Evolution of Central Banking in India

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I must congratulate the organizers for choosing this important topic for deliberation in this seminar. I have great pleasure in mentioning that the theme of the *Report on Currency and Finance - 2004-05*, prepared by the staff of the Reserve Bank of India (RBI), is also that of evolution of Central Banking in India (RBI, 2005a). In going through the process of compilation of the Report, I have found the evolutionary process of central banking all over the world and also that in India to be very interesting and informative. The most striking feature of central bank functioning both across time and over countries in a contemporaneous manner, is not how similar their functions are or have been, but how heterogeneous they are and how their functions have constantly evolved over the changing times. My interest in tracking the evolution of central banking in India has also been triggered by the recent publication of the history of the Reserve Bank of India in three volumes, covering the period 1935 - 1981 (RBI, 2005b).

I. Global Evolution of Central Banking

Evolution of central banking is essentially a twentieth century phenomenon as there were only about a dozen central banks in the world at the turn of the twentieth century. In contrast, at present, there are nearly 160 central banks. This is not surprising since the need for central banks obviously emerged as banking became more complex, while becoming an increasingly important part of the economy over time. The many vicissitudes experienced by banks and their depositors inevitably led to cries for their regulation. Second, central banks are essentially a nation state phenomenon, and hence proliferated as nation states themselves emerged and multiplied: again a twentieth century phenomenon. Third, it is useful to recall some of the reasons for the origin of central banks: to issue currency; to be a banker and lender to the government: to regulate and supervise the banks and financial entities: and to serve as a lender-of-last-resort.

This is ironic since much of the current professional thinking is that a central bank should be independent of government, should no longer be a debt manager of the government, and should not regulate or supervise commercial banks. The new objective function assigned to the central bank is to focus on price stability, with financial stability as an additional objective in some cases.

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This is perhaps not surprising since price stability was historically achieved, along with preservation of currency value, through the gold standard, and later through the dollar anchor and its relation to gold. The world lost its monetary anchor on August 15, 1971 when the US decided to delink the dollar from gold, and has been floundering ever since in search of a new anchor.

After the convulsions of the 1960s and 1970s, mainly related to the financing of the Vietnam war, the expansion of world liquidity, and the ensuing somewhat enduring inflation, along with Latin American fiscal and monetary expansion, the new holy grail is independence of the central bank, a concept that is becoming almost synonymous with inflation targeting. And here, though I am too new to central banking to really offer a definitive view, I have to admit to a certain skepticism related to the current fashion among central bankers. Two pertinent questions are natural to be asked. First, why is it so obvious that central banks should abandon their 'parents', the sovereign government? One quick explanation could be that the central banks have 'come-of-age' in recent years. But then, some instances like the case of two currencies in Iraq in the 1990s and that of the Bank of Japan in recent years provide a contrary view to the 'come-of-age' hypothesis (King, 2004). Second, is it really the case that supervision and regulation of banks by the central bank leads to conflict of interest? In consideration of this conflict, the Financial Services Authority was established in the UK in 2000, and a number of countries have followed suit. What I would like to do today is to explore some of these issues as they relate to India at the present time.

II. The Historical Antecedents of Central Banking in India

In India, the efforts to establish a banking institution with central banking character dates back to the late 18th century. The Governor of Bengal in British India recommended the establishment of a General Bank in Bengal and Bihar. The Bank was set up in 1773 but it was short-lived. It was in the early 20th century that, consequent to the recommendations of the Chamberlain Commission (1914) proposing the amalgamation of the three Presidency Banks, the Imperial Bank of India was formed in 1921 to additionally carry out the functions of central banking along with commercial banking. In 1926, the Royal Commission on Indian Currency and Finance (Hilton Young Commission) recommended that the dichotomy of functions and divisions of responsibilities for control of currency and credit should be ended. The Commission suggested the establishment of a central bank to be called the Reserve Bank of India, whose separate existence was considered necessary for augmenting banking facilities throughout the country. The Bill to establish the RBI was introduced in January 1927 in the Legislative Assembly, but it was dropped due to differences in views regarding ownership, constitution and composition of its Board of Directors. Finally, a fresh Bill was introduced in 1933 and passed in 1934. The RBI Act

came into force on January 1, 1935. The RBI was inaugurated on April 1, 1935 as a shareholders' institution and the Act provided for the appointment by the Central Government of the Governor and two Deputy Governors. The RBI was nationalized on January 1, 1949 in terms of the Reserve Bank of India (Transfer to Public Ownership) Act, 1948 (RBI, 2005b).

