

**Golden Jubilee of
Reserve Bank Staff College, Chennai**

July 3, 2013

Reserve Bank as a Knowledge Institution

Governor's Speaking Notes

1. **Delighted to be participating in the Golden Jubilee of RBSC.**
 - Over the last 50 years, RBSC has established a formidable reputation for the quality of its training programmes, innovations in training techniques and for its commitment to be moving up the learning curve.
 - The RBSC can take pride in having trained generations of RBI staff who are known for their subject matter expertise, professional integrity, and value based conduct.
 - This is a tribute to the past chairmen of the Governing Council, Principals, faculty and staff of the College over the last 50 years.
 - On the occasion of the college's Golden Jubilee, I am privileged and delighted to place on record our homage to their contribution.
 - In particular, I want to acknowledge the past principals of the college who are present at the celebrations today:
 1. Shri R.C. Mody
 2. Shri O.P. Sodhani
 3. Shri P.K. Biswas
 4. Shri S. Venkataraman

5. Shri T.R. Devarajan
6. Shri M. Jesudasan
7. Smt. ChitraChandramouliswaran
8. Shri S. Karuppasamy
9. Dr. J. Sadakkadulla
10. Ms. Uma Subramanian (present Principal)

- Some past principals who are not able to be present here today are the following:

1. Shri K.K. Mukherjee
2. Shri K.N.V. Nair
3. Shri K. Hariharan
4. Shri K. Sivaraman
5. Shri S. Ganesh

Looking Ahead - Goals and Aspirations

2. Golden Jubilee is an occasion to celebrate past achievements; equally it is an occasion to look ahead to the challenges and to redefine goals and renew aspirations.

Looking ahead by looking back

3. What I want to do in my comments is to look ahead by looking back and give some broad contours of the Reserve Bank's goals and aspirations which in turn should inform the role and responsibilities of RBSC.

Central Banking is Changing

4. Over the last five years, the world has gone through an extraordinary financial and economic crisis. Central banks have been blamed for getting

the world into the crisis. They are also being praised for getting the world out of the crisis. This is not the occasion to debate the faults or celebrate the heroics of central banks.

5. All I want to do on this occasion is to acknowledge that as a result of the impact of the global financial crisis and the follow on euro zone crisis, central banking around the world is changing in dramatic ways.
 - Vigorous debates about
 - autonomy and accountability of central banks
 - the mandate they must pursue with regard to monetary policy
 - their mandate beyond monetary policy
 - Debate playing out in different ways in different countries.
 - Debate playing out here in India too.
 - We know for sure that there will be changes in central banking everywhere; there will be changes here in India too.
 - What those changes will be is not clear.

RBI - Knowledge Institution

6. How should the Reserve Bank manage that change?
 - In one sentence - “by becoming a knowledge institution”.
7. If someone challenged me: What is a knowledge institution?

8. Cannot define. But I can explain it.
 - Hierarchy of learning:
 - **Data → Information → Knowledge → Wisdom**

9. So, how do we become a knowledge institution?
 - By becoming a storehouse of knowledge. Accumulate knowledge
 - Necessary but not sufficient

10. **Knowledge Institution - Sufficient Condition**
 - (i) Use that knowledge to achieve your goals. Knowledge → Wisdom
 - (ii) In doing so, your conduct and action must be based on values and ethics.

Focus of My Comments

11. Characteristics or attributes that the Reserve Bank must acquire to progress on the path to being a knowledge institution.
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12. **1st Attribute: Managing Monetary and Regulatory Policies in a Globalizing World**

- GFC and the eurozone crisis have demonstrated the uncertainties and dilemmas of macroeconomic management in a globalizing world.
- Before the crisis - we thought we were decoupled. Crisis proved that to be wrong.

