Changing Role of The Reserve Bank of India: Agenda for Attention*

Y.V. REDDY

I am grateful to the organisers of the Madon Memorial Lecture for inviting me to deliver this Lecture. That the contributions of Shri B.F. Madon are of lasting value is evident from the fact that although, over seventy years have elapsed since he passed away, lectures in his memory are organised, and the response is still overwhelming. There are several reasons why I feel especially elated at my association with this lecture series. First, Madon revealed a strong preference to reflect on the problems of the exchange rate and currency issues in his celebrated paper and two books. I hardly need reveal my keen interest in this subject. Secondly, he had a penchant for public opinion, and as an eminent publicist published several articles, somewhat similar to my weakness for public lectures. Thirdly, for understandable reasons, about half of the Madon Memorial Lectures were delivered by those closely associated with the Reserve Bank of India, the first by Mr. H.V.R. Iyengar and the latest, the seventeenth by Dr. C. Rangarajan. Fourthly, apart from my Gurus Dr. C. Rangarajan and Mr. M. Narasimham, I have close association with several of those who delivered these lectures, such as Dr. V.K.R.V. Rao, Dr. I.G. Patel, and Mr.Moeen A. Quereshi. I feel a sense of awe considering that the lecture series includes a galaxy of stalwarts such as Messrs Ramaswami Mudaliar, C.D.Deshmukh, L.K.Jha, B.K.Nehru and Jagdish Bhagwati and I am emboldened to suggest to the organisers, that the lectures provide a panoramic but insightful view of deep thinking on critical issues of economic policy in India since 1961, and hence a collection of these lectures could be brought out as a volume in this millennium year, with an appropriate overview. I trust my friend Mr. Jhaveri would volunteer to work on this project and for my part I would be delighted to assist the organisers if they wish to pursue this idea.

Today's subject essentially addresses the changing role of the Reserve Bank of India. Since I am on the verge of entering the final year of my term as Deputy Governor, there is a strong temptation to be retrospective and narrate what has been done and what could not be. But, I realise that apart from myself, many others have already commented on these events. So, the focus of today's talk is mainly prospective and I would freely address unsettled issues, emerging challenges, cognisable dilemmas, contingencies on the horizon, unfolding scenarios, and so on. It would be presumptuous to attempt to provide vision for the Reserve Bank or a list of issues at the frontiers and surely unwise to suggest a specific set of actions for future policy. Yet, I feel that this is about the time I should share with you, and place on record for the benefit of my younger colleagues in the Reserve Bank and Government, my random thoughts on what may be called an *Agenda for Attention*, in regard to the changing role of the Reserve Bank in the context of liberalisation and globalisation.

Monetary Policy Functions

The three important questions that often trouble central bankers are: What is money? How to measure money? Does money matter? The answer varies from country to country and, of course over time. To meet these dynamics, the Reserve Bank had set up three working groups on money supply and the latest working group submitted its report in 1998. The report of the third group has slightly redefined money, added credit and liquidity measures, and concluded that money

still matters though not in the same way or to the same extent as before. It is observed that spread of credit cards, innovations in financial instruments and onset of e-commerce have been far more rapid than envisaged by the Group and so, a fourth Working Group may need to be set up sooner than most of us would consider appropriate. Monetary policy in India, in the pre-reform period had to contend with a multitude of objectives prescribed as part of planning strategies for growth and societal concerns. The high level of automatic monetisation of the fiscal deficits and Government's market borrowings at rates of interest unrelated to market conditions coupled with a plethora of other administered interest rates and preemptions of credit in the banking and financial sectors had resulted in stunted growth of financial sector and virtual absence of a market for financial assets. As a result, monetary policy had to rely heavily upon direct instruments as evidenced by high pre-emption of the banking system's resources. An objective of reform has been to develop an efficient and integrated financial market as a prerequisite for switching over to indirect instruments of monetary control. With a series of reform measures in money, government securities and foreign exchange markets, the markets have now grown in size, depth and activity paving the way for a flexible use of policy instruments.

The transition has been made possible through several initiatives initiated by the Government and the Reserve Bank of India, in a coordinated manner. These include deregulation of interest rates; rationalisation of CRR and SLR, structural reforms in the real economy, phasing out of *ad hoc* treasury bills, eliminating the system of automatic monetisation and replacing it with a system of Ways and Means Advances, activation of Bank Rate and reduction in the reliance on refinance. Consequently, the thrust of monetary policy in recent years could include use of instruments in a more flexible and bidirectional manner.

These reforms have laid a solid foundation for the Reserve Bank to respond more effectively to the international challenges such as the East Asian currency crisis, sanctions and domestic uncertainties. The measures have assisted the attainment of a respectable growth rate, reasonable price as well as exchange rate stability.

