

**<sup>1</sup>RESERVE BANK OF INDIA**  
**[March 18, 2006]**

**Prime Minister's Speech**

My Cabinet colleague Chidambaramji,  
Dr. Reddy, Ladies and Gentlemen,

It is always a pleasure to be here. There is always something special about returning to a place that was one's own home. Even more so when one has only happy and warm memories. For me and my family, Mumbai has been a second home, and I have the fondest of memories of my tenure here at the Reserve Bank of India.

I am delighted to release the third volume of the History of Reserve Bank of India covering the period 1967-1981. Those were truly momentous years for the central bank, marked by the nationalization of banks, a phenomenal expansion and diversification of the financial sector and battles with monetary policy during an era of high inflation.

Taken together, the three published volumes covering the period 1935 to 1981, span a truly historic phase in the economic evolution of India and in the maturation of our financial institutions. On this occasion, I pay tribute to the former Governors of the Reserve Bank such as C.D.Deshmukh, L.K. Jha, S. Jagannathan, I.G. Patel, R.N.Malhotra, C.Rangarajan, and Bimal Jalan who contributed to the growth and evolution of this great institution.

Institutional histories are important because they record the role played by institutions in shaping events of the time. But history is not a mere record of events. A useful history must also look beyond and behind the events, analyse, explain and evaluate the role played by the institutions in shaping and designing public policy of the time as well as the impact of the political and economic circumstances of the time on the institution itself. I am sure that the three volumes narrating the functioning of the Reserve Bank during the period 1935-1981 will not only have a 'historical value' but also 'contemporary relevance'.

Ladies and Gentlemen,

The role of central banks, starting with the establishment of the Bank of England in 1694, has evolved over time. It is now widely agreed that the key functions of a central bank are to maintain monetary and financial stability. Central banks in developing and emerging economies, however, have the additional responsibility of promoting development and growth through a proactive role. I had noted more than two decades back when I was the Governor of the Reserve Bank: "the policies of a country's central bank and monetary authority have profound implications for the functioning of any modern

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<sup>1</sup> "Credit Policy of the Reserve Bank of India". Inaugural Address at the seminar organized by Maharashtra Economic Development Council, Mumbai on November 18, 1982.

"economy", and the "objectives of our monetary and credit policies have to be consistent with the nation's overall social and economic objectives"<sup>1</sup>. Viewed from this perspective, the Reserve Bank has contributed to economic growth and employment generation in the economy through maintenance of price and financial stability while ensuring adequate availability of credit to various sections of the society. In addition, the Reserve Bank has also successfully discharged its non-traditional responsibilities such as the development of agricultural credit, rural co-operatives and development finance institutions. These facets of the Reserve Bank's role are well documented in the History volumes being released today.

During the 1990s, in the changed milieu, the Reserve Bank had a greater role to play in ensuring macroeconomic stability. Structural reforms were initiated to improve the efficiency of the economy and the country's growth prospects in the aftermath of the unprecedented balance of payments crisis of the early 1990s. These reforms were successful in achieving their objectives. In the post-reform period, India has been able to achieve a higher growth rate in an environment of macro-economic stability. Financial and external sector reforms have been a key ingredient of structural reforms initiated in the Indian economy and in both these areas the Reserve Bank has played a proactive role in coordination with the Government.

### **Price Stability**

Ladies and Gentlemen,

Compared with many developing economies, the Indian inflation experience can be considered satisfactory despite recurrent supply shocks. Although inflation increased during the 1970s and remained high thereafter till the mid-1990s, reflecting in large part fiscal expansion, the period since then has witnessed a significant lowering of inflation and inflation expectations, thanks to a prudent monetary policy. Indeed, inflation has averaged less than 5% over the past decade. It is a matter of great satisfaction that in the past couple of years, despite record high international crude oil prices, we have been able to keep inflation low and contain inflationary expectations.

### **Monetary-Fiscal Interface**

Cross-country experience suggests that success with achieving and maintaining price stability is crucially dependent upon the nature of monetary-fiscal interface and fiscal prudence. I had observed two decades back "Indian experience both in 1974-75 and 1981-82 shows that an active monetary policy can play an important role in curbing inflationary expectations. However, if monetary restraint is to achieve its objective without too much loss of potential output, excessive burden must not be placed on monetary policy. In addition, the fiscal system must be so operated as to avoid excessive recourse to Reserve Bank credit for financing public expenditure"<sup>2</sup>. While this aspect was recognized in the 1970s and 1980s, it was only during the post-reform 1990s

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that the Reserve Bank began to enjoy flexibility in the conduct of monetary policy. The key policy development that enabled a more independent monetary policy environment was the discontinuation of automatic monetisation of the government's fiscal deficit through an agreement between the Government and the Reserve Bank of India in 1997.

This has been further strengthened by the enactment of the FRBM Act. From 2006-07, the Reserve Bank will no longer be permitted to subscribe to government securities in the primary market. Given the critical importance of fiscal-monetary interface in ensuring macroeconomic stability, our Government is committed to pursuing the path of fiscal consolidation as laid out by the FRBM Act. A prudent fiscal policy lightens the burden to be borne by monetary policy. Adherence to these fiscal rules will help to manage inflation expectations and keep inflation low and stable. It is now widely acknowledged that the best way monetary policy can contribute to growth and higher employment generation is through price stability - defined as low and stable inflation. Inflation is a regressive tax that hits the poor the most. Price stability is, therefore, all the more important for an economy like ours, with a large proportion of poor population that has no hedge against inflation.

