X CONCLUDING OBSERVATIONS

10.1 This Report has attempted to capture the changing features of central banking in India since the inception of the Reserve Bank in 1935. The functions of the Reserve Bank have emerged out of a diversity of roles entrusted to it and its key functions have been specifically examined in this Report – regulation and supervision, financial markets, the monetary fiscal interface and dynamics of the balance sheet. The changing contours of monetary policy were dealt with extensively in last year's edition of the Report on Currency and Finance (RBI, 2005). The organisational and operational evolution of the Reserve Bank has reflected its functional responsibilities as they emerged with the changing socio-economic and political conditions through its history, a phenomenon similar to most of the central banks.

10.2 In the last century, across the world, central banks have played an increasingly important role in macroeconomic policy making and have continually reoriented their policies to cope with new challenges thrust upon them. To strengthen the monetary policy transmission channels, central banks have also played a vital role in the development of financial markets and the related institutions, especially after the South East Asian crisis of 1997. The central banks of developing countries have matured immensely in terms of policy making and have leap-frogged by adopting the best practices in the payment systems and banking technology. Indeed many central banks have taken over a whole range of functions, becoming multitasking institutions that conduct monetary policy, regulate and supervise the banking system, perform a crucial role in the payment and settlement system, and seek to maintain financial stability in the economy. Interestingly, central banking was initially practiced with a large number of informal norms, conventions and self-imposed codes of conduct. These were later formalised and institutionalised into laws that form the basis of modern central banks in recent years.

10.3 The functions of central banks have evolved with their respective financial systems and successfully transited from direct to indirect instruments of monetary policy. But, most importantly, since the early 1990s, the objectives of monetary policy have become increasingly focused and more precisely defined, consistent with the central banks' goals of price and financial stability.

10.4 In recent years, the emphasis on regulation and supervision of financial system has been intensified as central banks are increasingly focusing their attention on financial stability. Commercial banks, generally the most prominent part of the financial system, are subjected to more intense regulation as compared to the non-financial firms, as banks are much more leveraged than other firms due to their capacity to garner public deposits. In view of rapid globalisation, integration of financial markets and free movement of capital, bank regulation is increasingly becoming risk-centric. The adoption of Basel norms by many central banks, especially Basel II, has not only brought regulation and risk management in focus but also helped in universalising uniform standards across the banks in different countries.

10.5 Central banks have served as a reservoir of expertise that is generally drawn upon by governments and institutions, both domestic and international. In this context, economic research has played a critical role in defining the functional responsibilities of any central bank. Central banks have occupied the center-stage of the financial system in any economy despite a continuous change in their functions and are expected to continue to make a significant contribution in policy making and financial stability.

I. CENTRAL BANKING EVOLUTION IN INDIA

10.6 There is no standard international model for the evolution of a central bank. The Reserve Bank has undergone incessant transformation on account of a continuous change in its environment and has successfully operated in distinctly different regimes since 1935. The only constant in the evolution of the Reserve Bank since its inception is change. During most part of the earlier phase, it was a privately owned institution, though formed under a statute and overseen by the then colonial Government. The Central Office of the Reserve Bank, which was initially located in Calcutta was permanently shifted to Bombay, the commercial capital, in December 1937. Establishment of the Issue and Banking Departments was the statutory responsibility of the Reserve Bank and these were set up at inception of the Bank. The other departments were formed to perform functions that devolved on the Reserve Bank in different economic situations and political regimes.

10.7 The evolution of the Reserve Bank since independence has been marked with flexibility in responding to domestic necessities and compulsions, and an endeavour to match the best international practices. The transformation in central banking functions over the decades can be traced quite conveniently through the different phases. In the early years, the main functions were note issuance and banker to the Government. The Reserve Bank provided a range of services to the Government, facilitated war finance, administered exchange control and ensured a smooth transition of currency management from the colonial to independent India. In its formative years, there was no formal monetary policy formulation other than regulating the supply and demand for credit in the economy. The Bank Rate, open market operations and the reserve requirements were the prime mechanisms for modulating credit availability. The regulatory and supervisory role received focus only after 1949, with the nationalisation of the Reserve Bank and enactment of the Banking Regulation Act, in the backdrop of a number of bank failures.