To ensure that the Reserve Bank's conduct of monetary policy continues to command respect and credibility, it is necessary to focus on existing constraints, emerging factors, and possible impact on the policy in the future.

Existing Constraints

Among the existing constraints, first and foremost is fiscal dominance or high fiscal deficits. We have to recognise that fiscal management is essentially in the realm of political economy and not a technical issue. Once a final decision is taken by Government on the level of borrowings, the Reserve Bank as a debt manager, has to manage it successfully. Merely wishing the deficit away or trying to conduct monetary policy as though deficits do not exist would be disastrous. No doubt, the cost of fiscal deficit goes beyond managing public finances and spills over into monetary and external sector management. We should recognise that any further progress in monetary and financial sector reform is clearly contingent on the progress in the magnitude and quality of fiscal adjustment. The proposal for a Fiscal Responsibility Bill is a necessary step in this direction.

Second, the large share of publicly owned financial intermediaries, including banks and the nature of their responses to micro-market developments currently operate as a constraint to several policy changes. Monetary policy initiatives, have to assess market responses, but if such a response from a large segment of the market is uncertain, policy initiatives tend to be very cautious. Thus, the pace of further refinements in monetary policy is linked to the pace of improvements in overall efficiency in the public sector banks as a whole.

Third, the state of development of financial markets is yet another important constraint. While significant progress has been made in the recent past in all parameters of money and Government securities markets, the technological infrastructure initiatives including launching of Real Time Gross Settlement, computerisation of Public Debt Office, establishment of a Clearing Corporation are still underway. The Reserve Bank's successful handling of these is a major expectation.

Fourth, legal and institutional infrastructure conducive to healthy financial markets is also necessary for effective transmission of the policy. A beginning has been made on the issue of Stamp Duty and Securities Regulation. The new Government Securities Bill has, however, yet to be passed. The Finance Minister has assured actions for amending the RBI Act and Banking Regulation Act to grant greater operational autonomy to the Reserve Bank and banks.

Fifth, transparency in market operations is essential for an efficient monetary policy transmission mechanism. This will depend a great deal on the mounting of electronic dealing system, establishment of uniform accounting systems and evolving proper codes of conduct for market practices.

Sixth, in regard to the data availability on many fronts, be it real sector or prices, there are issues of adequacy, timeliness and quality. In a globalisation context, policy conducted with data of poor quality could be very inefficient. In this context, the work of the *National Statistical Commission* is of great interest to the RBI.

New Challenges

With globalisation and impact of technology, several new challenges are likely to emerge for the fraternity of central banks.

The emergence of 'e-money' or electronic devices that store monetary value in electronic form could have perceptible implications for monetary policy. In this regard, two inter-related issues namely, impact on the balance sheet of the central bank and the conduct of monetary policy have been widely discussed. The balance sheet effect implies that extensive use of e-money could substantially replace central bank money, i.e., currency notes in the hands of the public. Since currency notes form a major chunk of any central bank's balance sheet, the expansion of e-money would imply that the size of the balance sheet would shrink resulting in the erosion in its capacity of conducting effective Open Market Operations (OMO). In this situation, large additional reserves with the banking system created in the wake of large-scale use of e-money cannot be sterilised and could pose a challenge to monetary policy.

The rapid expansion of e-money would also pose challenges in the area of compilation of monetary statistics and, therefore, render the monetary policy prone to operational errors. The issue of e-money, not backed by central bank money, by private issuers would also be subject to the problem of moral hazard and would necessitate careful and extensive supervision by central banks.

Recent advances in information technology have reduced transmission lags of monetary policy resulting in a narrowing of the distinction between the short and long run. Thus, in the new set up, the relationship between money, output and prices may also change, and become relatively less predictable posing a new challenge for monetary policy. Such has been the experience of many other countries where, financial liberalisation made the link between monetary aggregates and inflation unstable.

Another challenge that central banks might face would be in their role in crisis prevention in the context of large volume and high speed transactions through complex instruments. This would require building of enhanced expertise to deal with moral hazard and systemic problems and strategies of intervention with safeguards against undue credit risk exposures. Central banks will also have to monitor the growth and pace of financial innovations by the private sector that may sometimes tend to avoid regulations. Thus, the scope of central bank activities would have to extend beyond the traditional realm of monetary policy to various issues that impinge on the overall health of the financial system.

As the virtues of fiscal rectitude are recognised and progressive structural corrections in our fiscal system instituted, the monetary policy, in the future, may even have to be conducted with concurrent fiscal surpluses in the accounts of the Government. Such a situation may need a careful reassessment of the way that monetary policy measures would have to be implemented in order to balance and stabilise movements in the structure of interest rates that might arise on account of a mix of productivity changes in the economy and the presence of budgetary surpluses. Moreover, the creation of surpluses and the Government options to retire public debt could have far reaching implications for the effectiveness of traditional monetary instruments. This would be especially so, if a substantial part of such debt is held in the books of the central bank.