The main functions of the RBI, as laid down in the statutes are - a) issue of currency, b) banker to Government, including the function of debt management, and c) banker to other banks. The Preamble to the RBI Act laid out the objectives as "to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage." Unusually, and unlike most central banks the RBI was specifically entrusted with an important promotional role since its inception to finance agricultural operations and marketing of crops. In fact, the Agricultural Credit Department was created simultaneously with the establishment of the RBI in 1935.

The RBI, as a central bank, has always performed the function of maintaining the external value of the rupee. Historically, the rupee was linked with pound sterling, which continued even after the establishment of the RBI. It was only in late September 1975 that the rupee was delinked from pound sterling and the value was determined with reference to a basket of currencies until 1991. The exchange rate regime, soon thereafter, transited from a basket-linked managed float to a market-based system in March 1993, after a short experiment with a dual exchange rate regime between March 1992 and February 1993. Prior to the Second World War, India was a net debtor country and the British introduced exchange controls to conserve foreign exchange. Exchange Control was introduced in India on September 3, 1939 on the outbreak of the Second World War by virtue of the emergency powers derived under the financial provisions of the Defence of India Rules, mainly to conserve the non-sterling area currencies and utilize them for essential purposes. Even after the War, the controls continued mainly to ensure the most prudent use of the foreign exchange resources. However, the vast accumulation of sterling balances during the Second World War provided an opportunity for repatriation of the sterling debt, an initiative which came at the behest of the RBI.

The RBI's responsibility as bankers' bank was essentially two-fold. First, it acted as a source of reserves to the banking system and served as the lender of last resort in an emergency. The second, and more important responsibility, was to ensure that the banks were established and run on sound lines with the emphasis on protection of depositors' interest. A banking crisis in 1913 revealed major weaknesses in the banking system, such as, maintenance of low reserves and large volumes of unsecured advances. Thus, regulation of the banking system was considered essential to maintain stability in the economy. In the

initial years, banks were governed by the Indian Companies Act, 1913 followed by *ad hoc* enactments, such as the Banking Companies (Inspection) Ordinance, 1946 and the Banking Companies (Restriction of Branches) Act, 1946. As dissatisfaction with bank failures increased the need for a statutory bank regulator became more pressing. Consequently, a special legislation called the Banking Companies Act was passed in March 1949, which was renamed as the Banking Regulation Act in March 1966.

III. Development Role of the RBI

As in many developing countries, the central bank is seen as a key institution in bringing about development and growth in the economy. In the initial years of the RBI before independence, the banking network was thinly spread and segmented. Foreign banks served foreign firms, the British army and the civil service. Domestic/Indian banks were linked to domestic business groups and managing agencies, and primarily did business with their own groups. The coverage of institutional lending in rural areas was poor despite the cooperative movement. Overall financial intermediation was weak. In an agrarian economy, where more than three-fourth of the population lived in the rural areas and contributed more than half of GDP, a constant and natural concern was agricultural credit. Therefore, almost every few years a committee was constituted to examine the rural credit mechanism. There has perhaps been one committee every two or three years for over a hundred years.

A clear objective of the development role of the RBI was to raise the savings ratio to enable the higher investment necessary for growth, in the absence of efficient financial intermediation and of a well developed capital market. The view was that the poor were not capable of saving and, given the small proportion of the population that was well off, the only way to kick start the savings and investment process in the country was for government to perform both functions. Thus the RBI was seen to have a legitimate role to assist the government in starting up several specialized financial institutions in the agricultural and industrial sectors, and to widen the facilities for term finance and for facilitating the institutionalisation of savings. A special need was felt for accelerating industrial investment, particularly with the launching of the Second Five Year Plan in 1956. Over time, various term lending industrial finance institutions were established with varying degrees of RBI involvement: the Industrial Finance Corporation of India (IFCI), State Financial Corporations (SFCs), Industrial Development Bank of India (IDBI) and the Industrial Credit and Investment Corporation of India (ICICI).

The traditional concern with agricultural credit continued and the Agriculture Finance Corporation was established in 1963, followed by its transformation into the National Bank for Agriculture and Rural Development in

1982 for extending refinance for short, medium and long term finance for agriculture. The Unit Trust of India was established in 1964 to mobilize resources from the wider public and to provide an opportunity for retail investors to invest in the capital market, thereby also aiding capital market development. The National Housing Bank was set up in the late 1980s to develop housing finance and the Infrastructure Development Finance Company (IDFC) in the late 1990s for infrastructure finance. The Reserve Bank also actively promoted financial institutions to help in developing the Government securities market. The Discount and Finance House of India (DFHI) was set up in 1988; primary dealers were promoted in the late 1990s; and the Clearing Corporation of India was incorporated in 2001 to upgrade the financial infrastructure in respect of clearing and settlement of debt instruments and foreign exchange transactions. More recently, the Board for Regulation and Supervision of Payment and Settlement System has been constituted in 2005, and the Banking Codes and Standards Board of India in 2006 to develop a comprehensive code of conduct for fair treatment of bank customers. The RBI has been continuously involved in setting up or supporting these institutions with varying degrees of involvement, including equity contributions and extension of lines of credit.

