Speech

MODERN DAY CENTRAL BANKING*

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The Seminar has three modules, all of which are inter-related and are a part of what may be called `macroeconomic dynamics'. The scope and content of the seminar are so worked out that they can easily be regarded as the bread and butter of modern day central banking. Gone are the days when Central Bankers used to be aloof and stern, and markets used to freeze, whenever Governors caught cold. Central bankers nowadays are publicly seen; they participate in seminars, interact with market men and are generally proactive. The addresses and speeches of Central bank Governors nowadays are innumerable: they are often referred to and cited even in learned journals. Central bankers realise that markets have expanded beyond recognition and have attained unimaginable depths in many cases. More importantly, markets have spread beyond national boundaries. With the growth of markets, the number of participants have grown enormously, and the volume of transactions has increased by leaps and bounds in almost every conceivable financial instrument and asset. This has been rendered possible by the networking applications and dissemination technologies. Undoubtedly, laws relating to financial transactions differ from country to country but the economies of financial development has ensured that legal provisions which could be commonly applied across nations could be quickly set in place for settlements to be final and uncontestable. In such a milieu, Central bankers have to be continuously on the alert to the financial market developments, and come out with feasible answers in an expeditious way. If this is not done, Central bankers would be faced with diverse market expectations. In fact, Central bankers will have to see that they influence these expectations by their announcements and actions. They should at no time allow the markets to test them or to tease them.

Clearly, modern day central banking has gone far beyond traditional functions. One such function of central bank is that it is an issuer of currency. Notwithstanding the recent interest in the institution of currency boards, central banks have come to stay. Every central bank has to re-orient the other traditional functions of being a banker to the Government and an adviser to Government, as also of being a banker to banks. These re-orientations will be the natural corollary of pursuing monetary policy measures that

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would have to be necessarily focussed on definitive, well defined and quantifiable objectives. In addition, modern day central banks will have to promote soundness of the financial system and to bring about changes in the institutional set-up and financial structure.

We need to elaborate on the new look in the functioning of central banks, keeping at the back of our minds, the Indian situation. To be a banker to the Government does not mean that mere credit and debit entries in the Government books of accounts have to be maintained in the central bank. In most developing countries, as is the case in India, central banks manage debt of Governments, and provide services akin to those rendered by investment bankers without charging costs for the services provided. Here, a number of interesting questions/issues arise. Quite apart from the need to decide on issues such as the kind of auctioning system, the types of Government securities, and the maturity structure of these securities, the issue of the extent of support that the central bank and commercial banks should extend to Government borrowing programme would have to be determined. This determination is vital from a number of points of view. First, it provides an understanding about the likely increase in net domestic assets of the central bank and commercial banks. Where the share of net foreign exchange assets in money supply is limited, credit to Government forms an important element in the overall availability of liquidity in the economy. Secondly, it needs to be recognised that if public borrowing is relatively large, it is likely to move market interest rates upward, which in turn will impact on the cost of credit and capital flows. Assuming that commercial judgement of commercial banks is constant, such a development will have the potential of creating adverse selection and influencing the very quality of the loans disbursed by banks. There is, besides, the need to develop and deepen the secondary Government securities market, should the Governments resort increasingly to market borrowing.

From the view point of the central bank, public borrowing from the banking system will mean undertaking of policy actions to improve transparency, increase the number of dealers and other participants, improve the securities settlement system, notify the amounts to be mobilised for all auctions, and develop repo market. Larger market borrowing would imply the need to activise open market operations (OMO) as an important tool of monetary policy.

As adviser to Government, central banks in developing countries are often required to concert with the Governments on fiscal policy matters, and signal to markets, a unified, coherent approach to macro-economic policy. In more recent years, central banks have become pro-active in the area of structural reforms. The Indian case is an excellent example in this regard. Financial reforms, including those relating to industrial securities where Governments would normally have an important say by virtue of the fact that there will be securities and exchange commissions or boards, as in the case of India, will need to be worked out in detail, and undertaken in appropriate sequential steps as also be synchronised with real sector reforms. Where Government has a large stake in banks and other financial institutions, financial sector reforms carry budgetary and other implications. Recapitalisation, for example, would imply a certain expenditure while divestment will mean some loss of managerial control in so far as Government is concerned. Bank consolidation will influence not only industrial relations but also economies of

scale and scope. Public sector banks in particular will have to prepare themselves for change, when consolidation efforts are attempted/made.

