Y V Reddy: Evolving role of the Reserve Bank of India – recent developments

Speech by Dr Y V Reddy, Governor of the Reserve Bank of India, on the occasion of the Foundation Day of the Institute of Development Studies, Jaipur, 30 June 2007.

Dr. Reddy is thankful to Mr. Kanagasabapathy, Adviser-in-Charge (Retd.), Reserve Bank of India, for his valuable advice.

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Respected Professor Vyas, distinguished participants, ladies and gentlemen,

I am indeed thankful to the Institute of Development Studies and Professor Vyas for providing me this opportunity to share my thoughts with you today on the "Evolving role of the Reserve Bank of India: Recent Developments".

My association with Professor Vyas has been long, but it became closer since November 2000, when he was appointed as a director on the Central Board of the Reserve Bank of India. Professor Vyas was also the Chairman of the "Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System", which was constituted by the Reserve Bank of India (RBI) in December 2003. Many of the recommendations of the Committee have since been implemented with good results. Professor Vyas is easily among the most eminent agricultural economists of the world and had been associated with the Food and Agriculture Organisation of the United Nations, where he made a significant contribution. As a person, he is extremely soft spoken and very scholarly, but his scholarship and erudition sit very lightly on his shoulders. Humility is a trait which comes very naturally to him. It is my pleasure and honour to be here at his invitation.

The Institute of Development Studies, set up in 1981 at the initiative of a group of academic scholars and the Government of Rajasthan, has had the benefit of Professor Vyas' leadership. The Institute aims to contribute to the understanding of the development processes broadly defined, besides providing a forum for better understanding of the issues involved in resolving the problems unique to the State of Rajasthan. Given the track record of the Institute, I am confident that it will continue to make a meaningful contribution to the development process of the Indian economy in general and of Rajasthan in particular – especially those of bypassed sections.

I. Evolving role of RBI

The Reserve Bank, established through the Reserve Bank of India Act, 1934 commenced its operations in 1935. It draws its powers and responsibilities through other legislations also such as the Banking Regulation Act, 1949. The RBI has over the years been responding to changing economic circumstances and these organisational developments have been documented in a recent Report on Currency and Finance for the year 2004-05, the theme of which was "The Evolution of Central Banking in India". Today, I would like to highlight some recent developments and discuss certain issues of contemporary relevance relating to the evolving role of RBI.

First, compared with several countries which introduced rapid reforms in central banking law and governance in the last about two decades, the Indian experience reflects an evolution or adaptation of central banking to new economic realities. These changes were brought about both through some legislative measures and changes in operating procedures.

Second, this evolution has *inter alia* contributed to imparting some autonomy to the central bank, *de facto*, particularly in the areas of monetary management and financial regulation.

Third, in sharp contrast to the situation before 1991, since then, apart from a transparent communications policy and a broad based consultative approach to policy making, Governors' speeches and appearances on the electronic media and the press have been substantial, having significant influence on markets and opinions. In the process, the RBI has gained reputational bonus and public credibility.

Fourth, thanks to related developments in the last 15 years, financial and external sectors in India have also become relatively more efficient and resilient.

Fifth, while the effectiveness of monetary policy has improved significantly to meet the evolving demands, some constraints are persisting, which impact the choice and effectiveness of our policy framework.

In reviewing the evolving role of RBI, it is necessary to distinguish between an exclusive monetary authority and a generic central bank, which performs not only monetary functions, but also other functions, in particular, banking supervision. A recent survey by the Bank for International Settlements (BIS) has shown that over sixty per cent of central banks across developed and developing countries have banking supervisor's role exercised by a central bank. India has adopted a middle path. Banking Supervision continues to be with RBI, but it has been accorded a distinct semi-independent status. A Board for Financial Supervision (BFS), a Committee of the Central Board of RBI, was set up in 1994 and meets at least once a month to guide and oversee the RBI's supervisory functions. The BFS includes four independent members drawn from the Central Board of Directors of RBI with relevant professional background and experience.

While it is true that globally the general tendency recently has been to stress the independence or autonomy of central banks in general and monetary management in particular, this has been brought about by different countries in a variety of means: constitutional changes, legal amendments, treaty, obligations, policy reorientation or by changes in practices, procedures and overall environment of public policy. Evolution, thus, does not exclude legislative changes to meet the challenges of globalisation and new economic realities, though in India most changes have thus far been effected within the basic structure of the original legislation in terms of mandate, governance procedures and instruments. A notable legislative measure in the recent past (The Reserve Bank of India Amendment Act, 2006) nevertheless relates to greater flexibility to RBI in regard to cash reserve requirements, deployment of forex reserves, and clarity in regulation over money, forex and government securities markets.

