

1.1 Central Banks have evolved worldwide on a continuous basis in response to changing political and economic forces around them. Beginning in the late seventeenth century in Sweden (1668) and England (1694), central banks spread rather slowly in different parts of the world over the eighteenth century (Broz, 1998). In the nineteenth century, however, several countries in Europe such as France (1800), Finland (1811), the Netherlands (1814), Austria (1816), Norway (1816), Denmark (1818), Portugal (1846), Belgium (1850), Spain (1874), Germany (1876), Italy (1893), and Japan in Asia (1882) established the central banks. From then on, the mandate of central banks underwent a complete metamorphosis. Expansion of the financial system led to refinements in regulatory and supervisory framework and growth of clearing systems. Monetary policy assumed critical importance in the conduct of central banking with the emergence of concerns about inflation. Similarly, the developing countries that emerged out of shackles of colonialism entrusted their central banks with the objective of economic growth alongwith price stability. In the late twentieth century, development of global financial markets and proliferation of financial instruments coupled with episodes of financial crises brought to the fore central banks' concern for price stability, financial stability and risk management. The journey of central banking, seen through history, has indeed been quite remarkable.

1.2 The primary impulses for establishing and strengthening of central banking activity in many parts of the world in the twentieth century emanated from exigency of war financing. Economic historians assign war finance as prime consideration for constitution of many of the early central banks (Clapham, 1944 and Hamilton, 1945). Further, war financing led to nationalisation of many central banks, which till then were functioning as private entities. Once the spectre of war receded, the role of central banking was increasingly focused in mobilising resources for planned development and at the same time in tackling high inflation. With the emergence of a number of nation states with the weakening of colonial regimes, central bank mandates in the developing countries, including that in India, went well beyond typical central banking functions so as to encompass a wide range of developmental pursuits. Consequently, central

banks in the developing countries envisaged broadening of their mandate beyond the traditional functions of issuing currency and managing the government debt towards facilitating economic recovery and growth. The seeds of the twin and oft-divergent objectives of central banking in emerging markets were thus planted. While this transition entrusted the central banks with greater responsibility in national development, they also became exposed to the threat of fiscal dominance, where developmental objectives restrained the growth of financial markets and consequently, the efficient conduct of monetary policy.

1.3 The core of modern central banking also consisted of development of financial markets, financial regulation and supervision, management of government debt, administration of payment and settlement systems and maintenance of the external value of currency. Several variants of instruments and targets emerged in different central banks. Though many of the central banks have adopted inflation targeting as the core objective and recorded a fair degree of success, the consensus on inflation targeting as an exclusive central banking mandate remains elusive. Further, with a view to strengthening the operating procedures of central banking in order to achieve the desired objectives, the issues of autonomy, transparency, accounting standards and risk management have assumed importance. With a vision to deal with increasing complexities in operational procedures, research activities have been given considerable importance in analysing the economic environment and devising suitable strategies. The challenges of globalisation leading to free flow of capital, trade and information across the borders have necessitated redefining the statutes of central banking, both in developed and developing countries.

1.4 The Reserve Bank of India, currently at its seventieth anniversary, has also traversed a challenging voyage. To delineate the progression of central banking in India, the present report attempts a journey through time and tries to capture the transformation of central banking in India. The initial endeavors to constitute a central banking institution in India can be traced to 1773 when Warren Hastings introduced the plan for a 'General Bank in Bengal and

Bihar' in the backdrop of the need for a treasury in the then prevalent socio-economic circumstances. It was, however, much later that the sequence of initiatives crystallised into a concrete proposal. It was about the beginning of the twentieth century when the debate on the issue of constitution of a central bank veered in favour of the proposal. The Imperial Bank of India which emerged as a consequence of the amalgamation of three Presidency Banks of Bengal, Bombay and Madras in 1921 assumed certain central banking functions except currency management. The control of currency management continued to be with the Government of India in order to ensure that the central banking entity did not appropriate powers greater than those mandated by the political authority. Notwithstanding the general support for a 'mixed' type of institution, through the years of controversy on the constitutional set up of the central bank, the Reserve Bank of India Act was placed on the statute book on March 6, 1934. The Reserve Bank commenced operations on April 1, 1935 and was nationalised on January 1, 1949. This report with the theme 'The Evolution of Central Banking in India' attempts to analyse the evolution of the Reserve Bank of India over the last seventy years in the context of development of central banking worldwide.

1.5 As a prelude to the substantive theme based chapters, chapter II titled, "Recent Economic Developments", provides an analytical review of the macroeconomic environment in the Indian economy during 2004-05 and 2005-06, until February 28, 2006.