- Virtually every country affected by the crisis. If there is one country that should not have been affected, it is India. Among large EMEs, India least integrated into the world. Shows the power of globalization.
- Does it mean we are paying too high a price for globalization? Does it mean we opt out of globalization?
- No. Perish the thought.
- Globalization is a double edged sword. Immense opportunities. Ruthless challenges.
- India benefitted from globalization. Great Moderation - benign global environment. India's growth acceleration is due to Great Moderation.
- India also paid the cost of globalization. India being impacted by the crisis - example of costs of globalization
- Manage globalization - minimize the costs.
- maximise the benefits.

13. **Managing Globalization in Monetary Policy**

How do we manage globalization in making our policy?

- Earlier monetary policy by looking at just the domestic situation. Credit policy documents in the 1970s, 80s, 90s – no reference to external situation.
- That has changed in a fundamental way.

- Because of India's integration, external developments impact our domestic macroeconomic situation in complex, uncertain and capricious ways.
- Now in making our policy, we need to take external developments into account. Our policy documents contain an important section on global developments.

Example 1: Great Exit

- Prospect of the Great Exit - US Fed tapering off its QE
- If you analyse - Fed did not say anything new. But markets reacted.
- Managing globalization means we need to understand how market participants react to global developments. And how that impacts our economic and financial conditions. And what should be policy response?

Example 2: Basel III

14. Example from regulatory domain

- Basel III -started implementing wef April 1, 2013
- Why do we have to implement Basel III?
- Argument: AE banks that misbehaved. It's they which had to be set right. It's they that require higher capital standards.
- Argument is flawed. Our banks are operating abroad. Foreign banks are coming to operate in India.
- India cannot be an outlier.
- Admittedly, higher capital requirements and tighter regulation will make credit costlier.
- But the cost of not implementing Basel III greater than the cost of implementing it. Indeed, the cost-benefit calculus could be positive.

15. **1st Attribute:** Knowledge institution - manage both economic and regulatory policies in a globalizing environment

- Understand global developments
- Analyse implications for domestic economy
- Frame policies in that context

16. **2nd Attribute:** Knowledge institution - make intelligent, mature, balanced judgement

- After all the debate, all the analysis, policy decision is a matter of judgment
- Operating at the bridge from knowledge to wisdom

17. **Example 1: Monetary Policy Decision**

- Monetary policy decision (calibrate interest rate)
- Managing the crisis vs managing the recovery
- Crisis: What was important was not what you did, but that you did something at regular intervals.
- Recovery - calibration was very important
- *Chakravyuh* in *Mahabharata*: Getting in was easy. Getting out was difficult.

18. Post - Crisis: Applying judgement in treading the growth-inflation balance:
If we alter interest rates, what impact will it have on inflation? On growth?
Transmission. Criticism of RBI.

19. **Example 2: Deposit Insurance**

- During the crisis - UK banks insured all their deposits
- Pressure on us to do the same
- Can we afford it? Will it not set off a panic?

20. **Example 3: Costs and Benefits to Regulation**

- Tighter regulations - safe financial system but also a dysfunctional financial system.
- Excessive or premature tightening can mean loss of growth and welfare.
- Excessively loose regulation can result in financial instability.
- Drawing the right balance requires fine judgement.
- Ability to make the right judgment is a key attribute of a knowledge institution.

21. **2nd Attribute:** Ability to make intelligent, mature and balanced judgment.

22. **3rd Attribute: Be open minded. No dogma. Galileo and the Church**

- By far the most famous and high profile example of dogma in the history of science is the conflict between Galileo and the Church.
- Church refused to accept the heliocentric view of the universe against the prevailing geocentric view of the universe.
- No dogma means when new evidence that invalidates prevailing view comes in, we are willing to change our view and accept the new proposition (Thomas Kuhn– Paradigm Shift).

- Galileo himself was not fully correct because he believed in a stationary sun.

23. **Example: Corporates into the banking sector**

Why are you allowing corporates into the banking sector?