10.8 The functions of the Reserve Bank, as the central bank of a developing country emancipated from centuries of colonial rule, became more diversified with the launch of Five-Year Plans in 1951, in terms of Plan financing and institutional development to promote savings and investment in the economy. The Reserve Bank was expected to finance the resource gap of the Government that had taken up the task of growth promotion in the economy. The system of automatic monetisation of fiscal deficit initiated in 1955 which restricted the operation of monetary policy, was extensively used until 1994. In the 1960s and 1970s, institutional development assumed importance in view of the weak financial system that existed alongwith an underdeveloped commercial banking network in the economy. To facilitate sectoral development, specialised institutions were set up. The developmental phase that followed, mainly involving nationalisation of banks and directed priority sector lending, was characterised by a number of controls and regulations.

10.9 Monetary policy assumed a new focus in the 1980s. The expanding banking network in terms of geographical coverage, even in non-viable locations, sectoral allocation of credit, maintenance of high levels of reserve ratios and concessional rates of interest in some sectors affected the quality of bank assets and strained their profitability. The high level of monetisation of the fiscal deficits and market borrowings by the Government at non-market rates of interest, alongwith administered interest rates resulted in somewhat stunted growth of the market for financial assets. The underdeveloped state of financial markets impaired the effective transmission of policy signals.

10.10 In the 1990s, the process of liberalisation of the economy added several new dimensions to the responsibilities of the Reserve Bank. In the backdrop of financial sector reforms, the monetary policy framework was adjusted and conventional central banking functions were revamped in consonance with global trends, technological developments and domestic expediency. The first phase of reforms focused on deregulation of the banking industry; strengthening of the institutional framework in banking, non-banking financial companies and financial institutions through prudential norms; and improvements in payment and settlement systems. The second phase of reforms emphasised the adoption of prudential norms in the financial system, in a gradual manner with an objective to converge to the international standards.

10.11 A number of innovative measures were undertaken by the Reserve Bank in the earlier years of reforms to overhaul the financial system. The important measures were - deregulation of interest rates, rationalisation and lowering of reserve ratios, elimination of automatic monetisation of the fiscal deficit, activation of the Bank Rate and introduction of indirect instruments of monetary policy, especially the Liquidity Adjustment Facility, to modulate daily liquidity. Although there is no formal targeting of overnight interest rates, the LAF has enabled the Reserve Bank to de-emphasise targeting of bank reserves and to focus increasingly on maintaining an interest rate corridor. The introduction of measures has been gradual and has generally been done after wide consultations with market participants, policy makers, international experts and academicians through various technical committees and sub-groups.

10.12 In the context of the monetary policy framework, there has been greater activism in liquidity management and an enhanced focus on the short-end of the market. In the deregulated framework, with the role of market forces becoming critical, there has been increasing evidence of changes in the underlying transmission mechanism of monetary policy, *i.e.*, interest rates and the exchange rate gaining importance *vis-à-vis* quantity variables in India. With the liberalisation of the external sector, the monetary targeting framework came under stress owing to increasing capital inflows. These developments solicited review of the monetary policy framework and in accordance with this, the Reserve Bank switched to a more broad-based "multiple indicators approach" in 1998 in monetary policy formulation.

II. REGULATION AND SUPERVISION

10.13 The regulatory and supervisory role of the Reserve Bank gained prominence after independence but has been in focus since nationalisation of commercial banks in 1969. At present, the complex financial system in India, mainly consisting of commercial banks, cooperative banks, financial institutions and non-banking financial companies, is regulated and supervised by different authorities. The Reserve Bank regulates and supervises major part of the financial system covering commercial banks, cooperative banks, some financial institutions and deposit taking non-banking finance companies. In the initial years, the regulation of banking system was geared towards meeting the demands of a developing economy and a number of measures undertaken to strengthen the banking system were successful. Then, the regulatory and supervisory functions of the Reserve Bank focused primarily on ensuring soundness of banking operations and protection of small depositors through measures of compulsory mergers and liquidations, and introduction of deposit insurance scheme. Reserve Bank's new era of regulation began with the 'Social Control' of banking which took the shape of nationalisation, directed lending to priority sector and administered interest rate regime. The need for social control over banks was felt in the context of the major lacuna that banking services were not available in many rural and urban areas, as well as in many preferred sectors, notwithstanding the considerable progress made in both functional and geographic coverage of the banking system since 1951. In terms of outcome, nationalisation succeeded in spreading the network of banks in rural areas and mobilising private savings. However, the savings so mobilised were mainly used for supporting government borrowings though *hitherto* neglected genuine credit needs in the rural areas were also met to a certain extent. The Reserve Bank supported nationalisation of the banks to ensure compliance with social control norms. This called for significant changes in the institutional arrangements, and more stringent regulation and supervision of the banking system.