Thus, the developmental role of the RBI has spanned all the decades since independence and is quite different from central banks in developed countries. Although the Reserve Bank was actively involved in setting up many of these institutions, the general practice has been to hive them off as they came of age, or if a perception arose of potential conflict of interest. There can be little doubt that the establishment of these institutions has helped financial development in the country greatly, even though some of them have been less than successful in their functioning. It can be argued, of course, that similar institutional development could have taken place through private sector efforts or by the Government. The availability of financial sector expertise in the Reserve Bank, however, was instrumental in these tasks being performed over time by the Reserve Bank.

Expansion of Banking

In the initial years of the RBI, considerable progress was made in extending the banking system but there was continuing concern about the overall accessibility of banking to the needy. In terms of coverage, many rural and semi-urban areas were yet to be covered by banking services. The transformation of the Imperial Bank of India into the State Bank of India in July 1955 was mainly motivated by the desire to extend branches across the country to stimulate banking activity. It was in continuation of the same policy to serve the needs of the developing economy that 14 large banks were nationalized in 1969 followed by six more in 1980. The nationalization of banks, mainly attempted to align banking activities with national concerns and norms, as it was

perceived that the private banks neither understood social responsibilities nor observed social obligations. The general inclination in the 1950s, 1960s and 1970s was essentially to get Government to become active in economic activities where it was felt that the private sector was not able or willing to perform actively. As a result of nationalization, the total number of branches rose from 8,262 in 1969 - to 60,220 in 1991 and those in rural areas from 1,833 to 35,206. The increased network of branches certainly led to a large expansion of rural credit. This dimension of nationalisation and expansion had its impact on the functioning and working of the RBI. Despite such vast expansion, it is interesting that we still have concern with financial inclusion today.

Development of the Payments System

The development of a payments system is one development role that is common to most central banks. It is well recognized that an efficient payment and settlement system is essential for a well functioning modern financial system. Therefore, in recent years, banks have been making efforts to upgrade payments and settlement systems utilizing the latest technology. One of the characteristic features of the Indian economy, historically, has been the widespread use of cash in the settlement of most financial transactions. While this has been the trend for several years, it is noteworthy that India had pioneered the use of non-cash based payment systems long ago, which had established themselves as strong instruments for the conduct of trade and business. The most important form of credit instrument that evolved in India was termed as '*Hundis'* and their use was reportedly known since the twelfth century. *Hundis* were used as instruments of remittance, credit and trade transactions.

In modern times, with the development of the banking system and higher turnover in the volume of cheques, the need for an organized cheque clearing system emerged. In India, clearing associations were formed in the Presidency towns in the nineteenth century and the final settlement between member banks was effected by means of cheques drawn on the Presidency Banks. With the setting up of the Imperial Bank in 1921, settlement was done through cheques drawn on that bank. After the establishment of the RBI in 1935, the Clearing Houses in the Presidency towns were taken over by the RBI, and continued for more than five decades.

In recognition of the importance of payment and settlement systems, the RBI had taken upon itself the task of setting up a safe, efficient and robust payment and settlement system for the country for more than a decade now. In the recent past, the RBI has been placing emphasis on reforms in the area of payment and settlement system. It was with this objective that the Real Time Gross Settlement (RTGS) system was planned, which has been operationalised

in March 2004. The system, once fully operational, in its present form, would take care of all inter-bank transactions and other features would be added soon.

In view of the positive response to reforms in the financial sector and the banking segment also coming of age, the RBI has now taken the policy perspective of migrating away from the actual management of retail payment and settlement systems. Thus, for a few years now, the task of setting up new MICR based cheque processing centers has been delegated to the commercial banks. This approach has yielded good results and the RBI now envisions the normal processing functions to be managed and operated by professional organizations, which could be constituted through participation of commercial banks. This would be applicable to the clearing houses as well, which will perform the clearing activities, but the settlement function will continue to rest with the RBI. A beginning has been made in the form of the operations performed by the Clearing Corporation of India Ltd. for effecting the clearing processes related to money, government securities and foreign exchange markets. Under this arrangement, the RBI will continue to have regulatory oversight over such functions without actually acting as the service provider. The RTGS, which provide for funds transfers across participants in electronic mode with reduced risk, will continue to be operated by the RBI.