- True, they have not been allowed so far.
- True, rules in this regard around the world are different.
- After extensive consultation, due deliberation and careful consideration, we have decided to allow corporates into the banking sector
- Why?
 - Corporates have been allowed entry into other financial service sectors
 - Corporates have a long and credible record of building and nurturing new businesses in highly regulated sectors like telecom, power, airports.
 - Corporates can bring in capital, leverage on their business experience and management expertise
 - Innovative ideas for financial inclusion
- Arguments against
 - Scope for connected lending, using public trust for private gain
 - Opportunities for regulatory arbitrage and for contagion of risk across the financial system
 - Concentration of economic power and influence

- Safeguards (endogenous and exogenous) against self-centred business practices and self-dealing.

24. **3rd Attribute:** Be open minded.

4th Attribute: Learning Institution

25. Knowledge institution has to be a learning institution

- You learn something every day (ICICI girl)

Example

- Rogoff and Reinhart
“This Time is Different”
- Studied 800 years of history of financial crisis
- Every time a crisis has occurred – economists and policy makers have said: “This time is different.”
- Yet over 800 years, the origins of all financial crises can be traced to the same fundamental causes.
- This is a controversial and contentious debate.
- Without taking a position on this, I want to emphasize that a knowledge institution tries to distil lessons from every experience.

Example 2: Humility

- At the same time, a knowledge institution must have humility: We have to admit that we can't control everything.

- Instead of believing that the world must behave according to what our theories say, we have to take the work as given and try to fit theories into that.
- Known unknowns. We have to accept them as they are without any presumption about superior knowledge.
 - Einstein: Propounded the theory of relativity
 - All his life couldn't reconcile to the probabilistic nature Implied by quantum mechanics.
 - "God doesn't play dice"
 - Neils Bohr: Stop telling God what he can or cannot do

26. **4th Attribute:** Knowledge institution is conscious that it is forever on a learning curve.

5th Attribute: Generate knowledge

27. Knowledge institution has to generate knowledge
- Research
 - I've asked Research Department to publish papers of international standards.
 - RBI - Public Policy Institution - We generate not esoteric knowledge but knowledge based on what we learn from experience.
 - That should be our comparative advantage
 - It's here that our knowledge generation differs from that in natural sciences.
 - In natural sciences, knowledge progression is a two way street

- Knowledge advances in both directions.
- From empirical findings to theory, and from theory to empirical findings.
- Michelson Morley experiment that velocity of light is constant led to the theory of relativity. Progression from experience to theory.
- Search for Higgs Boson triggered by prediction of quantum theory. Progression from theory to experience.
- In public policy, learning is only one way street -from real world to knowledge
- Other attributes of learning
 - (i) Shuns group think (risk managers who dissented were silenced)
 - Plurality of views. Minority voices and opinion are heard and considered with respect
 - (ii) Internal Communication is very important
 - Thematic Video Conferences in RBI
 - Should be a two way learning process
 - Great learning experience. Some staff, especially younger staff, ask searching questions.
 - (iii) No working in silos. Cross fertilization of ideas from across disciplines and departments.

(iv) Capacity to deal with complexity and
Uncertainty

- Conant-Ashby Theorem from cybernetics -
Every regulator of a system must have a
model of the system it seeks to regulate

28. **5th Attribute:** Environment for generating knowledge

6th Attribute: Open, communicative and consultative

29. Knowledge institutions - Open, communicative and consultative

- Power of central bank communication is striking
- Fed - after 9/11: “The Federal Reserve System is open and operating. The discount window is open to meet liquidity needs.
- Those two banal sentences had remarkable calming effect on US and world financial markets. Announcement effect is stunning.
- Mario Draghi “Whatever it takes” Prevented what many thought was an imminent collapse of the euro.
- During the crisis - RBI communicated about uncertainty but also preparedness to act. Calming effect.

“The Reserve Bank is committed to maintaining financial stability and flexible liquidity management using all policy instruments.”

- You might think these are routine, vacuous statements devoid of any content. Can be incredibly effective in restoring calm.

