Summary of the Welcome Remarks by Dr.Bimal Jalan, Governor, at the 11th C.D. Deshmukh Memorial Lecture 7-12-2000

On behalf of the Reserve Bank of India and myself, I am very happy to welcome Professor Charles Goodhart to Mumbai to deliver the Eleventh C.D. Deshmukh Memorial Lecture. Prof. Goodhart's work, both as a Central Banker and as an economic thinker, is well known and he hardly needs any introduction before this audience. Educated at Cambridge and Harvard Universities, he has held several high academic positions, and is at present the Norman Sosnow Profesor of Banking and Finance at the London School of Economics. He was appointed as one of the first four independent outside Members of the Bank of England Monetary Committee in 1997.

Prof. Goodhart has also written extensively on monetary history, monetary economics and monetary policy. What I have admired most in Prof. Goodhart's writings, and what you are going to hear, is his ability to take the unconventional and open-minded views on most intricate technical as well as policy issues. With perhaps one or two exceptions, I can think of no one else who has brought so much practical experience to his academic work and vice versa.

We are indeed fortunate in having persuaded him to deliver this Lecture in honour of one of India's most distinguished thinkers and policy makers - Shri Chintaman Dwarakanath Deshmukh.

I do not wish to stand between you and Prof. Goodhart for very long. The subject of his lecture "Whither Central Banking?" is both timely and interesting since the last few years have seen the most significant changes in redefining central banking. Central banks themselves are, of course, very old institutions – I think, Bank of England was founded by an Act of Parliament as long ago as 1694, and Bank of France recently celebrated its 200th Anniversary. The Federal Reserve was set up in 1913. The Reserve Bank of India – although a toddler or at most a young adult by these standards – was set up in 1935, but is one of the oldest central banks in the developing world. For a very very long time, all Central Banks performed more or less similar functions as bankers to Government, issuers of currency, lenders of last resort, supervisors of banks, and so on.

However, in the last few years, several Central Banks around the globe have assumed newly defined roles and identity and are now concentrating on a single monetary policy objective of inflation control with the use of a single instrument. Some have also given up their role as supervisors of banks or as Government debt managers, and concentrate solely on monetary policy. The year 1998 was a landmark year – Bank of England gained independence, Bank of Japan was given operational independence, and the European Central Bank was set up. Their operational styles and methodologies are still evolving, and we in India are also watching current developments with considerable interest. I would like to take advantage of Prof. Goodhart's presence to raise a couple of issues on which Reserve Bank is working and on which there are some unsettled questions. These issues, I understand, will also figure in his lecture.

As I mentioned, there is a growing consensus now – in theory as well as practice - that Central Bank should have instrumental independence, and concentrate on a single target of inflation control with the use of a single instrument. The position, no doubt, is theoretically

sound, but as I look at the history of economic thought and changing fashions in economic policy making, I must confess to a sense of some discomfort on whether the current dominant view on "one target, one instrument" will survive the test of time.

Ultimately, Governments and Central Banks have to respond to the primary concern of the people, and the principal economic problem facing their countries during particular periods of time. When growth is good, productivity and wages are rising in step, external conditions are favourable and inflation is low – there is obviously no problem or conflict, and everyone involved in policy making can concentrate on the objective of keeping things going as they are. Central Banks can do what they know best – inflation control; Government can keep fiscal deficit under control; and businesses can go about doing their business in expanding markets.

But what happens when things are not so good, or there is a conflict between the goal of preventing inflation from going up in future, say, 18 months later by half a percentage point over a low target of 2 or 2.5 per cent, and a sharp down turn in industry here and now? This is when the real problem arises – partly because of transmission lags in the effect of monetary policy and uncertain projections about future outcomes. Under such circumstances, I feel that reliance on mechanistic, simple and narrow rules, designed to restrict Central Banks or Government's discretion or judgement to the maximum possible degree, may not survive the test of time. Already, there are some signs of discomfort emerging in different parts of the world about the pitfalls of too narrow and "pre-set" approach to policy. For example:

- There is some evidence or a fairly respectable view in at least one country, which was a pioneer in introducing the independence of central bank and where an inflation target was prescribed under legislation, that growth was held back and recessionary conditions intensified in the past, because of excessive caution on the part of the central bank.