IV. Relationship of the RBI with the Government

The RBI is a banker to the Central Government statutorily and to the State Governments by virtue of specific agreements with each of them. The loss of autonomy of the RBI that took place in early decades was not because of any conscious decision based on the currently prevalent thinking on the relationship between central banks and the Government, but rather as a consequence of overall economic policy then prevailing regarding the appropriate dominant role of the Government in the economy as a whole. Thus, it is useful to review the relationship of the Reserve Bank with the Government as it has evolved over time.

The Monetary Fiscal Interface

It is common for central banks in developing countries to act as debt managers of their respective governments. Central Banks have typically financed governments through monetisation as and when the need arose for expansionary fiscal policy which has been often in developing countries. War financing through monetization has also been the norm for developed countries. Such financing has normally had predictable inflationary consequences for the economy. The Indian experience has been no different and expansionary fiscal policy was indeed financed by resort to automatic monetization, accompanied by

financial repression and effective loss of central bank autonomy with respect to monetary policy.

In 1951, with the onset of economic planning, the functions of the RBI became more diversified. As the central bank of a typical developing country emancipated from centuries old colonial rule, the RBI had to participate in the nation building process. Fiscal policy assumed the responsibility of triggering a process of economic growth through large public investment, facilitated by accommodative monetary and conducive debt management policies. The RBI played a crucial role in bridging the resource gap of the Government in plan financing by monetising government debt and maintaining interest rates at artificially low levels for government securities to reduce the cost of government borrowing.

The provisions of the Reserve Bank of India Act, 1934 authorizes the RBI to grant advances to the Government, repayable not later than three months from the date of advance. These advances, in principle, were to bridge the temporary mismatches in the Government's receipt and expenditure and were mainly intended as tools for Government's cash management. However, in practice, the tool of short-term financing became a permanent source of funds for the Government through automatic creation of *ad hoc* Treasury bills whenever Government's balances with the RBI fell below the minimum stipulated balance. This automatic monetization led to the RBI's loss of control over creation of reserve money. In addition, the RBI also created additional *ad hoc* Treasury bills whenever funds were required by the Government. As there was unbridled expansion of fiscal deficits and the Government was not in a position to redeem the *ad hoc* Treasury bills, the RBI was saddled with a large volume of these bills constituting a substantial component of monetized deficit. This process continued from the 1950s to the 1990s.

By the end of the 1980s a fiscal-monetary-inflation nexus was increasingly becoming evident whereby excessive monetary expansion on account of monetization of fiscal deficit fuelled inflation. The RBI endeavored to restrict the monetary impact of budgetary imbalances by raising the required reserve ratios to be maintained by banks. As the growth of pre-empted resources was inadequate to meet the Government's requirement, it had to perforce borrow funds from outside the captive market through postal savings and provident funds, by offering substantial fiscal incentives and at administered low rates of interest. Thus, the economy was pushed into the throes of financial repression.

The logical question that follows is whether the experience of fiscal dominance over monetary policy would have been different if there had been separation of debt management from monetary management in India? Or, were

we served better with both the functions residing in the Reserve Bank? What has really happened is that there was a significant change in thinking regarding overall economic policy during the early 1990s, arguing for a reduced direct role of the Government in the economy. A conscious view emerged in favour of fiscal stabilisation and reduction of fiscal deficits aimed at eliminating the dominance of fiscal policy over monetary policy through the prior practice of fiscal deficits being financed by automatic monetization. It is this overall economic policy transformation that has provided greater autonomy to monetary policy making in the 1990s.

In pursuance of the financial sector reforms undertaken in 1991, despite the proactive fiscal compression and efforts made by the RBI in moderating money supply during the early part of the 1990s, the continuance of the *ad hoc* Treasury bills implied that there could not be an immediate check on the monetized deficit. In order to check this unbridled automatic monetization of fiscal deficits, the First Supplemental Agreement between the RBI and the Government of India on September 9, 1994 set out a system of limits for creation of *ad hoc* Treasury bills during the three-year period ending March 1997. In pursuance of the Second Supplemental Agreement between the RBI and the Government of India on March 6, 1997, the *ad hoc* Treasury bills were completely phased out by converting the outstanding amount into special undated securities and were replaced by a system of Way and Means Advances. The participation by the RBI in primary auctions of the Government has also been discontinued with effect from April 1, 2006 under the provisions of Fiscal Responsibility and Budget Management Act, 2003 (FRBM). Other related measures that have been initiated since 1991 are deregulation of interest rates and lowering of statutory ratios.

The Indian economy has made considerable progress in developing its financial markets, especially the government securities market since 1991. Furthermore, fiscal dominance in monetary policy formulation has significantly reduced in recent years. With the onset of a fiscal consolidation process, withdrawal of the RBI from the primary market of Government securities and expected legislative changes permitting a reduction in the statutory minimum Statutory Liquidity Ratio, fiscal dominance would be further diluted.