10.14 The phase of excessive regulation and financial repression in the 1970s and 1980s resulted in large scale inefficiency and rigidities in the financial system. The reforms in the 1990s mainly led to a shift of banking sector supervision from micro level intervention towards prudential regulation at the macro level, reduction in statutory pre-emptions, liberalisation of entry level norms and introduction of Risk Based Supervision and international accounting standards, in consideration of the Basel norms.

10.15 In order to ensure financial stability in the economy alongwith the rising level of economic activity and integration of the financial system, the Reserve Bank has initiated measures to strengthen the cooperative sector, in particular the urban cooperative banks (UCBs), while recognising its low manoeuvrability due to 'duality of control'. The regulatory and supervisory measures in this direction are steered towards bringing UCBs on par with the main-stream banking system. The agreements between the Reserve Bank and some of the State Governments to facilitate corrective action in a critical situation, and preparation of institution specific development action plans are important developments, given the complexity of dual control.

10.16 The banking system in India is attempting to transform itself to international standards, despite the emerging challenges. To achieve international excellence, the Reserve Bank is promoting safety and soundness while allowing banking system to compete and innovate through induction of new technology, improved credit risk appraisal, continuous financial innovation, better internal controls and appropriate legal framework.

10.17 The Indian approach to banking sector reforms has been gradual and different from many other emerging market economies, where financial sector reforms resulted in privatisation of erstwhile public sector financial intermediaries. To infuse market discipline, a key objective of privatisation, the public sector banks have been allowed to raise capital from the market in a phased pattern and have hence been listed in the stock market. As the commercial banks are scheduled to implement Basel II with effect from end-March 2007, the Reserve Bank has begun to focus on supervisory capacity-building measures, to identify the gaps and to assess as well as quantify the extent of additional capital, which may have to be maintained by such banks. Finally, while recognising the importance of consolidation, competition and risk management to the future of banking, the Reserve Bank has stressed corporate governance and financial inclusion increasingly.

10.18 In recognition of the importance of payment and settlement systems, the RTGS system was operationalised in March 2004 to take care of all inter-bank transactions. In view of the positive response of the financial sector to the initiatives of the Reserve Bank and with the banking sector coming of age, the Reserve Bank has taken the policy perspective of migrating away from actual management of retail payment and settlement systems but to continue to have regulatory oversight over such functions.

10.19 The Reserve Bank has played a proactive role in implementation of IT in the banking sector as IT based initiatives help to achieve better house keeping, improved customer service and overall systemic efficiency. Consequently, many new processes, products and services offered by banks and other financial intermediaries are now IT-centered.

III. FINANCIAL MARKET DEVELOPMENTS

10.20 The Reserve Bank, like other central banks, has taken a keen interest in the development of financial markets, especially the money, government securities and forex markets in view of their critical role in the transmission mechanism and implementation of monetary policy. The money market is the focal point in intervention by the Reserve Bank for equilibrating short-term liquidity flows, and on account of its linkages with the rest-of-the-world, the foreign exchange market. Similarly, the government securities market has become important for the entire debt market as it serves as a benchmark for pricing of market instruments.

10.21 The conscious efforts by the Reserve Bank to develop efficient, stable and healthy financial markets gained importance as they were repressed in several ways, in the past, by law, regulation and policies. Several factors, mainly administered interest rates, directed credit, weak banking structure, lack of proper accounting and risk management systems hindered market development in India until the 1990s. It was realised early in the reform process that mere easing of restrictions would not automatically help to create vibrant financial markets. Hence, the Reserve Bank initiated measures to facilitate the development of markets through necessary institutional changes and dynamic improvements in market microstructure. Over the years, several measures were taken by the Reserve Bank to address these issues and create a supportive environment for market development. The pace of the reform was contingent upon putting in place appropriate systems and procedures, technologies and market practices. The experience of India indicates that financial market development is a complex process and depends on several factors like sound financial institutions, a favourable legal framework, technological support and congenial policy environment.

10.22 In India, the Reserve Bank has followed a gradual and well-calibrated policy of market reform. The markets have now grown in size, depth and activity, paving the way for a flexible use of indirect monetary policy instruments by the monetary authority. There has also been greater coordination between the Government and the Reserve Bank, as also between the various regulators of financial markets, which has helped in orderly and smooth development of the financial markets in India. Though the various initiatives have resulted in developing deep, wide and liquid, money, government securities and foreign exchange markets, the reform process continues. In context of the integration of the Indian financial markets with global markets, the Reserve Bank has been constantly refining the operating procedures and instruments as also various aspects of financial institutions, markets and financial infrastructure, consistent with international best practices to minimise the domino effect.

