# FOREWORD

The Report on Currency and Finance (RCF) has a long and chequered history, intertwined with that of the Reserve Bank of India (RBI) itself and the Indian economy. It was first published in 1937, covering the years 1935-36 and 1936-37.

2. Those were formative years for the RBI as an institution, years in which history was being made rather than written. On April 1, 1935 the RBI came into being. The Bank Rate was officially announced for the first time on July 4 at 3.5 per cent, followed the next day by official contact with the so-called scheduled banks [included in the Second Schedule of the Reserve Bank of India Act, 1934 on satisfying the criteria laid down *vide* section 42(6)(a) of the Act)] that became eligible for debts/loans at the Bank Rate from the RBI, and membership of the clearing house. That year, the RBI published its first ever Annual Report covering a period of 9 months and declared a dividend of 3.5 per cent per annum, with net profits of Rs. 56.055 lakhs. There were 92,047 shareholders on April 1, 1935 but by December 31, 1936 this number had fallen to 66,273.

3. When the Issue Department took over the management of currency from the Government of India in April 1935, the annual Currency Report that was being prepared by the Controller of the Currency was discontinued. Responding to the ensuing clamour for its revival, the RBI agreed in the interest of 'statistical continuity'[1]. Noting that an Annual Report was being published and that there was also a monthly and annual statistical summary, the RBI decided to publish an annual review that would be different: it would be based generally on the framework of previous Currency Reports, but with a commentary on developments and statistics describing those times, including the changes in circumstances due to the creation of the RBI. It was decided that this report 'should be published annually as soon as possible after the close of each financial year' (RBI, 2005)[2].

4. The first Report (1937) set the tone when it commented on the macroeconomic situation that it discerned from the available statistics. Commodity producing countries were severely hit by the Great Depression. In India, general prices, measured by the Calcutta index of wholesale prices, rose as a result of increasing demand for raw materials. Industrial production improved, driven up by the output of cotton and jute manufactures, iron and steel, and sugar. Non-speculative share prices rose sharply, and speculative shares followed at a moderate pace. The balance of merchandise trade showed a remarkable improvement, and this kept the 'exchange' strong, enabling the RBI to put Government in a position to repay the 5.5 per cent India Bonds 1936-38 amounting to £16,858,000. Easy money market conditions prevailed and were reflected in the Bank Rate being reduced by 0.5 per cent to 3 per cent. A budget surplus was recorded, and record borrowings occurred at record low interest rates. Burma was separated from India (1937) and new provinces of Sind and Orissa were created (1936). Silently and without flourish, a third voice in the RBI was born – the voice of the institution's professional research.

1,2 Report on Currency and Finance, 1937, Introduction (Para. 1).

5. Post-Independence, the contents of the RCF were broadly categorised into two parts – International Economic Developments; and Indian Currency and Finance. The early 1960s saw a change in its contents. Reflecting the changing politico-social dynamics that governed the national narrative those days, the preoccupation with international developments waned and the focus of the RCF increasingly turned inwards. Its contents came to be divided into three parts - Macroeconomic Developments of India; Output and Price Trends; and Statistical Statements. From 1974-75 to 1997-98, two volumes of RCF were published – Volume I covered an Economic Review and Volume II contained Statistical Statements.

6. The year 1998-99 marked a turning point in the history of the RCF, and a watershed in its narrative. In a significant departure from its usual descriptive chronicling, the RCF adopted a theme-based approach and addressed *The Structural Transformation of the Indian Economy*. The events of that time provided the perfect context for this noteworthy transition. The Indian economy was emerging from a cyclical slowdown and the turnaround was accompanied by supply shocks that raised inflation pressures. The external environment was riddled by the after-shocks of the Asian financial crisis and the contagion spread to Russia and several parts of Latin America. In response to its nuclear testing, India faced sanctions from several countries and rating downgrades, prompting the issuance of Resurgent India Bonds overseas.