All of these changes took place despite the continuation of debt management by the Reserve Bank. Thus, one can argue that effective separation of monetary policy from debt management is more a consequence of overall economic policy thinking rather than adherence to a particular view on institutional arrangements.

The core issue of the conflict of interest between monetary policy and public debt management lies in the fact that while the objective of minimizing

market borrowing cost for the Government generates pressures for keeping interest rates low, compulsions of monetary policy amidst rising inflation expectations may necessitate a tighter monetary policy stance. Therefore, the argument in favor of separating debt management from monetary policy rests on the availability of effective autonomy of the central bank, so that it is able to conduct a completely independent monetary policy even in the face of an expansionary fiscal stance of the government.

But is this a realistic possibility? If there is an understanding amongst policy makers that expansionary fiscal policy that is financed by monetization leads to undesirable results would such a policy be pursued? The Indian experience has itself shown that as such realisation took place in the 1990s the policy response was to arrive at policy conventions between the Government and the Reserve Bank that enabled the practice of independent monetary policy, despite debt management continuing to be housed in the RBI.

In theory, separation between the two functions would perhaps enhance the efficiency in monetary policy formulation and debt management, but the debate in the Indian context needs to recognize certain key dynamics of the fiscal-monetary nexus. First, in India, the joint policy initiatives by the Government and the RBI have facilitated good co-ordination between public debt management and monetary policy formulation. Wheres commitment to fiscal discipline and reduction in monetized deficit have imparted considerable autonomy to the operation of monetary policy, the proactive debt management by the RBI also facilitated the conduct of monetary policy, especially through the use of indirect instruments. In fact, the substantial stock of Government securities held by the RBI enabled it to sterilize the monetary impact of capital flows through open market operations since the late 1990s. In recent years, with the reversal in the interest rate cycle, the RBI was able to prescribe higher risk weights on assets to protect the balance sheet of the banks. This step certainly ensured financial stability for the economy. Second, the RBI's experience in managing public debt over the years has equipped it with the requisite technical capacity of efficiently fulfilling the twin responsibilities of debt and monetary management in tune with requirements of the Government and market conditions. The RBI has been making efforts to develop the money and government securities market since 1988 and has gained valuable experience and knowledge about related markets. This may have been difficult to accomplish if the debt management function had been effectively separate. Third, in the next five years, significant changes are slated to unfold in the Indian fiscal system: operationalisation of the recommendations of the Twelfth Finance Commission, whereby the Centre ceases to operate as an intermediary for mobilizing resources for States with the latter having to raise funds directly from the market; the RBI's withdrawal from the primary market of Government paper from April 1, 2006 has implications for the management of interest rate

expectations; and implementation of the proposed amendment to the Banking Regulation Act permitting flexibility to the RBI for lowering the Statutory Liquidity Ratio(SLR) below 25 per cent of net demand and time liabilities of banks would reduce the captive subscription to Government securities.

With all of these changes taking place in the monetary fiscal environment in the near future, there will be great need for a continued high degree of coordination in debt management between RBI and the Government. In fact, in the U.S., even though debt management is formally done by the Treasury, the close co-operation that actually exists between the Federal Reserve Bank of New York and the Treasury is not very different in function from the relationship between the RBI and the Government in its debt management function.

The evaluation of our experience therefore supports the position that a pragmatic view needs to be taken on this issue keeping in mind the specific institutional context of a particular country in mind.

Regulation and Supervision

Normally, there would be little discussion of regulation and supervision of banks in the context of the relationship between a central bank and the Government. This issue arises in India because of the predominant Government ownership of banks after nationalization of banks in 1969 and 1980. By the 1990s, more than 90 per cent of banking assets were in banks owned by the Government. In this institutional setting there was a perception given that banks cannot fail and that depositors are effectively fully protected.

Moreover, all management appointments in banks rested with the Government, and hence the norms of corporate governance in public sector banks. Furthermore, in the presence of administered deposit and lending rates, credit allocation and other banking decisions that rested with the government, regulation and supervision of banks also effectively became subservient to the Government during the 1970s and 1980s.

Once again, it was only after the change in banking policy in 1991, emphasizing competition along with interest rate deregulation and elimination of credit allocation, that banking regulation and supervision by the Reserve Bank could become effective.

It is the introduction of competition through the entry of new private sector banks and expansion of foreign banks, along with the idea of equal regulatory treatment of private and public sector banks, that has necessitated the practice of modern regulation and supervision. The promotion of safety and soundness of the banking system and protection of depositors have again become relevant.