The independence of a central bank sometimes is rigidly associated with a single objective, such as price stability. But, in practice, there are many instances of dual or multiple objectives with equal or different weights and there are many cases of hierarchy of objectives for a central bank. In the overall context of its policy and operations, the RBI in practice is subject to the current legal framework and operates as a monetary authority with multiple objectives and multiple functions assigned to it. Within such a mandate, efforts are made to (a) articulate the hierarchy of objectives in a given context; (b) impart transparency through enhanced communication, emphasise participative nature of decision making in its activities, including monetary management, through advisory committees; and (c) move towards greater autonomy in operations relating to monetary policy while ensuring harmony in macro policies in coordination with the government.

II. RBI autonomy: *de jure* versus *de facto*

The RBI was established under the Reserve Bank of India Act, 1934 on April 1, 1935 as a private shareholders' bank, but since its nationalisation in 1949, is fully owned by the Government of India. The RBI is placed under the Entry 38 of List 1 of Schedule VII of the Constitution of India, which is the Union List.

The Preamble to the RBI Act describes the basic objective as "*to regulate the issue of Bank notes and 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*". Thus, there is no explicit mandate for price-stability or formal inflation targeting. The twin objectives of monetary policy in India have evolved over the years as those of maintaining price stability and ensuring adequate flow of credit to facilitate the growth process. The relative emphasis between the twin objectives is modulated as per the prevailing circumstances and is articulated in the policy statements. Consideration of macroeconomic and financial stability is also subsumed in the articulation of policy.

The RBI is also entrusted with the management of foreign exchange reserves, which are reflected in its balance sheet. While RBI is essentially a monetary authority, its founding statute mandates it to be the manager of public debt of the Government of India and banker to the Government. In terms of Section 20 of the RBI Act 1934, RBI has the obligation to undertake the receipts and payments of the Central Government and to carry out the exchange, remittance and other banking operations, including the management of the public debt of the Union. In the recent past, a functional separation of monetary and debt management was debated and the Union Budget for 2007-08 has announced a proposal to setting up of an autonomous Debt Management Office to keep the debt management distinct from monetary management. Further, as per Section 21 of the said Act, RBI has the right to transact Government business of the Union in India.

While, as per statute, RBI is the monetary authority of the country, the RBI has also been entrusted with the work relating to Banking and Supervision by an enactment in 1949. The RBI exercised a tight regime of exchange control particularly under the Foreign Exchange Regulation Act (FERA), 1973; but, a qualitative change was brought about in the legal framework to enable liberalization by the enactment of the Foreign Exchange Management Act (FEMA) in June 2000 replacing the earlier FERA. With this, the objectives of regulation have been redefined as facilitating trade and payments as well as orderly development and functioning of foreign exchange market in India.

It is significant to note that the RBI Act, Section 19 precludes RBI from performing certain business which protects the integrity of the institution, such as trading or taking any direct interest in commercial, industrial or other undertaking, purchasing shares or giving loans against shares, and advancing money on security of immovable property, drawing or accepting bills payable otherwise than on demand. Because of the last provision, the RBI evolved the Market Stabilisation Scheme through an MoU with the Government, for undertaking stabilisation operations.

On practical considerations, central bank independence may be viewed as related broadly to three areas, viz., management including personnel matters; financial aspects; and conduct of policy. Managerial independence refers to the procedures for appointment, term of office and dismissal procedures of top central bank officials and the governing board. It also includes the extent and nature of representation of the Government in the governing body of the central bank and Government's powers to issue directions. Financial independence relates to the freedom of the central bank to decide the extent to which Government expenditure is either directly or indirectly financed *via* central bank credits. Direct or automatic access of Government to central bank credits would naturally imply that monetary policy is subordinated to fiscal policy. Finally, policy independence is related to the flexibility given to the central bank in the formulation and execution of monetary policy, under a given mandate.

While the Central Government may give such directions to the RBI after consulting the Governor as it may consider necessary in the public interest, the overall management of the Bank's affairs and business rests with the Central Board of Directors. The Governor is appointed by the Central Government and may be removed from office without specifying any reason. All Deputy Governors are also appointed by the Central Government and may be similarly removed. All Directors of the Central Board are nominated by the Central

Government with one Government official as a participant in the Board deliberations. The Directors hold office during the pleasure of the Central Government which can also supersede the RBI's Central Board.