30. **Dilemma in communication - How much do we communicate?**

- Two views about it.
- First view: If you have something negative, don't say it because it can have self-reinforcing negative impact.
- Mothers across cultures and across time: "If you don't have anything nice to say, don't say it."
- Alternative view: "Say it as it is. You must present the true picture."
 - Example: Bernanke: Results of banking stress tests.
 - If the central bank has credibility, communication can be effective. Our own experience supports this view.
 - Forward guidance on monetary policy – struggle with nuancing it
 - 'Little space for further monetary policy easing'. Governor doesn't know English.
 - Paradox here - Monetary Policy forward guidance most needed by market when there is uncertainty.
 - But that is also the time when you are least able to give definitive guidance.
- Communication is a double edged sword. It can lead to wrong interpretations and unintended consequences. Recent statements from the US Fed on tapering of the QE.

31. Communication should not be one way. We should also listen.

- Town Hall Meetings (at least once every year. Chandigarh, Jaipur, Pondicherry)
- June 29 - on illegal, unlawful financial schemes -Ponzi, multi-level marketing schemes - cheating people.

- Media Conferences
- Post-policy teleconference
- Pre-policy consultations
- Consultative: Discussion Papers on policy initiatives. On new bank licences, on subsidiarization of foreign banks, deregulating interest on savings bank deposits, white label ATMs, risk based supervision.

32. **6th Attribute:** Open minded, communicative and consultative.

7th Attribute: Outreach

33. Knowledge Institution - Effort at outreach - to get exposed to the real world.

- Reserve Bank cannot function in an ivory tower.
- Growth, inflation, interest rates and exchange rates are not mere statistics. They impact people's everyday lives.
- Outreach programme to listen and understand. To explain.
- Chennai - town hall meeting (3 years ago on the steps of the Egmore Museum)
 - inflation (middle aged people)
 - growth (young people)
- Village immersion programme for DRs
 - how do the poor live?
 - how do they manage their finances?
- Frontline Managers Conference
 - BC : BM makes me wait in the line

- humiliated in front of clients.

- You learn stuff that meetings, seminars, conferences and reports do not give you.

34. 7th Attribute: Outreach. Understand the world for which we make policy.

8th Attribute: Takes Accountability Seriously

35. Knowledge institution - takes accountability seriously

- As RBI, we jealously guard our autonomy
- “RBI is independent”. We know public interest. No one should interfere.
- But the autonomy that we assert so vehemently has to be earned. Not demanded. Need to earn by rendering accountability.
- We are an unelected body of officials making public policy with enormous implications for people’s everyday lives.
- Accountable for results - explain growth, inflation
- Open to be challenged
- Governor to go before the Standing Committee of the Parliament

36. **8th Attribute:** Takes accountability seriously.

9th Attribute: Think Positive

37. Knowledge Institution -Think Positive

- Executive of a shoe company to explore the demand for shoes
- Nobody wears shoes. No demand.

- Rival Company: Nobody wears shoes. Enormous demand.

38. **9th Attribute:** Think positive.

10th Attribute: Values and Ethics

39. Values and ethics (Prof. Dipankar Gupta)

- Sensitivity - inflation and the poor
 - Humility - Financial markets are misbehaving
 - Compassion
 - Always uphold larger public interest
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40. **The Difficulty of Being Good**

- Every character in *Mahabharata* is morally flawed in some sense or the other. Every episode raises a moral debate about “What is *dharma*?”
 - *Draupadi* to *Yudhistara* : Whom did you lose first?
 - *Bhishma*'s silence -Did his *dharma* become hostage to the abiding sense of loyalty to the king?
 - Knowledge institution - upholding *dharma*
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41. Ten attributes of a knowledge institution. Not comprehensive. Not a unique listing.

42. RBI has come a long way. Becoming a knowledge institution is not an event but a process.

Remind ourselves of the challenge and opportunity of becoming a knowledge institution.

43. RBSC - will be the prime lever of the Reserve Bank's journey to become a knowledge institution.

44. My privilege to be at this knowledge institution when RBI celebrated its platinum jubilee in 2009/10 and when the RBSC is celebrating its Golden Jubilee in 2012/13.