The primary justification for financial regulation and supervision by regulatory authorities is to prevent systemic risk, avoid financial crises, protect depositors' interest and reduce asymmetry of information between depositors and financial institutions. The business of banking has a number of attributes that have the potential to generate instability as banks are much more leveraged than other firms due to their capacity to garner public deposits. Therefore, the need for establishing an agency to regulate and supervise the banking activity arose from frequent bank failures in various countries with ramifications for the whole economy. The central banks had started to focus their attention on ensuring financial stability and avoiding a financial crisis, since the late nineteenth century. The experience of the Great Depression had a profound effect on banking regulation in several countries and commercial banks since then have progressively been brought under the regulation of central banks.

The basic objective of bank supervision is to ensure that banks are financially sound, well managed and that they do not pose a threat to the interest of their depositors. The emphasis of supervision has been shifting in the recent period from the traditional Capital, Assets, Management, Earnings, Liquidity and Interest Rate Sensitivity (CAMELS) approach to a more risk-based approach. Basel II, which encompasses the risk analysis, uses a 'three-pillar' concept – minimum capital requirements, supervisory review and market discipline – to ensure financial stability.

Central banks have traditionally regulated and supervised financial institutions, including commercial banks. However, since central banks are also regulators and influence the behavior of market participants, supervision conducted by central banks may pose a moral hazard problem. Therefore, the idea of a separate supervisory authority has gathered some momentum in recent years. In addition, as a practicing central banker, I can envisage situations of conflict between monetary policy, and regulation and supervision, especially in situations of economic and financial stress. To illustrate a case of conflict, the mounting inflationary pressures in a country may require interest rates to rise sharply but then banks would be potentially exposed to write-downs of their asset valuations.

The role of the RBI, in the changing environment, recognises the differences among various segments of the Indian banking system and accommodates appropriate flexibility in the regulatory treatment. The changing role of financial regulation and supervision of the RBI can be characterised by less accent on 'micro' regulation but more focus on 'prudential' supervision, and on risk assessment and containment. The Indian approach to banking sector reforms has been gradual and different from many other emerging market economies, where financial sector reforms resulted in privatization of erstwhile public sector financial intermediaries. As the commercial banks are scheduled to

start implementing Basel II with effect from end-March 2007, the RBI will continue 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, due to operational and market risk. Finally, while recognizing the importance of consolidation, competition and risk management to the future of banking, the RBI will continue to lay stress on corporate governance, ownership pattern of private banks, expansion of foreign banks and financial inclusion.

Monetary Policy

The operation of monetary policy in India before 1991 has to be analyzed in the context of nationalization of banks, the then prevalent financial repression and the closed economy. The banks were nationalized to exercise social control over their activities. In terms of outcome, nationalization succeeded in spreading the network of banks in rural areas and mobilizing private savings. The savings so mobilized were used for supporting public borrowing as well as for meeting hitherto neglected genuine credit needs in the rural areas. This called for significant changes in the institutional arrangements, and more stringent control and supervision of the banking system. To accommodate the fiscal requirements at low rates of interest, interest rates were administered and credit was directed in specific socially preferred sectors. The economy was closed, exchange rates were fixed and exchange controls were strictly observed. In this situation of nationalized banks, fiscal dominance and financial repression, operation of the monetary policy was severely constrained. Monetary policy resumed its operational efficiency with increasing liberalization of the economy only after 1991. Once again independence of monetary policy is more related to change in the overall economic policy framework and not from a purist stance of separating the central bank from the government.

As the financial system got liberalized up and monetary policy became more autonomous after the reversal of the previous mechanisms, the corresponding development of the money market, Government securities market and the foreign exchange market became necessary. Appropriate monetary transmission cannot take place without efficient price discovery of interest rates and exchange rates in overall functioning financial markets.

Earlier, various factors such as administered interest rates, directed credit programmes, weak banking structure, lack of proper accounting and risk management systems and lack of transparency in operations of major financial market participants had hindered market development. The RBI, 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 of monetary policy. The money

market is the focal point for intervention by the RBI to equilibrate short-term liquidity flows on account of its linkages with the foreign exchange market. Similarly, the government securities market has become important for the entire debt market as it serves as a benchmark to price other debt market instruments.

The RBI had been making efforts since 1986 to develop institutions and infrastructure for these markets to facilitate price discovery. The conscious efforts by the RBI to develop efficient, stable and healthy financial markets gained importance after 1991. The RBI followed a gradual and well-calibrated policy to facilitate the development of markets through institutional and financial infrastructure development through improvements in market microstructure. The pace of the reform was contingent upon putting in place appropriate systems and procedures, technologies and market practices.