The staffing pattern is left to the RBI, but rules governing their service conditions and compensation are not out of alignment with public sector in general and banking sector in particular. There is legal protection to the Bank and also to its officers for actions taken in good faith. There have been no noticeable changes in the recent past in the relationship between the Government and RBI on managerial/personnel matters.

On financial aspects of RBI *vis-à-vis* Government, however, there have been several positive developments. Since the 1990s, as the case for according greater operational flexibility to the RBI in the conduct of monetary policy and regulation of the financial system became stronger, the practice of automatic monetisation of the Government's fiscal deficit through the issue of *ad hoc* treasury bills came under severe criticism (Rangarajan, 1993). In subsequent years, the phasing out of automatic monetisation of fiscal deficits by 1997 and the enactment of FRBM legislation in 2003 are two important milestones in the direction of providing safeguards to monetary policy from the consequences of expansionary fiscal policy and ensuring a degree of *de facto* autonomy of the RBI.

It is interesting to note that the above autonomy in financial matters was obtained by the RBI through exchange of letters and agreements whereby automatic monetisation through *ad hoc* Treasury Bills was discontinued since April 1997. The Fiscal Responsibility and Budget Management (FRBM) Act, 2003, further strengthened the position by prohibiting the RBI from participating in primary issuances of all government securities.

The RBI has gradually withdrawn from the practice of providing concessional finance or refinance for specified sectors such as agriculture, industry and export, though the legal provisions continue to enable it. In the same view, as part of strengthening monetary management, only notional provisions are made out of RBI profits for Agriculture, Industrial and Housing Credit Funds. No doubt, there are persistent demands on RBI to reverse the process, but the RBI advocates direct fiscal support to development activities so as to be transparent, accountable and quantifiable rather than through monetary operations of RBI, which would tantamount to quasi-fiscal operations.

Transfer of the balance of profits, after necessary provisions, to the Central Government has been rationalised as part of the reform process in 1997. The present arrangement is governed by the objective of reaching a stipulated level of reserves in RBI's balance sheet over a period – though the timeframe to reach the level is extended by mutual consent to accommodate immediate fiscal compulsions.

In technical parlance, accountability of an institution like RBI goes together with a specific mandate and operational independence or autonomy to achieve the said mandate. In the absence of these, in practice, the RBI is accountable indirectly to Parliament through the Ministry of Finance, Government of India. At times, it is summoned by Parliamentary Committees, and even in such cases, it generally plays only a supportive role to the executive wing of the government.

In a recent IMF Working Paper published in April 2007, where the indices of central bank autonomy have been calculated for 163 central banks as of end-2003, in a group of 32 emerging markets, India has scored 0.25 for political autonomy of the central bank as against the average score of 0.56 for the group of emerging markets and scored 0.75 for economic autonomy of the central bank which is the same as the average score for that group.

Dr. Bimal Jalan at the time of laying down office as Governor in 2003 remarked: "the autonomy of a central bank is best set by convention rather than by statute, especially in emerging countries. There should be harmony between the government and the central bank with shared objectives, though the instrumentalities in achieving the objectives may be different".

Harmonious relations between Government and RBI have no doubt generally contributed to the successful policy outcomes thus far, but it would not be appropriate to conclude that there are no differences in analysis, approaches, judgements and instrumentalities. In the given legal and cultural context, while making every effort to give its views either informally or formally, but as unambiguously as possible, the RBI generally respects the wishes and final inclination of the government. The RBI, however, has to accept the responsibility for all its decisions and actions, while being generally conscious of the impact of its articulation and actions on the credibility for central banks operations. The Government, for its part, recognises the dilemmas posed to RBI, and accord significant weight to central bank's judgements.

In sum, *de jure,* RBI has not been accorded autonomy on par with recent trends in some of the industrialised as well as emerging economies; but, *de facto,* the experience reflects a growing degree of autonomy. During the period of reform since 1991, there has been a gradual and mutually agreed progress towards greater autonomy in matters relating particularly to financial markets and, in the conduct of monetary policy.

III. Monetary policy framework

The preamble to the Reserve Bank of India Act, 1934 sets out in a way broadly the tone of RBI's monetary policy objectives: "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". I can do no better than quote one of my distinguished predecessor and current Chairman, Economic Advisory Council to the Prime Minister, Dr. C. Rangarajan on this subject:

> "In a broad sense, the objectives of monetary policy can be no different from the overall objectives of economic policy. The broad objectives of monetary policy in India have been: (a) to maintain a reasonable degree of price stability; and (b) to help accelerate the rate of economic growth. The emphasis as between the two objectives has changed from year to year, depending upon the prevailing conditions." (1997)

Thus, although, unlike the current trend in many countries, there is no explicit mandate for price stability, the twin objectives of monetary policy in India have evolved as those of maintaining price stability and ensuring adequate flow of credit to the productive sectors of the economy. Of late, considerations of macroeconomic and financial stability have assumed an added importance in view of increasing openness of the Indian economy.

