and comment. That is why I decided to speak on evolution of RBI as a Full Service National Institution. I will devote the second part of my talk to the evolving approaches of RBI to development, credit and inclusion.

1 Former Governor, Reserve Bank of India. He acknowledges valuable advice of Mr. K. Kanagasabapathy and support from Mr. Siddhant Reddy, in preparing an earlier version of the first part of the draft. The latter part of the paper draws heavily from the interview Dr. Reddy gave to Professor M.S. Sriram for his book: "Talking Financial Inclusion in Liberalised India".

Origins

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 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." In simple terms, it is to secure monetary and financial stability in the country ensuring sustainable growth. The important functions included issue of currency, monetary management, banker to banks and the Government, management of public debt and management of foreign exchange reserves. Over the period, it subsumed and assumed powers to regulate money, government securities and foreign exchange markets, regulation of banks and non-banks and payment and settlement systems. In serving public good, RBI has traversed a long distance and faced many challenges but, in the process evolved into a full-service institution encompassing regulatory and developmental roles in the financial system, besides partnering with Central and State governments as their advisor in domestic and external sector policies. RBI saw a smooth transition from planned economy to market oriented system in early 1990s and purposeful integration with global economy in the last two decades.

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

Planned Subservience

With the establishment of Planning Commission in March 1950 and adoption of planning as the driving force for policy interventions in the economy, RBI's policies had to toe in line with plan priorities. For instance, when deficit financing became an acceptable mode of financing development plans, 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 RBI.

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. Six more banks were nationalised in 1980. Inevitably RBI became not merely a regulator but also a 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.

By the early 1980s there was some consensus in the RBI that inflation was rising because of surge in money supply. In 1985, the Sukhamoy Chakravarthy Committee recommended for the first time, a clear framework for 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. 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 more in favour of promoting long term savings.

Partnership in Crisis and Development

For most part of 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 1980s, short term external financing also increased. The collapse of USSR added to the imbalance in external sector. RBI negotiated transition of rupee trade agreement with Russia. Added to political uncertainties, Gulf crisis triggered high oil prices further tightening the balance of payments situation. Deposits and remittances from Non-Resident Indians (NRIs) 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.

RBI became the first line of defence as the stress in balance of payments became acute. 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 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 the support in an air of political uncertainty, but with professional expertise of government and RBI acting in tandem. The RBI and Government drew upon their professional skills and clout 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 in several fronts.

The redefined relationship was virtually negotiated by RBI, which convinced the government to cede its space in economic management to markets, regulators and RBI. Reforms in several fronts were based on recommendations of Committees led by Central bankers; as, for example, Narasimham Committee on financial sector, Rangarajan Committee on external sector, Malhotra Committee on insurance, and Tarapore Committee on capital account.

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. 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. This provided greater maneuverability 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 late 1990s, with the institution of regular meetings with Finance Secretaries and Committee of Finance Secretaries.

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 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.

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 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.

National Institution

In 1997, RBI convened the first of a series of Conferences of Finance Secretaries of State Governments. The Regional Directors located in State capitals were empowered, and their interactions with State Governments intensified. RBI emerged as a fiscal adviser to States. Governors had during their visits called on Chief Ministers. RBI transformed into a national institution from being one associated with Union Government only. Profile of RBI in the global community of Central banking and in multi-lateral fora increased. It became a member of Bank for International Settlements. It was active in developing International Standards and Codes. It envisaged as an active member of G 20. It reinforced its national stature and helped improve presence of India in global economy.

Against the Winds

From 2004, the government and the RBI had to face unfamiliar challenges. These related to large capital inflows, very high economic growth, unprecedented expansion in credit, asset bubbles and smooth 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.

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 Market Stabilisation Scheme involving close and continuous collaboration between government and RBI for liquidity management were put in place. The legislative, the policy and the institutional arrangements put in place during this period, enabled India to be spared of any severe impact of global financial crisis in 2008.

The onset of the global financial crisis required significant support from the governments in the tasks faced by the central banks. The coordinated actions in India were visible in measures relating to stimulus of the economy. However, as in the case of many other countries, differences arose between the RBI and the government on the pace and the timing of the exit from the stimulus. India emerged relatively unscathed from the global financial crisis and has been described as an island of stability in the financial circles.

New Directions

Regarding the structural measures, however, post 2008 marked a distinct shift from the earlier period. Several legislative changes brought about during this period emphasised more of accountability of the central bank and less of discretion to the central bank. The role of the Governor has been redefined in the context of financial stability and development council. The institution of Monetary Policy Committee and the amendments to the Banking Regulation Act on non-performing assets indicate redefined relationships within the financial sector and between the financial sector and the government, and between the Government and RBI. A Commission under the chairmanship of a retired Chief Justice of the Supreme Court provided the overall framework for many of the reforms in the financial sector.