There has been close co-ordination between the Central Government and the RBI, as also between different regulators, which helped in orderly and smooth development of the financial markets in India. Following the reforms, the markets have now grown in size, depth and activity paving the way for flexible use of indirect instruments by the RBI to pursue its objectives. In the context of the integration of Indian financial markets, with global markets, the RBI has been constantly refining the operating procedures and instruments as also various aspects of financial institutions, markets and financial infrastructure such as risk management systems, income recognition and provisioning norms, disclosure norms, accounting standards and insolvency in line with international best practices (Mohan, 2006).

V. Autonomy of the Reserve Bank of India

The trend towards central bank independence is not of recent origin. 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 an interesting turn. Before the First World War, the central banks in most cases were private institutions and were formally independent of their governments. Interestingly, some central banks were established to serve as banker and debt manager to the government. The position changed around the Second World War - central banks in a number of countries (e.g., Germany, France, England, Japan, Italy and Sweden) were made subordinate to their governments. In recent years again, there has been a reversal in the trend. Governments have started granting more autonomy to their central banks: on the argument that a country is more likely to have low inflation if the central bank is independent. This argument has its roots in the breakdown of gold standard in early 1970s and the phase of high inflation that followed during the 1970s and 1980s. To achieve price stability, increasingly, central banks were granted autonomy along with an inflation target to meet, implying that independence was

saddled with accountability. To illustrate, the Bank of England, which had substantial independence for much of the eighteenth and nineteenth century, but was later made subservient to the government, was legally granted independence in June 1998 but with an inflation target to achieve. The recent trend towards central bank independence has been influenced greatly by the experience of the Bundes Bank and Reserve Bank of New Zealand.

In the Indian context, central bank autonomy has to be examined in a different context. Initially, since the launch of the Five-year Plans, monetary policy was expected to accommodate the expansionary fiscal policy, as I have discussed, to meet the requirements of the Government. Later, to meet social obligations, the commercial banks were nationalized and statutory ratios raised, interest rates were administered, credit was rationed and channeled into priority sector, exchange rate was fixed/managed, the economy was closed and movement of foreign exchange was strictly controlled. In such an arrangement, there was no scope for autonomy of monetary policy. Since 1991, due to reforms, the situation has changed. The reforms have led to disinvestment in public sector banks, encouragement given to private sector banks, deregulation of interest rates, lowering of statutory ratios, cessation of automatic monetization and implementation of current account convertibility. In recent years, short-term liquidity in the market is being managed successfully by the operation of a liquidity adjustment facility on a daily basis, while longer term liquidity has been addressed through traditional OMOs (Open Market Operations) in government security auctions. As excess foreign exchange inflows intensified in 2003-2004, cooperation between the Reserve Bank and the Central Government resulted in a rare innovation designed to empower the RBI with new instruments for sterlisation. The government agreed to permit the RBI to issue additional government securities for sterlisation purposes upto a specified limit. Thus Government/RBI cooperation resulted in a new instrument that strengthened the Reserve Bank in pursuing its monetary policy objectives. Monetary policy operation has also been constrained by the existence of minimum limits, on the CRR (Cash Reserve Ratio) of 3 per cent, and on the SLR of 25 per cent. In order to provide greater monetary policy flexibility to the RBI the Government has agreed to eliminate these minimum limits through introduction of amendments to the relevant acts in Parliament. Thus, monetary policy has moved from using direct instruments to market based indirect instruments, with the development of the money and government securities market. These developments since 1991 indicate that the RBI already enjoys substantial autonomy in formulation of monetary policy.

Inflation Targeting

Central banks are divided on the advisability of setting explicit inflation targets. Several central banks, such as, Bank of Canada, Bank of England, and

the Reserve Bank of New Zealand, have adopted explicit inflation targets. Others, whose credibility in fighting inflation is long established (e.g., the Bundesbank (earlier) and the Swiss National Bank), do not set explicit annual inflation targets. However, concentrating only on numerical inflation objectives may reduce the flexibility of monetary policy, especially with respect to other policy goals.

High and sustained growth of the economy in conjunction with low inflation is the central concern of monetary policy in India. The rate of inflation chosen as the policy objective has to be consistent with the desired rate of output and employment growth. An inappropriate choice can lead to losses of macroeconomic welfare. Monetary authorities have to continually contend with the short-run trade-off between growth and inflation. The problem is compounded by the fact that the association between growth and inflation is non-linear. At some low rates, inflation could operate in a manner that assists in bringing back unemployed resources into the economy and be beneficial or, at worst, neutral to growth. At higher levels, inflation is inimical to growth. There are also very low levels of inflation that are associated with no growth or even deflation. At what level should the policy choice of inflation be or what is the threshold rate of inflation, if there is one, which is associated with the absence of harmful effects of growth? There have been various studies that have attempted to estimate threshold inflation rates. They suggest that the threshold inflation rate depends upon a number of factors such as the structure of the economy, past inflation history, the degree of indexation, and inflation expectations. Some studies suggest that the threshold inflation for developed and developing countries fall in the ranges of 1-3 per cent and 7-11 per cent, respectively. An abiding problem with cross-country studies, however, is the risk of being influenced by extreme values since samples include countries with inflation as low as one per cent and as high as 200 per cent and even higher. The estimation of such inflation threshold rates, therefore, needs to be done for each country separately, in order to understand the behaviour of the economy in relation to inflation.