The increasing degree of interdependence among economies in the world and the large movements of capital imply that the role of monetary policy *vis-à-vis* the exchange rate would have to be carefully addressed. This would essentially require having clarity in a country's monetary policy framework and the building up of credibility to sustain the size and volatility of capital flows that characterise the world financial system.

Implications for the Future

What do these existing constraints and emerging challenges imply for the future conduct of monetary policy. As regards objectives, while price stability and credit availability would continue to be the main objectives, and relative weights may vary from time to time, a more transparent articulation of relative weights may have to be sought. Furthermore, as the economy develops, sacrifice ratios in terms of the short-run trade off between growth and price stability

may come down warranting greater stress on price stability.

With progressive globalisation of the economy, the exchange rate becomes a very critical factor in the conduct of monetary policy. The excessive weight that may be given to popular perceptions in regard to exchange rate as against what is warranted by compulsions of economic factors could certainly complicate monetary management. Creating public awareness of forex situation and forex markets would thus be an important task for the Reserve Bank.

Greater recourse to indirect instruments is inevitable and that would require sophistication, nimble-footed response and market savvy approach – qualities that have been demonstrated by the Reserve Bank so far, but in a rapidly changing environment, the skills of the RBI could be continually tested.

Of the four transmission channels, it is clear that the quantity variable is still valid but is yielding place to rate variables though conditioned by the evolving status of financial markets. The exchange rate channel will, however, emerge important and the future relevance of significance of asset price channel cannot be ignored.

In terms of operating procedures, the increasing importance of foreign currency assets in the balance sheet of the Reserve Bank accompanied by greater discretion to the RBI in the stock of domestic assets, essentially Government paper, facilitated by termination of system of automatic monetisation, gives more control to the Reserve Bank over the size and quality of its balance sheet. That in some senses gives operational freedom in regard to conduct of monetary policy, though continued fiscal dominance will constrain such freedom.

Finally, the Reserve Bank of India may have to operate on liquidity even on intra-day basis, utilise banks as major planks of policy although banks' share in financial intermediation would be less, while at the same time improving data systems, management information systems, market intelligence, and understanding the global trends. It is in this context that the recently introduced *Liquidity Adjustment Facility* is a watershed in the refinement of techniques of monetary intervention.

Financial Markets

As the process of reform continues, the role of financial markets in the economy gets significantly enhanced. While this process essentially involves domestic liberalisation, the decision to open up the economy adds urgency and complexity to the process of developing financial markets in India. The changing role and increasing responsibility of the Reserve Bank has to be seen in this context and in conjunction with development of financial markets in areas outside of the Reserve Bank jurisdiction but relevant to its activities, especially equity markets and insurance activities.

More specifically, the role of the Reserve Bank in the financial markets should be assessed in the light of the following :

First, the primary interest of the Reserve Bank in financial markets is because of its criticality in

the transmission of monetary policy.

Second, the conscious effort by the Reserve Bank towards the development of efficient, stable and healthy financial markets is important since they were repressed in several ways in the past by law, regulation and policies. Mere lifting of restrictions will not automatically help create vibrant financial markets. Hence, the Reserve Bank of India has been facilitating and should continue to facilitate the development of markets through legal changes, technological and institutional development and dynamic improvements in market microstructure.

Third, regulation of some financial markets is warranted by virtue of the Reserve Bank's charter. This relates to money market which is central to monetary policy, Government Securities market which is significant from the point of view of developing a yield curve, forex market which is integral to external sector management and gold markets, which have been more recently deregulated. This position has been formalised with the recent amendments to the Securities Contract Regulations Act and Government notifications thereunder giving jurisdiction to the Reserve Bank.

Fourth, with the gradual development of sophisticated instruments and innovations in market practices, technological infrastructure has become an indispensable part of the reform of the financial markets.

The Reserve Bank of India has, therefore, to equip itself to perform its developmental and regulatory roles effectively. The process involves constant interaction with the rest of the world in order to identify best practices, benchmark existing practices in our markets, identify gaps and take measures to move towards these international standards, within the framework of our unique country circumstances.

Secondly, coordination with other regulators within the country is important to sort out regulatory gaps and overlaps.

Thirdly, it is important to constantly interact with market participants without in any way compromising confidentiality so as to effect changes in the regulatory aspects of the markets through consultative mechanisms.

Fourthly, with increased liberalisation, there is also need to update information and market intelligence to assess the prevailing situation and take quick actions.