Development, Credit and Inclusion

RBI has a very unique Board. The RBI Board has representatives from agriculture, social services and even scientists. Most central banks are monetary authorities packed with economists. RBI is not just a monetary authority worried exclusively about issues of inflation, but much beyond. RBI continues as full service central bank. RBI has an intellectual and cultural tradition of being sensitive to the issues of society.

RBI has been a builder of development institutions. It was an originator of Development Finance Institutions (DFIs) like Unit Trust of India (UTI) and Industrial Development Bank of India (IDBI); UTI became independent of RBI and so did IDBI. Ownership of SBI has been transferred. Ownership in several other institutions is being transformed to Government or banks (For example, Cheque clearing and payments functions). But in-keeping with modern times, it is also shedding some of its functions. It also promoted new institutions like Clearing Corporation of India and Institute for Development and Research in Banking Technology.

The basic thrust of public policy in India has been in the discourse that money lending is bad; informal credit is bad; we must get rid of it; and therefore we should extend more formal credit. As a philosophy, RBI believed that credit has to be channeled essentially through the banking system. So in a way it was a mandate to RBI to see that banking expands to virtually replace the (evil) moneylender.

In 1969, banks became direct instruments of policies in regard to financial sector, as dictated by Government. The role of RBI in 1970s and 80s was virtually to support or accept what Government wants in financial sector, and it doubled up as the regulator.

Directed lending became the norm, and prescriptions of priority sector lending were large.

The Narasimham Committee report of 1991 (Narasimham I) described these as behest lending, and it was not in favour of continuing the priority sector lending. The Narasimham Committee report of Banking Reforms in 1998 (Narasimham II) also suggested that that RBI should ensure competition, and have a good regulation and keep off from the developmental business. That was the intellectual argument, but the political argument seemed to be going against the intellectual one.

Government was not keen to give up control over banking business and was also encouraging RBI to finance development. So, there is a sort of continuing dualism in banking and credit allocation.

After 1991, there were two forces in RBI - the intellectual one and the practical one. The intellectual one advocated RBI's withdrawal from priority sector lending; focusing on regulations; ensuring competition and gearing up the financial sector to let the market play leading role. We also had monetary reform which meant that we create money only for monetary conditions – there was no question of refinancing; no question of RBI creating money for development financing. The RBI will create money in the context of monetary conditions. In other words, RBI will contribute to development and stability with relative emphasis, depending on the circumstances. It will not refinance development. It may use regulatory instruments for allocation of credit, but not direct.

This view meant that the intellectual framework of the reform no longer justified RBI's involvement in credit directly. 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.

Basically, Priority Sector lending continues. The scope keeps changing with pressure from Government and Banks to expand the coverage. The shortfalls are common. Sometime ago, shortfalls by banks could be filled by lending to NABARD for onward lending to rural infrastructure to States. More recently, the shortfalls could be made up by trading with banks who surpass their obligations.

Recently, the financial inclusion gained prominence over priority sector, though the latter continues. The term 'financial inclusion' was used for the first time, in monetary policy statement of RBI in 2005. This was to encompass initiatives taken through opening no frills accounts, zero balance accounts, in general, and access to all banking services not just credit. Business correspondent model was also part of this.

The government noticed that financial inclusion was an attractive concept and Rangarajan committee was announced in 2006. The committee defined financial inclusion with emphasis on credit, but recognised the significance of access in the concept of financial inclusion.

That was also the time that technology was being introduced in financial sector. The first Direct Benefit Transfer experiment was introduced in Warangal in Andhra Pradesh (2003-04).

The government's objective of efficient payments was identified as an advantage to push RBI's agenda for financial inclusion. The agenda was about financial service in general and not about credit alone. In particular, it was to provide a place for the poor to keep their savings safe, effect monetary transactions virtually free, and obtain Credit for consumption smoothening. That was the approach till 2008.

Priority till 2008 was that RBI should treat finance as a service and this service should be accessible to everybody who wants it. And, we have to go to the door of the citizen, to ensure access.

The financial inclusion became a global agenda after the Global Financial Crisis.

In recent years, financial inclusion became a major policy instrument of Government of India that encompasses service, credit and financialisation.

Full Service

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. However, 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, custodian of the trust of people in money and finance; the protector of integrity of banking system, the policy instrument for development and adviser to State Governments also. It was 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, as a full service national financial institution.

Thank you.