### **Financial Stability**

Ladies and Gentlemen,

While price stability is important and necessary, it is not sufficient. With the opening up of the economy since the early 1990s, financial stability has now emerged as a second key consideration in the conduct of monetary policy in India. It is heartening to note that the RBI has also been successful in maintaining financial stability in the country even during the progressive liberalization of the economy from the early 1990s. The Indian record on this front is especially noteworthy as the decade of the 1990s has been otherwise turbulent for the financial sector in most emerging market economies. Financial sector reforms in India initiated during the 1990s were aimed at promoting a diversified, efficient and competitive financial sector and the reforms have succeeded in their objectives. In the environment of a deregulated financial sector, our ability to maintain financial stability, even as it eluded many other economies, can be attributed to the success achieved in ensuring reasonable price stability in the economy on the one hand and prudent policies in regard to financial and external sector management on the other.

### **External Sector Management**

External sector management of the economy has been one of the more notable successes of macroeconomic management in the country. India's cautious approach towards opening of the capital account with preference for FDI flows, while de-emphasising short-term debt flows, and viewing capital account liberalization as a process contingent upon certain pre-conditions has been vindicated in the light of the financial crises in a number of emerging economies. This cautious approach in regard to capital flows is clearly warranted, given the fact that capital flows are known to exhibit a highly cyclical pattern. It is, therefore, necessary to attract relatively stable component of capital flows while de-emphasising the volatile components. Concomitantly, there is a need to build foreign exchange reserves beyond the traditional import

cover criterion. India's policy of building adequate foreign exchange reserves has contributed to maintaining financial stability and added to the economy's resilience.

Ladies and Gentlemen,

India's current account balance, after posting modest surpluses during 2001-2004, has returned to a deficit in consonance with the resurgence in investment demand in the economy. India's merchandise exports have been recording a robust growth along with exports of services. Non-oil import demand remains strong. Against this backdrop, the current account deficit by itself should not be a cause for concern. I believe our current account deficit is still in a comfort zone as it can easily be financed through normal capital flows.

Finally, our exchange rate policy of a largely market-determined exchange rate with a focus on managing volatility has stood the test of time. The Indian experience highlights the need for flexibility and pragmatism in the management of exchange rate.

Ladies and Gentlemen,

In concluding, I must confess that the success of the reforms we launched in the 1990s, both in stabilizing our economy and modernizing our financial sector, has been beyond our expectations at the time. The Reserve Bank has played an important role in the implementation of reforms by maintaining price and financial stability and by contributing to building a robust external sector during a time of great flux.

We have bigger challenges ahead. Growth has to accelerate further. Poverty has to be reduced faster. Employment has to be expanded quicker. The credit needs - both of our farmers and the small and medium enterprise sector - have to be met on a priority basis. Our banking system must also pay adequate attention to meeting the demand for credit by the decentralized sector at an affordable cost. This is our national agenda. The Reserve Bank too will have an increasing role in pursuing this national agenda.

Today, globalization is changing many familiar things - the way we think, act and perform. It is changing central banking too. Funds in large amounts move across borders with ease and speed. Maintaining financial stability in the face of such forces of globalization is a challenge. But globalization is an opportunity too as it makes it possible to harness global capital in search of investments for furthering national goals. The Reserve Bank has to remain ahead of the curve so as to minimize the costs and maximize the benefits of globalization for the country.

A proposal to make Mumbai a Regional Financial Centre is already under active consideration. Our economic reforms have accelerated growth, enhanced stability and strengthened both external and financial sectors. Our trade as well as financial sectors are already considerably integrated with the global economy and the trend is irreversible. Mumbai, with all its inherent advantages in terms of human capital and commercial acumen, can be positioned as a viable Regional Financial Centre. We need to work towards this objective.

Given the changes that have taken place over the last two decades, there is merit in moving towards fuller capital account convertibility within a transparent framework. This issue was first examined by the Tarapore Committee. Much water has flown down the Ganga since then. Our own position, internally and externally, has become far more comfortable. I will, therefore, request the Finance Minister and the Reserve Bank to revisit the subject and come out with a roadmap based on current realities. Progress in this regard will facilitate the transformation of Mumbai into not only a Regional but also a Global Financial Centre. There are multiple options that are possible for such a centre, including as an SEZ, and I am confident that we can make steady but firm progress in that direction. The State Government will have to ensure an appropriate enabling environment, in particular the physical infrastructure.

Ladies and Gentlemen,

As a large, fast growing economy, there is increasing global interest in India. The motive force behind India's emergence as a knowledge economy is the skill endowment and capacity of our work force. We should strive not only to maintain, but improve our comparative advantage in the services sector. Financial services have emerged as one of the major service industries in the Indian economy. At the same time, the integration of Indian financial markets into the global system and the introduction of new financial products require better risk management and financial engineering skills. It also casts new burdens on regulatory institutions. Enhancing the skills of personnel involved in the financial sector is, therefore important.

The Bankers Training College is one of the frontier institutions under the RBI umbrella. In view of the rapidly changing environment, and given the growing strength of the Indian financial sector, there is a strong need for an institution that can act as a centre for policy research on areas relating to banking and finance. The BTC is well-poised to take on this new role. Therefore, the BTC will henceforth be repositioned as a policy oriented institute and I am happy to rename the BTC as "Centre for Advanced Financial Learning". I am sure that in the near future, the Centre would grow into a global hub for banking and finance. I wish the Centre all the best in its challenging role.

Ladies and Gentlemen,

The independent role of the Reserve Bank in articulating its views on the economy and the pursuit of policies aimed at promoting monetary and financial stability are key factors in our economic management.

I wish you the very best in fulfilling these tasks. Thank you.