Fifthly, a major challenge within the Reserve Bank will be to institute arrangements to improve its skills to keep pace with the speed and the skills of market participants.

Specifically, in the money markets, in order to facilitate the conduct of monetary policy and improve the efficiency of transmission mechanism, it would be necessary for the Reserve Bank to manage the transition of switching over from direct to indirect instruments, reducing preemptions not only to their statutory minimums but beyond that, developing a transparent and liquid repo market and institution of a full fledged Liquidity Adjustment Facility. Some of these developments do call for adequate progress by way of legislative actions.

Currently, the Government securities market is an overwhelming part of the overall debt market. Interest rates to put this market provide benchmarks for the system as a whole. In the recent past, several initiatives have been launched to put this market into a high growth trajectory, in terms of depth, liquidity, turnover, participants, etc. Several initiatives for development of this market helped the success of a large borrowing programme in recent years, and far larger than budgeted programmes were carried out successfully. But, the benefit of innovations may not be inexhaustible. Recent initiatives towards retailing would hopefully provide headroom, but there is a well recognised need for fiscal support in terms of tax treatment for this laudatory objective.

There are some conflicts in the role of the RBI as regulator and supervisor of banks which, for example, tilts favouring short-term paper to match ALM guidelines while the RBI as debt manager prefers to balance the maturity profile with long duration paper. This could throw up more conflicts in future.

The dilemmas involved in the Reserve Bank being both debt manager of Government and a monetary authority have been chronicled extensively. At this stage, minimisation of adverse impact of high fiscal deficit requires such a combination of roles but perseverance with the objective of separating these two functions at the earliest viable window of opportunity would be advisable.

In the Government securities market, currently, the RBI has two roles, that of a debt manager and a regulator. The RBI Act enjoins upon the Reserve Bank the role of debt manager. The future role of the RBI that is likely to emerge in the Government securities market can be visualised in four phases. The first phase may see the RBI withdrawing from the primary market in Government debt with a phased cessation of devolvement and private placements. This phase will also see the completion of the major reforms that are currently in progress such as repo documentation, establishment of clearing house, commencement of electronic dealing system, etc. The second stage would relate to separation of debt management function from the RBI. As fiscal deficit comes down, Government debt as a percentage of total debt would also come down and the regulatory framework for the Government securities market and the corporate debt market would converge. In this context, the Reserve Bank's regulatory oversight of banks and financial institutions exposure to debt will have to be refocused. The final stage will involve the changed role of the RBI in an environment of fiscal surplus, though in such *Paradise* the RBI will face yet another set of problems. As you see, there is no peace for wicked creatures.

In the foreign exchange market, the absence of well conceived risk management systems in the treasury operations of end-users has constrained its healthy development. PSUs are large players in the forex market and their internal systems are not always consistent with development of efficient risk management approaches. The main challenge would be to evolve means of removing such constraints. A further challenge relates to inculcating and encouraging the practice of hedging by corporates and commercial banks, who, in their own interest ought to be closely monitoring their exposures.

In India, there is extreme sensitivity to volatility in exchange rates and with a public fixation and a dollar-rupee rate, the relative movements of exchange rates, which are routine in international

financial markets, are not clearly considered. In the circumstances, the challenge for the RBI is to develop the forex market given these constraints and relaxations of restrictions in the market.

There is some enthusiasm for early integration of financial markets but currently, we have to identify linkages. For example, the integration between call money market and forex markets operates essentially through banks' permissible limits on investments in overseas markets, and options to hedge, prepay, etc. in foreign currency under FCNR (B), on banks' own account or that of corporates. These linkages will get widened and deepened and ought to be tracked. Another example relates to the linkages between call money market and Government securities market where large positions in Government securities are funded through short-term borrowings, especially call money market. As the reforms in the financial markets progress, linkages will improve -between the different segments of market and between domestic and international markets. Internationally there will be increased pressure for rapidly and more deeply integrating domestic and global markets.

External Sector Management

It is generally appreciated that the RBI has distinguished itself in regard to external sector management, whether it was meeting the balance of payment crisis in 1991, or managing the transition to a liberalised exchange rate, unified exchange rate, current account convertibility and capital account liberalisation. The basic parameters set for itself in terms of current account deficit, market-determined but non-volatile exchange rate, containing debt especially short-term, well sequenced liberalisation of capital account, and building up as well as managing adequate foreign exchange assets have all been met and often exceeded, despite several international and domestic uncertainties. In all this, the Government's own actions have provided active support in achieving these objectives.