In India, the broad money (M3) emerged as the nominal anchor from the mid-1980s based on the premise of a stable relationship between money, output and prices. In the late 1990s, in view of the ongoing financial openness and increasing evidence of changes in the underlying transmission mechanism with interest rates and exchange rates gaining in importance vis-à-vis quantity variables, it was felt that monetary policy exclusively based on the demand function for money could lack precision. The RBI, therefore, formally adopted a multiple indicator approach in April 1998 whereby interest rates or rates of return in different financial markets along with data on currency, credit, trade, capital flows, fiscal position, inflation, exchange rate, etc., are juxtaposed with the output data for drawing policy perspectives. Such a shift was gradual and a logical outcome of measures taken during the reform period since the early 1990s. The switchover to a multiple indicator approach provided necessary flexibility to respond more effectively to changes in domestic and international economic environment and financial market conditions.

In the context of monetary policy making, let me highlight some recent developments:

First, the availability of instruments to manage, in the context of large capital flows and sterilisation, has been strengthened with open market operations through Market Stabilisation Scheme (MSS), which was introduced in April 2004. Under the MSS, the RBI

was allowed to issue government securities as part of liquidity sterilisation operations in the wake of large capital inflows and surplus liquidity conditions. While these issuances do not provide budgetary support, interest costs are borne by the fisc; as far as Government securities market is concerned, these securities are also traded in the secondary market, on par with the other government stock.

Second, another development in the recent period has been to fix a numeraire to inflation. The RBI's self-imposed medium-term ceiling on inflation at 5.0 per cent has had salutary effect on inflation expectations and the socially tolerable rate of inflation has come down. In recognition of India's evolving integration with the global economy and societal preferences in this regard, going forward, the resolve would be to condition policy and expectations for inflation in the range of 4.0-4.5 per cent. This would help in maintaining self accelerating growth, keeping in view the desirability of medium-term inflation at around 3 per cent to ensure India's smooth global integration.

Third, while the preferred instruments are indirect, and varied, there is no hesitation in taking recourse to direct instruments also, if circumstances so warrant. In fact, complex situations do warrant the dynamics of different combination of direct and indirect instruments, in multiple forms, to suit the conditions affecting transmission mechanism.

Fourth, there are occasions when the medium-term goals, say reduction in cash reserve ratio for banks, conflict with short-term compulsions of monetary management requiring actions in both directions. Such operations do warrant attention to appropriate articulation to ensure policy credibility. Drawing a distinction between medium-term reform goals and flexibility in short-term management is considered something critical in the current Indian policy environment.

Fifth, while there is considerable merit in maintaining a broad distinction between monetary and prudential policies of the central bank, the RBI did not hesitate, as a complement to monetary tightening, to enhance the provisioning requirements and risk weights for select categories of banking assets, namely real estate, housing and capital market exposures. These measures were needed to specifically address the issues of rapidly escalating asset prices and the possible impact on banks' balance sheets in a bank dominated financial sector. This combination, and more important, readiness of the RBI to use all instruments, has a credible impact, without undue restraint on growth impulses.

Sixth, some of the important factors that shaped the changes in monetary policy framework and operating procedures in India during the 1990s were the delinking of budget deficit from its automatic monetisation by the RBI, deregulation of interest rates, and development of the financial markets with reduced segmentation through better linkages and development of appropriate trading, payments and settlement systems along with technological infrastructure. With the enactment of the FRBM Act in 2003, the RBI has withdrawn from participating in the primary issues of Central Government securities with effect from April 2006. The recent legislative amendments enable a flexible use of the CRR for monetary management, without being constrained by a statutory floor or ceiling on the level of the CRR. The amendments also removed the statutory floor of 25 per cent on the Statutory Liquidity Ratio (SLR) – which would further improve the scope for flexible liquidity management by the RBI.

IV. Major issues in analytics of monetary policies

Let me now discuss some major issues in the analytics of monetary policy in India. It is generally recognised that monetary policy framework, to be efficient and effective requires a reasonable assessment of potential output, a measure of unemployment, and above all a convincing measure of inflation. Monetary authorities are acutely aware of inherent and growing difficulties in regard to all these three but in India, perhaps the problems are less than fully appreciated.