10.23 A review of market developments in India during the past seven decades reveals that there is a close link between reforms in the banking sector, monetary policy and financial markets, and that they have to develop together to reap the benefits of reforms so as to avoid disruptions. Financial markets have enabled banks and financial institutions to improve the management of liquidity and treasury operations, and thereby strengthen their fund-based income and profitability. Financial markets development in India, apart from improving monetary policy transmission mechanism, has also facilitated the switchover of emphasis of the monetary policy from credit allocation to monetary targeting and subsequently to the multiple indicator approach.

IV. MONETARY FISCAL INTERFACE

10.24 The monetary fiscal interface in India post-Independence, followed a sequence typical of a developing country whereby monetary policy was expected to accommodate the expansionary fiscal policy. With the onset of development planning requiring large public investment, the fiscal-monetary-inflation nexus was apparent by the end of the 1980s whereby excessive monetary expansion on account of monetisation of fiscal deficits fuelled inflation.

10.25 The history of monetary fiscal interface in India offers useful lessons from the Reserve Bank's experience over the past seven decades. The Reserve Bank had to cope with the challenges emerging from the changing phases of fiscal policy – from fiscal neutrality to fiscal dominance and further to fiscal consolidation, and adapted its instruments and operating procedures suitably so as to foster monetary and financial stability. It was the macroeconomic crisis of 1991, which highlighted the urgency to address the fiscal dominance over monetary policy. Therefore, to phase out automatic monetisation of fiscal deficits, a historic agreement was signed between the Government and the Reserve Bank – a significant step in cooperation and understanding between the fiscal and monetary authorities.

10.26 In view of the high levels of public debt in India, continuation of high fiscal deficit and a history of fiscal dominance, the case for separation of monetary and debt management has evoked some debate. In theory, separation between the two functions would enhance the efficiency in monetary policy formulation and debt management, but the debate in the Indian context needs to recognise certain key dynamics of fiscal-monetary nexus. First, in India, the joint policy initiatives by the Government and the Reserve Bank have facilitated the achievement of a remarkable degree of coordination between debt management and monetary policy formulation. While fiscal discipline and reduced monetisation of deficits have imparted considerable autonomy to the operation of monetary policy in recent years, the Reserve Bank's proactive debt management techniques have also facilitated the conduct of monetary policy, particularly through the use of indirect instruments. In fact, the substantial stock of Government securities held in the portfolio of the Reserve Bank was used to sterilise the monetary impact of the capital flows. Second, the Reserve Bank's experience in managing government borrowings over the years has equipped it with the requisite technical expertise to efficiently fulfill the twin responsibilities of debt and monetary management and simultaneously meet the expectations of the Government and the markets. Third, in the next few years, significant changes are slated to unfold in the Indian fiscal system – a) the central government would cease to operate as an intermediary for mobilising resources for States with the latter having to raise funds directly from the market (as per the recommendations of the Twelfth Finance Commission); b) the Reserve Bank's withdrawal from participation in the primary market of Government securities from April 1, 2006 would have implications for the management of interest rate expectations; and c) the implementation of the proposed amendment to the Banking Regulation Act permitting flexibility in reserve ratios to banks would reduce the captive subscription to Government securities. Therefore, in view of the concerns expressed above, a pragmatic view needs to emerge on the issue to ensure smooth functioning of the financial markets.

10.27 An important aspect of the monetary fiscal interface relates to the autonomy of the central bank. In the process of evolution, globally, while the spectrum of activities of the central banks has widened, the stance regarding the independence of central banks has taken interesting turns. In the Indian context, two related aspects regarding central bank autonomy are being emphasised. The first one relates to the fiscal dominance over monetary policy. The second aspect pertains to the legislative provisions, which clearly provide for government direction of the Reserve Bank, including the appointment of its top management. During the development phase, the growing market borrowings of the government and its monetisation by the Reserve Bank gave rise to questions regarding the relative roles of fiscal policy and monetary policy. Monetary policy, particularly in the 1980s, had to address the task of neutralising the inflationary impact of rising fiscal deficits by mopping up the large increases in reserve money. However, in recent years, the phasing out of automatic monetisation of fiscal deficits in 1997 and the enactment of FRBM legislation in 2003 are two important milestones in the direction of providing safeguards to monetary policy from the consequences of expansionary fiscal policy and ensuring healthy monetary fiscal relationship.

10.28 It is also imperative to take cognizance of an important issue that could shape the future course of the monetary fiscal interface. As per the FRBM stipulations, the Reserve Bank would not be accommodating the Government in the primary market from April 2006. This measure while imparting greater functional autonomy to the monetary authority would necessitate a strict vigil on interest rate movements and sharpening of other tools to transmit monetary signals to the market.