Perhaps an ideal starting point could be the replacement of the Foreign Exchange Regulation Act (FERA) by Foreign Exchange Management Act (FEMA) with effect from the beginning of this month. The philosophy of foreign exchange management has shifted from that of conservation of foreign exchange to one of facilitating trade and payments as well as developing financial markets. This definitive shift in the objectives of foreign exchange management will automatically get reflected in the operations of the Reserve Bank. Under the new system, all current account payments except those notified by the government are eligible for appropriate foreign currency in respect of genuine transactions from the Authorised Dealers without any restrictions. The surrender requirements in respect of exports of goods and services continue to operate. The Reserve Bank, however, would have the necessary regulatory jurisdiction over capital account transactions. To this extent, further action in regard to capital account liberalisation appears to have been put by government squarely in the court of the RBI.

On the current account, the RBI will have to closely monitor the trends in imports given the liberalised environment, the growth in exports, particularly export of services, and private inward remittances. Overall, the impact of possible increased investment activity in the future, particularly in infrastructure, on the level of current account would have to be assessed. In doing so, the fact that the combined share of exports and imports has gone up from about 13 per cent of GDP in the latter half of eighties to over 20 per cent in the recent period as well as the sharp

increases in capital flows and the level of reserves could be kept in view. In this background, and on the assumption of sustainable level of non-volatile capital flows, the possibility of an acceptable band of sustainable current account deficit may need to be conceptualised.

Similarly, the level and the composition of the capital flows would also change and the stability of these will be impacted less by capital controls and more by the domestic policies as well as transparency practices and standards and codes, though international factors would continue to be critical.

As regards exchange rate management, the unfolding events with reference to fiscal policy, financial sector, especially financial markets and International Financial Architecture would determine the course of policy. Perhaps the biggest dilemma for the Reserve Bank as for many central banks would be reconciling monetary and external sector management.

Regulatory and Supervisory Functions

Significant improvements have been made in the quality of performance of regulatory and supervisory functions by the RBI. Admittedly, the level of our compliance with international practices, is one of the best among the peers. Attention is being paid by my fellow Deputy Governor, Mr.S.P. Talwar to several contemporary issues such as, relative roles of onsite and off-site supervision, functional *versus* institutional regulation, relative stress on internal management, market discipline and regulatory prescriptions, consolidated approach to supervision, etc. Several legislative initiatives have also been taken up with Government, covering procedural law, debt recovery systems, Credit Information Bureau, Deposit Insurance, etc. Progress in these is critical for effectiveness of the Reserve Bank in the regulatory sphere.

Basic Features

While appreciating these initiatives, it will be useful to list what may be considered as the basic features that would govern the Reserve Bank's role in future.

As we move forward in the reform, it is recognised that the regulatory and supervisory framework in financial sector are no longer domestic concerns. Tracking international developments, participating and contributing to them, conforming to the extent possible to international practices and maintaining a convincingly efficient and stable financial sector would continue to be a priority.

Second, in the light of the above, both avoidable regulatory intrusion and inadequacies in supervision would be harmful. The critical objectives of a supervisory system should be clear viz., protection of depositors interests, mainly retail, enhancement of efficiency through competition, and avoidance of instability and potential systemic failure.

Third, while developments in technology would pose several challenges to banks, they will continue to be special as long as they are significant for payments system.

Fourth, there have been movements between public and private ownership of banks in many

countries as warranted by circumstances but in all these the central bank concerned did play a part. The movements in ownership between public and private will have to continue to dominate the attention of the Reserve Bank.

Fifth, the effect of crisis in banking system, irrespective of status of ownership will be on the fisc, i.e., government finances. Even if the Reserve Bank is operating as a lender of last resort the burden is on the fisc, since in the ultimate analysis a central bank's resources put at risk really belong to Government.

Sixth, while persevering with improvements in prudential regulation, the sequencing and the application of rigour cannot ignore the inevitable business cycles, though regulatory forbearance has to be eschewed. This is no doubt a delicate balance.

Seventh, the regulatory and supervisory framework has to reckon with expanding capital flows, faster and faster movement of such flows, increasing recourse to technology for such capital transactions, and rapid financial innovation. These make the tasks of regulator increasingly complex. These developments would warrant a qualitative change in the nature of relationship between the regulated and the RBI as the regulator and the relationship may be one of greater transparency and more consultation than before.

Eighth, there could be an emerging asymmetry between transparency practiced by market participants and the regulator, since the latter as a public institution has to demonstrate its accountability. This would add to the complexities faced by the regulator.

Major Issues

In the light of the broad considerations described, it is possible to list the major issues that would need the Reserve Bank's attention in the near future.

First, whether the regulatory and supervisory functions need to be combined as is currently the position or whether they should be separated from other RBI functions. What is of overriding concern is not whether regulation / supervision should be combined or separated from other functions of the RBI but how regulation/ supervision is conducted.