A major source of uncertainty in conducting monetary policy is the lack of a clear understanding of the inflationary process as it has unfolded in recent years. This has obscured a proper assessment of the nature of shocks impacting on the economy and the resulting risks to price stability. Variations in the timeliness and reliability of inflation indicators, uncertainty surrounding unobservable indicators like potential output and gaps in the intrinsic knowledge of the central banks about the state of the economy complicate the making of monetary policy. In countries like ours, there are other rigidities related to administered prices, wage setting procedures, and weather induced supply shocks that influence prices. Knowledge of the relationship between inflation and its determinants remains limited. Even if there were a consensus on a suitable

model, considerable uncertainty would remain regarding the strength of the structural relationships within the model. An even more fundamental problem is that parameters may vary over time as a result of structural changes in the economy. This presumably explains why no central bank uses a formal model to derive its actual policies; for the foreseeable future, models will be an aid to judgment rather than a substitute for judgment. The simple principle of inflation targeting thus is also not so simple and, poses problems for monetary policy making in developing countries.

In India, we have not favoured the adoption of inflation targeting, while keeping the attainment of low inflation as a central objective of monetary policy, along with that of high and sustained growth that is so important for a developing economy. Apart from the legitimate concern regarding growth as a key objective, there are other factors that suggest that inflation targeting may not be appropriate for India. First, unlike many other developing countries we have had a record of moderate inflation, with double digit inflation being the exception, and largely socially unacceptable. Second, adoption of inflation targeting requires the existence of an efficient monetary transmission mechanism through the operation of efficient financial markets and absence of interest rate distortions. In India, although the money market, government debt and forex market have indeed developed in recent years, they still have some way to go, whereas the corporate debt market is still to develop. Though interest rate deregulation has largely been accomplished, some administered interest rates still persist. Third, inflationary pressures still often emanate from significant supply shocks related to the effect of the monsoon on agriculture, where monetary policy action may have little role. Finally, in an economy as large as that of India, with various regional differences, and continued existence of market imperfections in factor and product markets between regions, the choice of a universally acceptable measure of inflation is also difficult.

VI. The Way Ahead

The RBI has, over the years transformed itself continuously functionally and structurally in response to the changing needs of the economy and Government policies. Since 1991, a special period of reforms and change has been ushered in the economy and the RBI has participated in this change very actively. The RBI continues to pursue the development role but now with some difference. In recent years, it has made consistent efforts to develop financial markets, build institutions and encourage use of technology in the financial system.

The economy is passing through a new phase due to the enactment of the Fiscal Responsibility and Budget Management Bill, encouraging participation of private and foreign banks, increasing globalisation and continued liberalisation

of the capital account. The gross savings rate is nearly 30 per cent of GDP and the economy is recording a growth rate of about 8 per cent annually, in recent years. In this situation, a substantial increase in household financial savings is expected as well as the need for higher credit disbursement in the economy. The emphasis on financial inclusion will also lead to enhanced need for financial intermediation. The financial institutions would therefore have to prepare for higher volume of transactions. In view of the expected increase in competition, banking institutions would need to integrate various services like banking, e-commerce, mutual funds, insurance, and money market operations.

The new challenges facing the RBI are many. First, if the Indian banking system is to attain international excellence, it will require action on several fronts like introduction of greater competition; convergence of activities and supervision of financial conglomerates; induction of new technology; improvement in credit risk appraisal; encouragement of financial innovation; improvement in internal controls and establishment of an appropriate legal framework. The role of the RBI in this context amounts to promoting safety and soundness while allowing the banking system to compete and innovate. Second, as a central bank, the RBI would further need to develop the financial markets, especially the money, government securities and foreign exchange markets to enhance the efficiency of the transmission mechanism, along with the corporate debt market. Third, price stability and financial stability would continue to be of concern with expected increase in credit expansion and global integration. Fourth, concerns regarding social security, and investment of pension and insurance funds would need to be addressed.

I would like to finish on an optimistic note. As the RBI has successfully faced challenges in the past, it can be expected to continue to adapt to the changing economic environment in future. We need to be mindful of the extant objectives of overall economic policy, within which monetary policy has to be placed, and the realities of economic management in India, as we contemplate the further evolution of central banking and financial regulation in India

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