1.6 The theme based discussions begin with chapter III titled "Functional Evolution of Central Banking". The chapter presents a theoretic exposition of the genesis of central banking alongwith an account of the evolving contemporary functions and procedures. It presents an overarching view of the central banks since their incorporation based on global developments. There is an attempt to trace the historic evolution of central banking functions while dealing with the core traditional functions in detail, mainly as creators of innovative methods of the exchange medium, maintain the internal and external value of currency, act as bankers to the government, lenders-of-the-last-resort, and regulators and supervisors of the banking system. The function of maintenance of financial stability is also analysed, besides covering the developmental functions performed by central banks in developing countries such as market making and financial sector reforms, institution building, coordination and cooperation, and data dissemination and communication in the face of

evolving needs. It further captures the role of central banks in development of the financial markets, in bridging information asymmetry and significance of policy-oriented research function as the in-house research activities form the backbone of central banking operations. The chapter concludes by underscoring some of the contemporary issues that are being actively debated in the literature on central banking such as independence, accountability, transparency and credibility.

1.7 In chapter IV of the Report titled, "Central Banking in India", the conceptual evolution of central banking functions in India is traced by providing a historical perspective. The functional transition of the Reserve Bank from performance of core functions to taking over a multitude of new functions in the context of emerging macroeconomic and socio-political conditions is discussed in detail. The analysis is sequenced into three phases, viz., foundation phase (1935-1950); development phase (1951-1990); and reform phase (1991 onwards) for the purpose of exposition. The chapter also delineates the flexibility in the Reserve Bank of India Act which enabled the Bank to adapt to rapidly changing external and domestic economic environment. The earnest efforts of the Reserve Bank in institution building to complement the planning process for augmenting flow of rural and industrial credit, besides improving efficacy of monetary policy transmission impulses are also detailed. Further, the measures initiated by the Reserve Bank to build a financial system in line with the international best practices are highlighted. The evolution in monetary policy framework and exchange management and control have also been discussed, in some details.

1.8 In the reform phase, the chapter dwells on financial sector reforms, banking sector reforms and the complementary reforms in the debt market, external sector and monetary policy framework. Against this backdrop, the performance of the Reserve Bank's policies in withstanding shocks is highlighted. The irreversibility of Reserve Bank's approach towards liberalisation and reforms process is underscored. The chapter reflects extensively on liquidity management by the Reserve Bank in its approach to the conduct of monetary policy in the context of more transparent, market oriented procedures, shifts in basic functions towards technology oriented currency management, introduction of Real Time Gross Settlement (RTGS) system, advances in information technology and the pursuit of financial stability objective in alignment with best international practices in regulation and supervision.

1.9 Chapter V titled, “Financial Regulation and Supervision”, traces the genesis and evolution of regulatory and supervisory functions of the Reserve Bank of India. The chapter attempts to map out different stages of transition of the Reserve Bank in the area of regulation and supervision since inception and delineates evolution of regulatory and supervisory policies and strategies. The evolution of commercial banking regulatory framework is discussed during the periods of 1950-1968; 1969-1991; and 1991 onwards. It highlights the efforts of the Reserve Bank to align the Indian banking and financial systems to the best international regulatory and supervisory benchmarks with necessary modifications that suit the Indian system. Besides covering the banking sector, the multifarious dimensions of the Reserve Bank’s regulatory role over cooperative banks, non-banking finance companies (NBFCs) and the development financial institutions (DFIs) is also outlined. The chapter also discusses whether there is a conflict of interest for the Reserve Bank as regulator and supervisor and as the monetary authority. The chapter discusses the emerging issues relating to Reserve Bank’s approach to financial stability, Basel II norms and their implications for the Indian banking system, regulatory preparedness of the Bank in managing financial conglomerates, and regulation and supervision of electronic banking in India. The chapter finally sketches the possible future role of regulation and supervision in the light of various developments affecting the financial systems.

1.10 Chapter VI of the report titled, “Financial Market Evolution and Globalisation”, brings out the crucial role played by the financial markets in promoting economic growth. It presents a comprehensive analysis of the issues relating to the evolution of financial markets, while underscoring the rationale for central bank’s involvement in development of financial markets. Against this backdrop, it depicts the Reserve Bank’s role in development of the money, Government securities and foreign exchange markets in India. The growth, evolution and characteristics of the financial markets in India are framed into two phases, viz., the pre-reforms (before 1990) and post-reforms (since early 1990s) periods. The chapter further delineates the progression of institutional, legal, technological and regulatory frameworks and innovation of instruments through these phases. It analyses the issues relating to market integration and volatility, and outlines dilemmas and challenges. The chapter brings out the changing role of the Reserve Bank in development of financial markets in the context of liberalisation and

globalisation, the evolution of monetary policy transmission mechanism, the constraints posed by the legal and institutional infrastructure, and finally outlines the challenges for future.