Second is the issue of coverage of the Reserve Bank's supervisory role, which is currently focussed more strongly on banks, but only to some extent in the case of Non-Banking Financial Companies (NBFCs), especially those accepting public deposits, and to some extent, Development Financial Institutions (DFIs). For example, there could be a separate agency for regulating NBFCs but that would be adding another regulator to the multiple regulators in accepting public deposits.

Third, the broader issue of choice between mega regulator and single regulatory authority deserves to be addressed. In any case, the regulatory gaps and regulatory overlaps in the existing system have been noticed and they are being resolved through informal as well as *ad-hoc* arrangements. The market participants are somewhat uncomfortable with the vagueness implied in informal arrangements.

Fourth, there are multiple institutional structures in the financial system. This has to be revisited firmly in the context of the move towards universal banking. Convergence between banks and DFIs would be easier in future as the reserve requirements of banks are reduced. The management of transition, especially of individual DFIs, could face hurdles, especially due to existence of both the statutory corporations and company form of organisation in the DFIs. In fact, even the concept of State Financial Corporation as statutory bodies performing functions no different from NBFCs require a review. Quite apart from transitional problems, the recommendation of the Narasimham Committee, namely that there be only banks and NBFCs would need to be sooner or later faced, and my own preference is sooner than later.

Fifth, the concept of Public Financial Institutions (PFI) appears not only anachronistic but some of the PFIs are performing functions such as motor car financing. The continued relevance of such special categorisation needs to be considered.

Sixth, while the regulatory focus should be on protection of retail public depositors, currently, acceptance of public deposits are governed by regulations of Department of Company Affairs, SEBI and the Reserve Bank. In fact, the effectiveness of the monetary policy itself could be in jeopardy if these multiple systems of regulation, including fixation of interest rates, by several agencies persists. There is a group in the RBI studying this issue.

Seventh, the issue of dual regulation i.e., by the Reserve Bank and State Governments concerned has been repeatedly emphasised both in the case of urban cooperative banks and rural cooperatives. Some proposals have already been made in regard to Urban Cooperative Banks which are yet to be resolved in the Government. Rural cooperatives are yet another important set of credit institutions languishing from ill-effects of dual regulation.

Eighth, in regard to public sector banks, which form the most important segment of the banking system being owned by the government, the Reserve Bank's regulatory thrust is always circumscribed. The basic issues relating to the form of organisation i.e., corporate or company; the extent of ownership, the nature of control over management by the major shareholder, the system of corporate governance are still subject to considerable vagueness. In fact, this unresolved situation is perhaps the most significant stumbling block in considering further changes in technology, in financial markets and even in monetary policy.

Ninth, it is inevitable that the Reserve Bank takes a clear-cut view, at least in regard to Scheduled Commercial Banks, about the entry norms, the exit norms and norms for restructuring, inclusive of amalgamation. The problem of select weak banks in public sector and various solutions such as an asset reconstruction fund address the current issue. In a more dynamic sense, the RBI should have necessary freedom to regulate aspects relating to entry, exit and restructuring including mergers or acquisitions.

Tenth, the issue of conflict between owner and regulator in as much as the RBI holding a predominate share in the SBI apart from NHB and NABARD need to be resolved sooner than later. The Reserve Bank's position has already been made clear in various documents of the RBI that as a regulator, it would not wish to continue as owner.

Eleventh, in the light of Government's statement on Exim Policy that economic zones are to be treated as outside of the country for regulatory purposes, a view needs to be taken by the Reserve Bank as to whether offshore banking units of scheduled commercial banks as branches of each bank could be considered. Such a separate regulatory prescription is possible under the newly enacted FEMA.

Twelfth, with rapid growth in technology, and complexities in risk analysis as well as assessment, the regulated are racing ahead with both innovations and skills. The Reserve Bank as a regulator will have to specially equip itself to facilitate innovations and assess the prudential requirements as well as regulatory implications of market practices.

Finally, it is also essential to develop and sustain a well thought out framework for use of ratings of credit rating agencies by the RBI for regulatory purposes.

Developmental Function

The Reserve Bank played a significant role in enlarging skills and institutional capabilities in the area of credit to rural areas, to finance exports, and to industry. Institutions such as Industrial Development Bank of India (IDBI), National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB) and even Unit Trust of India (UTI) are virtually offshoots of the RBI. The Reserve Bank had promoted Securities Trading Corporation of India Ltd. (STCI) and Discount and Finance House of India Ltd. (DFHI) and most of Reserve Bank's shares in these two institutions have already been sold. A more recent example is Infrastructure Development Finance Company. The Reserve Bank had been providing funds to many of these organisations through several windows, enabled by legislative provisions and encouraged by policy-thrust in the process of planned development.