- The issue is also being debated in a couple of major industrial countries, including one in our region. The recent small increase in interest rate in anticipation of recovery has raised some questions as deflationary conditions have persisted and recovery has been much weaker than forecast.

In developing countries, this whole question of trade-off - particularly at the margin - and during periods of external or domestic uncertainties, becomes even more relevant because of a large non-monetised and agricultural economy.

It is also a fact that one of the most respected Central Banks in the world, the Federal Reserve, does not have a unitary narrow target or a mechanistic rule. It is enjoined to look after both price stability and employment, and does not have a declared inflation target.

It seems to me that a certain amount of target flexibility and balancing of conflicting objectives are unavoidable, particularly when things are not so rosy and there are multiple choices to be made and reconciled.

A related issue, which acquires particular significance in developing countries is the definitional issue. Granting that inflation should be the primary or exclusive target, how should it be defined? Most countries, which have adopted a quantitative target, define

inflation in terms of "core inflation" which excludes certain items such as food or oil, and not the so-called "headline" inflation rate. In developing countries, where food can account for more than half the weight in CPI, and where cooking oil can constitute a further significant weight, defining inflation in terms of "core inflation", after excluding these items, may not be very meaningful. In India also, we have gone through periods where core inflation was 2 or 3 per cent but headline inflation was 9 or 10 per cent. People are naturally more concerned about the latter. Reserve Bank is doing some research on this and we are tracking inflation rates on different definitions. However, we have yet to arrive at a firm conclusion. I hope this question will also receive greater attention of academic researchers here as well as abroad.

Another issue concerns the question of importance that should be given to the exchange rates objectives in the operations of the central bank. This issue is particularly crucial for developing countries where foreign exchange markets are generally thin, which do not have automatic access to reserves of other central banks, and where large volatility in exchange markets can have significant real effect. There are three features of the exchange market, which deserve attention:

i. First, capital flows in "gross" terms, which affect exchange rates from day to day, are several times higher than "net" flows on any day – and these are also much more sensitive to what everybody else is saying or doing rather than to changes in economic fundamentals;

ii. During periods of large volatility in "gross" flows, herding becomes unavoidable. "Daily Earnings At Risk" minimisation models necessarily give rise to "herd" behaviour, since everyone prefers to be wrong with everyone else rather than being wrong alone! Herding further accentuates movements in one direction in relation to a currency.

iii. Unlike equity markets, where investors have a choice of holding a large number of scrips, and diversifying their portfolio, such a possibility is limited in foreign exchange markets, as holdings are largely in one or two currencies. In this situation, volatility is unavoidable as there is a scramble to get out of Euro or dollars from Euro or Yen and vice versa on the slightest uncertainty or "news". Expectations are generally self-fulfilling and speculation is likely to be "one way" particularly during periods when stabilisation is most needed. In such situations, the theory about the presence of so called "stabilising speculation" becomes highly obtuse.

Most Central Banks which have adopted the 'single target, single instrument' rule claim not to be concerned about exchange rate unless it affects domestic inflation. Theoretically also, there is a strong case for the so-called "corner solution" – Currency Boards or Free floats – when there is capital account convertibility. Yet, with few exceptions, most Central Banks find themselves compelled to intervene in the forex markets in pursuit of some exchange rate objective, however, ill-defined. We have seen this happening in Australia, ECB, Japan – even Fed in favour of Yen or Euro from time to time. Most East Asian or Latin American countries also follow intermediate regimes. One country with a corner solution – that of Currency Board - in Latin America is currently in trouble.

So theory says 'corner solution', but the real experience says the opposite, and most Central Banks are somewhere between the corners. How do we reconcile the right theory with actual practice?

I am sorry to have taken a bit of your time, but I hope I have sufficiently stimulated Prof. Goodhart to include some of these issues, from the developing countries perspective, in his future research agenda.

I now invite him to deliver the Eleventh C.D.Deshmukh Memorial Lecture.