1.11 Chapter VII titled, “Issues in Monetary and Fiscal Interface”, analyses the major developments in monetary fiscal interface in India since inception of the Reserve Bank and discusses the future challenges in the context of introduction of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003. The chapter traces the evolution, theory and analytical framework on the subject in the global context. While recognising that monetary fiscal interface modalities are country specific, the issues of consistency and complementarity of monetary and fiscal policies, which are the prerequisites for market confidence and monetary stability are underlined. The evolutionary process of monetary fiscal interface in India is sequenced into three phases, viz., the formative phase (1935-1950); the fiscal dominance and monetary accommodation phase (1950-1991); and the phase of macroeconomic crisis, reforms and their impact (1991-2003). As public debt management by the Reserve Bank is a critical link between the monetary and fiscal policies in India, this chapter details the developments in this area, tracing the shift from passive to active debt management strategy in a rule-based fiscal consolidation framework (2003-2005). In the context of the FRBM Act, an analytical exposition of fiscal and monetary coordination for the period 2005-2009 is presented. Finally, while making an assessment of monetary fiscal interface in India, the chapter highlights certain issues by way of concluding observations.

1.12 The balance sheet of a monetary authority is unique since the central bank is a source of money creation on the one hand, and that it mirrors the central bank relationship with the government, banking and financial system on the other. Chapter VIII titled, “Balance Sheet of the Reserve Bank”, traces facets of central bank’s balance sheet and its linkages with the development dynamics of the Indian economy, reflecting the complex role of the central bank as monetary authority, debt manager, and regulator of the banking sector and financial markets. There is presentation of an analytical account of the Reserve Bank’s balance sheet against the backdrop of select country experiences. Beginning with an overview of the analytics of the balance sheet of a central bank, the chapter gives an account of the primary monetisation inherent in the balance sheet of the central bank in terms of creation of reserve money.

Further, besides focusing on the country experiences in formulation and presentation of the central bank balance sheets, it outlines a host of issues including the differences among central banks in terms of composition of assets and liabilities, capital and reserve positions, while also reflecting on the differences in the responsibilities entrusted to central banks. Issues relating to capital and reserve position and country experiences in respect of the mechanism of profit distribution between the government and the central bank are also dealt with.

1.13 A detailed analysis of Reserve Bank's balance sheet is presented against the backdrop of the regime shift in terms of monetary policy evolution and the changing macroeconomic environment. The analysis is undertaken in four phases, formative phase (1935-1949); foundation phase (1950-1967); phase of social control (1968-1990); and phase of financial liberalisation (1991 onwards). The chapter dwells extensively on the changing role of the Reserve Bank as reflected in the size of the balance sheet, its composition (domestic *vis-à-vis* international assets), support to the government, volume and terms of financing to the financial system, build-up of foreign exchange reserves and assesses its impact on the income profile of the Bank. In line with the global developments, the balance sheet of the Reserve Bank reflects an apparent shift towards the adoption of international best practices in accounting and disclosure norms. The evolution of accounting practices is also covered. Further, the chapter analyses the profit and loss account of the Reserve

Bank and its constituents. Besides, the trends in income and expenditure and issues relating to transfer of profits to the Central Government are also detailed. The emerging issues relating to transparency in central bank accounts; risk management in central banks; and contingency reserves are also addressed. Finally, an assessment of the emerging issues and their likely impact on the policy actions of the Reserve Bank is attempted.

1.14 Chapter IX titled, "Organisational Evolution and Strategic Planning", traces the organisational evolution and management development in the Reserve Bank since inception and brings out the changing role and functions taken over by it through the years. The chapter outlines the significant steps taken by the Reserve Bank in terms of organisational restructuring as well as manpower management to be able to appropriately respond to emerging situations in the economic and financial system. Strategic planning has, of late, come to the forefront of any debate on central banking. Against this backdrop, the chapter dwells on strategic planning initiatives of the Reserve Bank in terms of setting concrete objectives and crafting strategies for their achievement in the medium-term. The chapter outlines some of the BIS initiatives in this area and highlights the Reserve Bank's efforts in successfully calibrating the organisational transformation in the face of changing internal and external environment.

1.15 Finally, the chapter X titled "Concluding Observations" sets out some final reflections on various issues concerning the central banking in India.