As part of the reform, a decision has been taken, in consultation with the Government of India that the profits transferred to the LTO funds should be directly made over to Government which could be the best arbiter of allocation for development. There are persisting expectations and demands on the RBI for taking initiatives in directly financing developmental or social welfare activities. A clear articulation and a clear commitment to the legitimate role of the RBI in the developmental sphere is perhaps warranted.

The Reserve Bank can promote the process of accelerated economic growth by infusing efficiency in financial intermediation and stability in the financial system. It is recognised that while growth may not be a sufficient condition for elimination of poverty, it is a necessary condition. In this sense, there is a convergence between the Reserve Bank's core function of efficiency and stability in financial sector and objectives of growth.

Second, it is possible to argue that the broader objective of the financial system's efficiency coupled with stability, includes, and has as its core price-stability. As Dr. C. Rangarajan, former Governor, Reserve Bank of India is never tired of pointing out, the best anti-poverty programme that the RBI should concern itself with is price stability. There is undoubtedly a total convergence between the welfare of the poor and the core responsibility of the Reserve Bank

viz., price stability.

Thirdly, ensuring availability of credit for all productive purposes is necessary and this is made possible through the pre-condition of efficiency and stability in the financial system. The safety of the interest of the depositors, the goose that lays golden eggs for the financial system, and the meeting of social needs as well as priorities are important. Currently, there are institutional, structural and procedural bottlenecks for credit delivery in our country. In particular, the financial sector reform has provided greater avenues to corporates to raise resources and typically these benefits have not percolated to small and medium enterprises. There are legitimate concerns about credit availability to small and medium enterprises but recourse to the same instruments that have harmed the financial system in the past is not appropriate. Similarly, flow of credit to agriculture deserves attention. Regional spread of banking is important, and so far only public sector banks are carrying these obligations, and this needs to be corrected. The instrumentality of priority sector lending has not served its purpose as envisaged, and as articulated by my fellow Deputy Governor Mr. Jagdish Capoor, the subject needs a thorough review – sooner than later. Credit delivery systems should also recognise the changing composition of Gross Domestic Product in favour of services and effective steps should be considered to ensure flow of credit including extension of bill rediscounting to this sector.

Fourth, the total income generated by the RBI net of its expenditures in performing all of its legitimate functions and net of transfer to its own resources as needed for its balance sheet purposes should legitimately go to the Government, though priority is for adequacy of reserves. It is necessary to appreciate that prudence requires that attention is paid to the Reserve Bank building up adequate internal reserves to meet all possible contingencies. By ensuring efficiency and prudence in its own balance sheet management, the RBI would serve the purpose of making available surplus to the Government.

Finally, the Reserve Bank should give unstinted support to development of the technological infrastructure or financial structure or funding of research and training in the sector and being a catalyst for the development of new type of financial institutions. To this extent, there is a developmental function to be performed by the RBI in so far as it relates to its core functions but it should not become the conduit for resources for financial intermediaries.

It is useful to clearly enunciate the areas where the Reserve Bank should not engage itself under the mistaken notion that it is promoting economic development in an optimal way. Firstly, there is always the temptation for government to seek from the RBI extra budgetary resources for programmes which should essentially be funded by the government. There is a possibility of the RBI also being tempted to oblige, and in such a case, there is a potential for erosion of autonomy of the RBI.

Secondly, utilisation of the Reserve Bank's resources for funding equity in institutions such as National Housing Bank, NABARD are not on a much different footing from lending by the RBI. Indeed, the Reserve Bank should desist from continuing with its ownership functions in both commercial banking and refinance or development finance segment. Furthermore, some of the Reserve Bank's regulatory functions are being combined with the developmental functions in some of these institutions. As we move along the road of reform, combining such functions

needs correction.

Thirdly, there was some association of the Reserve Bank with credit guarantees, particularly through Deposit Insurance and Credit Guarantee Corporation. The concept of credit guarantee by a central bank in any form has proven to be wrong in theory and bad in practice. Fortunately, there is already an agreement in principle to eschew such guarantees.

Fourthly, there has been, as part of the reform, a review of the role of selective credit controls, direct lending and subsidisation of lending. Fortunately, selective credit controls have virtually disappeared. Directed lending tends to be very inefficient if there is an element of cross-subsidisation. When there is subsidised lending, the real problem arises not only in terms of moral hazard but also in terms of the health of the banking system. Increasingly, banks are recognised to be only one category of financial intermediary. In fact, as Governor Dr. Jalan pointed out, the share of banking system in financial intermediation is bound to go down in the interest of both efficiency and stability of the system. In such a situation, utilising the banking system for subsidisation or cross-subsidisation makes the banking system weak in relation to the other institutional categories of financial intermediation. As we move towards greater liberalisation and globalisation, any damage to the health of the banking system erodes international competitive strength of our financial sector and could impose a burden on the fisc when stability is threatened.