7. But history was turning over. The tryst with centralised planning since the early 1950s had resulted in inefficiencies, distortions and rent seeking activities. In the early 1990s, India faced a severe balance of payments crisis. Although it was triggered by external factors such as the Gulf war, the dismemberment of the erstwhile USSR, a surge in crude prices and the drying up of remittances, the unsustainable state of the underlying fundamentals of the Indian economy was stark. Structural adjustment was undertaken during the rest of the 1990s through a wide-ranging array of reforms and a shift in the development strategy in favour of market orientation and openness. As the RCF noted, the economy was exhibiting considerable resilience and dynamism on the threshold of the new millennium and this provided the rationale for the theme of the RCF. Consequently, the RCFs that followed in the wake of this turning point imbibed the spirit of transformation. Over the next decade, other evolutionary themes came to be addressed: the financial sector and market integration; revitalising growth; stock taking of the reform process and its outcomes; management of the external sector in an open economy framework; the evolution of monetary policy; the evolution of central banking in India; development of financial markets and role of the central bank; emerging issues and challenges facing the banking sector in India; and the global financial crisis and the Indian economy. The last published RCF was in the year 2013 and it addressed the theme of fiscal-monetary coordination. Since then, there has been a hiatus.

8. Many of those who toiled to give the RCF themes and direction, and later worked with me, expressed a latent passion for reviving it and by doing so, to restore a tradition that is as old as the Reserve Bank. They would often tell me that they drew their inspiration from the book titled *Indian Currency and Finance* written by John Maynard Keynes after he left the British civil service in 1908 to lecture on

Indian monetary issues at the London School of Economics and Cambridge University. It was his first published book in 1913, its publication hastened by the fact that he was offered a position on the Royal Commission on Indian Currency and Finance in that year, which was a major opportunity for him to influence policy. The book itself stands out for its critical exposition of the Indian currency and banking system of that time, with priceless nuggets such as debunking of the hypothesis that a depreciating currency is advantageous to a country's foreign trade, shifting the focus instead to its inflationary consequences; the appropriateness of the gold exchange standard of India at that time rather than a gold standard; the advantage of elasticity in a paper currency system as opposed to a metallic standard; and the need to lower rates of interest to more reasonable level than prevalent in those years.

9. What struck me was his advocacy for a central bank (he called it a State Bank) for India: *"Such a Bank, confining its transactions strictly to Banking principles and business, and established by Act of Parliament and possessed of adequate capital, would, under judicious management and control, become an instrument of general good by facilitating the employment of a portion of the redundant capital of this country for the general improvement of Indian commerce, giving stability to the monetary system of India, and preventing those occasional fluctuations to which it is at present subject….".* Towards the close of the book he went on to describe from his experiences the Indian banking and financial system incisively with perhaps as much relevance then as now: *"..the Indian system is an exceedingly coherent one. Every part of the system fits into some other part…But the complexity and coherence of the system require the constant attention of anyone who would criticise the parts. This is not a peculiarity of Indian finance. It is the characteristic of all monetary problems…I urge that, in her Gold-Exchange Standard, and in the mechanism by which this is supported, India, far from being anomalous, is in the forefront of monetary progress. But in her banking arrangements, in the management of her note issue, and in the relations of her Government to the money market, her position is anomalous; and she has much to learn from what is done elsewhere*." Indeed, so deep was the impact of Keynes' first book on professional research in the Reserve Bank that in the early decade following Independence, one section of the Report on Currency and Finance was called Indian Currency and Finance.

10. The motivation to restart the Report on Currency and Finance emanated from within. Our research teams would approach me with this fervent plea, appealing as much to history and tradition as to give expression to in-house research and the evolution of ideas which, on several occasions, I found to run ahead of contemporaneous developments in the environment around us. And when a gentle encouragement came from a leading opinion-maker and a long time observer of the Reserve Bank, I agreed[3]. We searched for a theme and what better one in the run up to the mandated re-appraisal of India's inflation target than a comprehensive review of the monetary policy framework! It is an apposite theme. Close to a quinquennium of experience with this major structural reform, inflation targeting is now under the belt of the Reserve Bank in spite of considerable initial – and I suspect, continuing – scepticism and reservation. Till COVID-19 struck, however, it had received a fair measure of acceptance

3 T C A Srinivasa Raghavan in the Business Standard, January 18, 2020.

and even appreciation, both domestically and externally, among international investors, analysts and multilateral institutions. Being a formal framework in the interest of transparency, accountability and clarity of communication, we continue to grapple with its nuances and their intersections with practical day-to-day central banking functioning. There has been also some lively debate on how the Reserve Bank of India would marry the primacy accorded by the framework to price stability with concurrent and often overriding concerns about strong and sustained growth that is so crucial for an emerging economy. Several leading central banks were also undertaking framework reviews around this time.