V. THE RESERVE BANK BALANCE SHEET

10.29 The balance sheet of a central bank is, in many ways, unique in character and portrays the financial outcome of its diverse roles and responsibilities in a changing environment in the economy. The Reserve Bank balance sheet has undergone a fundamental change over the past seven decades alongwith transformation of the Indian economy. From the primacy of the note issuance function during the formative years to steady fiscal ascendance during the early phase of planning which culminated into a period of fiscal supremacy coupled with strong developmental role, the Reserve Bank balance sheet has indeed come a long way in the 1990s to achieve dominance of foreign assets, considerable downsizing of investment in Government securities and reduction in reserve requirements. With a compositional shift in Reserve Bank's balance sheet, the risk profile assumes significance especially in a situation characterised by relatively lower rate of return on foreign currency assets, volatility in exchange and interest rates in the global markets, and adoption of mark to market valuation norms with asymmetric treatment for appreciation gains. This situation intensifies the need for adoption of effective and adequate risk management measures. Therefore, the Reserve Bank has not only initiated several measures to ensure revaluation of both domestic and foreign assets on a prudential basis, but also built an adequate cushion in the form of contingency reserves to impart policy flexibility and maintain public confidence.

10.30 In the case of a central bank, larger balance sheet does not necessarily connote sound macro economy. In contrast, transparent balance sheet enhances the credibility of the central bank and infuses efficiency in the conduct of monetary policy. A distinctive feature of the Reserve Bank since its inception has been preparation of two separate balance sheets - one for the Issue Department and the other for the Banking Department – providing transparency in its conduct of monetary policy. The balance sheet data is disseminated regularly at weekly intervals to the public. Similarly, the compilation and publication of broad money data at fortnightly frequency, and the reserve money at weekly frequency by the Reserve Bank, compares well with some of the leading central banks in the world.

VI. COMMUNICATION POLICY

10.31 The Reserve Bank has, over the years, transformed functionally and structurally to the changing domestic and external needs through appropriate policy responses. Transparency has assumed renewed focus with a clear communication policy of the Bank, which enables it to disseminate a wide range of information regularly to the public. The focus of the communication policy until 1991 was on a healthy interaction with the press so as to highlight the transparent manner in which the Reserve Bank conducted the tasks associated with central banking. In recent years, the Reserve Bank has been laying emphasis on a well-designed communication policy with three main features - transparency, timeliness and credibility. The objective of the communication policy is achieved through extensive dissemination of information on the Bank's policies and the processes of their formation. The Reserve Bank extensively uses its website for dissemination of information. The publications of the Reserve Bank, also available on the website, containing data, research studies and speeches of top-management of the Reserve Bank, provide rationale and explanations behind the policy decisions. In an interesting development in recent years, the Reserve Bank regularly solicits feedback on important issues placed on its website.

VII. ASSESSMENT

10.32 The evolution of central banking, not only in India but also globally, indicates that the central banks have successfully continued to adapt to the changing economic environment. In the interaction between the financial intermediaries and the central bank, the focus has been the welfare of the general public. Central banks carefully watch the market trends and monitor numerous variables, both quantity and rates, in the domestic and global economy. The information contained in these indicators and the direct feedback from the market participants helps in calibrating and crafting an appropriate monetary policy to ensure price and financial stability. In the last hundred years, when most central banks were established, the markets, the objectives and instruments of monetary policy have changed. Despite these changes, the central banks have established themselves as a necessary and a permanent part of the financial system.

10.33 The Reserve Bank presently at its seventieth anniversary has had a fair degree of success in achieving the twin objectives of growth with stability, especially in the post-reform period. The well calibrated strategies of the Reserve Bank in refining monetary policy operating procedures, managing the capital flows, ensuring evolution of competitive markets and sustaining a healthy financial system, while also performing the developmental role have yielded visible results. While successfully facing the challenges of globalisation, the Reserve Bank has earned international credibility in terms of efficacy of its policies. The Reserve Bank has achieved commendable transparency in its operations, especially in terms of evolving a communication policy aimed at addressing a wide range of audiences. In sum, notwithstanding the changing challenges of different regimes, the Reserve Bank has managed to evolve constructively on a continuous basis to cope with demands for stable macroeconomic management and financial stability, while meeting the objectives of economic growth and development. As the economy becomes increasingly open and global, the role of the Reserve Bank will undergo further change and it will need to equip itself for coping with these emerging challenges on a continuous basis.