In brief, a clear enunciation of what the Reserve Bank should not do in future may be as important as a recognition of what it should do in the cause of development and social objectives.

International Financial Architecture and the Reserve Bank of India

Since mid-nineties, India has been gaining in importance in the global financial community and the RBI has been playing its legitimate role. In 1996, we gained membership in the Bank for International Settlements and we have been active in utilising the facilities and contributing to its deliberations. The Reserve Bank has been taking an active role in the evolving process on the international financial architecture after the Asian crisis. The Reserve Bank also participated in the preparation of G-22 Reports on International Financial Architecture. Later, it was represented along with G-7 countries and other emerging market members in the Group of 20, whose objective is to encourage informal exchange of views leading to consensus on international issues.

The Reserve Bank of India is not only reacting to global changes but also participating in the process. For example, the RBI is one of the select few to be represented in the consultation process of BIS on new norms being considered for Bank's supervision. Similarly, the Reserve Bank is associated with a working group constituted by the newly setup Financial Stability Forum. The Reserve Bank of India is also associated with an international group on Settlements. This role is expected to increase in future and the RBI should be well-equipped for the purpose. A Standing Committee on International Financial Standards and Codes has been constituted in India with joint membership of Government and the Reserve Bank of India. The main task of this Committee is to identify and monitor developments in global standards and codes and

consider its applicability to the Indian financial system. The Committee would also help align to the extent necessary India's practices to the international best practices. In fact, closer collaboration between Government of India and the RBI is witnessed in several fronts and this needs to be strengthened in future.

Balance Sheet of the RBI

In the emerging scenario, there is need to accord the respect that is due to the balance sheet of a central bank. Fortunately, the Reserve Bank has been devoting special attention to several aspects of its balance sheet viz., avoiding contingent liabilities, building up adequate reserves thereby regaining some control over its balance sheet and further enhancing accounting and transparency standards. In view of significant amounts of foreign currency assets in its portfolio and the need to adopt internationally accepted valuation norms for all its assets, the RBI should be strong enough in its internal reserves so that it can withstand any possible adverse impact on its balance sheet. A fear of adverse impact on its balance sheet may inhibit the RBI to pursue otherwise desirable and prudent policies and the level of its reserves should be enough to remove such fears. The Reserve Bank of India should guard itself against pressures to dilute the policy framework on transfer to reserves between Board of the RBI and Government. It will be interesting to note that as the fiscal adjustment progresses and succeeds the potential for the Reserve Bank's profits decreases.

Finally, the balance sheet of the RBI can command credibility as well as effectiveness in its policy interventions, domestically as well as internationally; when among other things it has sufficient autonomy and control over its balance sheet.

Conclusion

In conclusion, I believe that the RBI has continued to acquit itself well in discharging its functions during the reform period. It has deservedly gained importance, credibility and respect. It is currently well equipped in terms of technical skills to meet domestic and international challenges.

It must be recognised that close understanding between the RBI and Government was instrumental in bringing about structural reform and meeting crisis-like situations during the recent years. In particular, the RBI has been providing analytical inputs in policy making in so far as financial sector is concerned. This approach should be carried forward while respecting the need for the Reserve Bank's autonomy in conducting its monetary operations.

Another significant recent achievement of the RBI is the close links it developed with State Governments - as banker, as debt manager and as policy adviser, and keeping up this momentum is desirable.

There has been a notable change in the work practices and approaches to policy making as well as problem solving. These include constant review of international experience, working group approach and multi-disciplinary and multi-departmental standing committees to aid decision making. The gains from this approach are evident and should be carried forward.

Finally, there is great merit in devoting urgent and serious attention to three aspects.

First, there should be deliberate efforts to continuously upgrade skills on a more extensive scale. For this purpose, both, facilities as well as incentives would be needed.

Second, whether, as a regulator or in performing other functions such as banker to Government or issuer of currency, there is significant interaction with users. With interest shown by Governor Dr. Jalan, there has been discernible impact but some more drastic changes in attitudes and procedures may be necessary.

Third, the work practices including placement, deployment, redeployment etc. need to be visited and thoroughly revamped to bring them in alignment with demands of a rapidly modernising financial sector.

In all these areas, it would be worthwhile for an immediate examination and consensus for moving forward.

Let me once again thank the organisers for giving me this opportunity to freely set out my random thoughts on changes in the RBI's role in future.

*** 18th B.F. Madon memorial Lecture delivered by Dr. Y.V. Reddy, Deputy Governor, Reserve Bank of India, organised by the IMC Economic Research and Training Foundation at Indian Merchants Chamber, Mumbai, on June 13, 2000.**
Dr.Reddy is grateful to several professionals in the RBI for their immense help.