As banker to banks, central banks these days exercise considerable discretion, and rarely go by rule-based methods. The lender of the last resort function of central banks would no doubt continue to be important, since it gives an element of insurance for the stability of the financial system. Access to refinance facilities and to a number of other services that central banks generally provide (for example, in the matter of payments and settlements, funds transfers or remittances, and securities settlement) would have to be important elements in the relationships between central banks and commercial banks. But more importantly, monetary and credit policies would need to ensure that banks' profitability is not eroded and banks render efficient services to the public at large. This is where, it is often claimed, there are possible conflicts of interest of individual entities of the banking system and the central bank, but this is not as relevant as it is made out to be, since both growth and price stability considerations, which central bank cherish, influence the very volume of business of banks.

In the areas of banking soundness and structural reforms, central banks of the present day, have become major initiators of activity. Financial supervision or surveillance, whether off-site or on-site or both, has gained in importance in the face of market imperfections and information asymmetries and data deficiencies. There is a view that the recent Asian crisis could have been avoided or at least, better addressed, had supervision systems been strong. Irrespective of the importance that one attaches to this contextual observation, it is a fact that soundness of banking and other parts of financial system would depend not only on the operations of the entities but also on the effectiveness of supervision. The 'core' principles of banking are recognised as relevant by all central banks and they can all be applied quickly with a confirmation to that effect by supervisors. The problem is that banks themselves have transformed so sharply that they undertake multifarious functions that go beyond the orbit of influence of traditional bank supervision. The operations of subsidiaries, the provision of guarantees and assumption of contingent liabilities for instance have become major sources of concern for supervisors. The links between banks and Non-Banking Financial Companies (NBFCs) and the operations based on financial derivatives have made matters very difficult for supervisors. Nonetheless, efficient supervision rules and procedures with provision for review, will have to be laid down to minimize risks and to provide for appropriate 'advance indicators' of the problems that are likely to arise in future. Such methods help to improve not only the operational efficiency of banks and other financial entities but also the confidence in the financial system and promote capital inflows. Co-operation between central banks in the area of supervision is vital for minimizing 'contagion' effects.

Modern day central banks rarely rely on one or two policy measures in their day to day operations. They undertake combinations of actions mainly to give signals of their intentions or policy stance. They would not mind interventions, if needed, and would persuade markets to pursue the chartered course in the light of the particular economic circumstances of the times and the future requirements of the economy. Reforms of the tools of monetary policy and of the institutional rigidities

associated with monetary policy making have, therefore, become significant. Undoubtedly, such reforms are not possible unless the emphasis is on indirect methods of monetary control and direct controls are eschewed or given up as quickly as possible. Earmarking of loans for specific purposes or directed lending or credit rationing is widely recognised as impinging on the quality of loan portfolio and on the profitability of the institutions concerned. Open market operations, in such a framework gains in importance. Interest rate flexibility is yet another tool inviting emphasis. Cash Reserve Ratio (CRR) is one instrument which is being increasingly de-emphasised and in some cases completely eliminated. Statutory Liquidity Ratio (SLR), which is essentially a prudential measure, can also, according to many observers, be limited, and if need be eliminated. The main idea behind such a transformation in the approach to monetary policy is to give banks complete freedom in making portfolio choice, without losing sight of the risks in asset accretion, and to provide opportunity to banks to ensure that resource allocation is optimal. Asset prices in particular have, as the recent experience shows, become the main focus of risk management strategies of banks and of transmission channel of monetary policy. If one were to closely observe the working of central banks in the last 10-15 years, one finds that their Annual Reports are growing in size, with improved professionalism and quality and that the number of initiatives taken by them have been substantial and frequent. Although central banks are expected to mainly concentrate on macromanagement issues, their actions often give impression of being micro-oriented in effect. They modulate interest rates and influence exchange rates, through OMO and intervention or swaps policies, all for the sake of minimizing volatility and risks. Many central banks in the industrial world are able to pursue such actions on a daily basis because they model liquidity position in the economy every day. Modern central banks have come to believe that while market conditions feed into their actions, they would also need to influence markets. Money and foreign exchange markets in particular, would be the first to experience the effects of monetary authorities' actions both in terms of rates and turnovers. The effective rates need to be stable and in line with economic fundamentals so as to give confidence to the economic participants about the future prospects of the economy.

Liquidity determination is the key to the efficacy of monetary authorities' actions. As the economy opens up, the interactions between the domestic and external economies will impinge on liquidity as much as the dynamic growth impulses from within. But it must be recognised that liquidity is not a static or an enduring number, given the fact that assets are substitutable, financial innovations abound, and the speed of transactions and settlements is incredibly sharp owing to the fast changing communication and networking technologies. Since liquidity is affected by domestic monetary policies as much as by exchange rate and debt management policies, it is imperative that co-ordination among them is essential and is rendered possible.

Central banking is passing through exciting and often challenging times. While developments within the country guide its transformation, the experience of other countries provide many invaluable lessons in our approach to promote growth within price stability. Central bankers have to be open minded and pursue with earnestness their objectives which, after all, are the same irrespective of the times and societies in which they live.