11. The outbreak of the COVID-19 pandemic brought extreme stress on the people of the world, throwing into disarray lives and livelihoods, and forcing fiscal, monetary and financial policies out of their standard operating procedures into unprecedented responses. Some of us were infected, some hospitalised and all of us lived dangerously. Yet, we survived and live to tell the tale.

12. Drawing on the country experience, this Report, the $12^{th}$ in the theme-based volumes that made their debut in 1998-99, reflects on the flexible inflation targeting (FIT) framework that was enacted in 2016 as the monetary policy architecture for India, its relevance to the Indian context and the way forward. The Report evaluates the level of the inflation target, and the tolerance band around it from the point of view of its appropriateness in evolving macroeconomic and financial conditions, the objective of growth and its compatibility in the tradition of dual mandates with FIT, the operating procedure and issues in transmission, procedural and institutional processes and the issues that impinge on the conduct of monetary policy in a globalised environment. All this is set in a historical perspective which depicts the conditions under which the monetary policy framework became an imperative, the graduated and calibrated establishment of certain pre-conditions and legislative processes that brought into force *de jure* institutional arrangements for its operation and accountability, and an assessment of the experience with the new framework. Woven into the narrative is a ringside view of the testing challenges that confronted us in these formative years, especially in the global environment, as well as the windfalls that facilitated its adoption. An important caveat to note is that the analyses and narrative exclude the period under the COVID-19 pandemic due to problems in data collection, consistency, coverage and quality.

13. In closing, it might be apposite to say a few words on the team of professional research personnel that has worked tirelessly in pandemic times to convert the evolution of ideas into a living report. The objective of theme-based reports has been to channel policy-oriented research energies in the form of analytical enquiry and empirical validation into topical issues that engage national attention. The purpose is to verify each testable hypothesis with facts and place the findings in the public domain so as to offer to the public readership a comprehensive, balanced and in-depth assessment of the subject in its entirety against the backdrop of contemporaneous developments. For this RCF, issues relating to monetary policy that engage public attention on a daily basis and the first few years under a new monetary policy framework provide a rich opportunity for directing research vitalities for a fruitful public engagement.

14. The team in the RBI pushed itself constantly, challenging every obstacle, every hardship that was flung at it by the pandemic even as timelines on all other work engagements, including other flagship reports, statistics and surveys, and presentations to the monetary policy committee, were assiduously maintained. Team members challenged each other too, with a diversity of views and differences of opinions on several issues that were relevant to the theme. Seniors mentored their younger colleagues, and this helped not only the diversity but also continuity and the building of bench strength. In turn, our younger professional researchers brought in new ideas and challenged the orthodoxy. This competitive evolution of ideas fascinated me and also drew my appreciation.

15. Every crisis provides useful lessons. The COVID-19 pandemic has tested the limits of both conventional and unconventional policies. Monetary policy authorities, in particular, stand at crossroads the world over. Phenomena such as negative interest rates, quantitative and credit easing, and long-term forward guidance are testing the standard models. In addition, they carry on their shoulders the huge burden of unprecedented responses and the trying dilemma of cliff effects, should they unwind and the moral hazard of ramp effects if they have to persevere with policy support for longer. Meanwhile, their policy frameworks are challenged by the simultaneous loss of demand and output, fundamental changes in people's lifestyles and preferences, and tectonic shifts in the environment around them. In this *milieu*, monetary policy authorities must strive to remain effective and relevant. This Report joins this existential debate and hopes to shed light rather than dust. I commend the team in the Reserve Bank for its efforts and I commend the report to its readership.

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