First, the measurement of potential output, a key prerequisite for forward looking monetary policy, is generally difficult and more so in an increasingly globalising economies like India. Recent studies have shown that the measurement of potential output is extremely sensitive to the choice of methodology. In respect of India, empirical exercises have projected potential output in India in the range of 6 to 8 per cent, based on alternative approaches (Ranjan *et al*, 2007). Besides the wide range of estimates, which in itself is indicative of the uncertainties surrounding potential output, it needs to be noted that these estimates do not fully factor-in fast and significant structural changes of the more recent period which are expected to have a positive impact on potential output. Similarly, reliable estimates of inventories, unit labour costs, coefficient of capacity utilisation and the like, which can serve as proximate determinants of potential output, are not readily available. Thus, what would appear in standard analysis as an elegant formulation of the monetary policy operating rule is extremely difficult to estimate and fashion, in terms of policy formulation, in India.

Second, lack of an economy-wide measure of the rate of unemployment makes the conduct of monetary policy in India complex. While framing appropriate policy responses to trends in output and inflation, policymakers would like to make some assessment as to whether the economy is operating beyond or short of full employment. In the absence of comprehensive data on employment, any measure of the natural rate of unemployment (NRU) would be inadequate for policy formulation. Given that only a small part of the Indian labour force, say about ten per cent, is employed in the organised sector and the greater majority is in the unorganised sector, estimation of unemployment is rendered difficult. Moreover, even within the organised sector, the process of gradual outsourcing of jobs compounds the problem of measurement.

A third set of issues which represents a gap in monetary policy analysis and, therefore, a constraint on operational autonomy, is the assessment of inflationary pressures in the economy. In terms of commodity prices, the issue relates to the choice of price index and RBI has to depend on those which are readily available. In India, there are two sets of indices, *viz.*, wholesale price index (WPI) and consumer price indices (CPIs). The latter is based on occupational classification and category of residence (rural or urban). Four broad measures of CPIs are available at the national level to capture prices of a defined basket of goods and services consumed by a particular segment of the population : (i) CPI for Agricultural Labourers (CPI-AL); (ii) CPI for Rural Labourers (CPI-RL); (iii) CPI for Industrial Workers (CPI-IW); and (iv) CPI for Urban Non-Manual Employees (CPI-UNME). While these various measures of CPI do move together in the long run, significant variations are observed in the short-run. Moreover, food and fuel items together, having a weight of 52.6 per cent in CP-IW, are prone to supply shocks, both domestic and global, which contribute to sudden spikes in the inflation rate. As a result, this renders the assessment of inflationary pressures difficult which, in turn, complicates the process of monetary policy formulation. The recommendation of the National Statistical Commission (NSC) regarding the importance of developing an appropriate index is relevant in this regard and, when implemented, may alleviate the situation. The NSC has recommended:

> "As the current CPI series does not provide changes in the prices for the entire rural and urban population since they are designed to measure the changes in the prices of goods and services consumed by specific segments of the population, there is a need to compile the CPI separately for the entire rural and urban population. TAC on SPCL should give a methodology for compilation of CPI of rural and urban areas separately using quinquennial NSS Consumer Expenditure Survey Data for the preparation of the weighting diagram. TAC should also give a procedure for compiling a combined index based on these two indices. The existing system of price data collection should be suitably streamlined and augmented so as to provide price data for compilation of CPI for rural and urban areas."

V. Instruments and transmission of monetary policy: dynamics

The instruments that the central bank uses in day-to-day implementation of monetary policy can be broadly classified into direct and indirect instruments. Typically, direct instruments include cash and/ or liquidity reserve ratios, directed credit and administered interest rates. The indirect instruments generally operate through price channel which cover repurchase (repos) and outright transactions in securities (open market operations), standing facilities (refinance) and market-based discount window. The RBI currently uses multiple instruments to ensure that appropriate liquidity is maintained in the system, consistent with the objective of price stability, so that all legitimate requirements of credit are met. Towards this end, the RBI pursues, *inter alia*, a policy of active management of liquidity through open market operations including liquidity adjustment facility (LAF), market stabilisation scheme and cash reserve ratio, and deploys the policy instruments at its disposal, flexibly, as warranted by the situation. Changes in fixed reverse repo/repo rates set by the RBI from time to time for the conduct of its LAF, under which the central bank conducts daily auctions for the banks, have emerged as the main instruments for interest rate signalling in the Indian economy. Institutional mechanisms have been evolved in parallel to improve transparency and communication of monetary policy.

Traditionally, four key channels of monetary policy transmission are identified, viz., interest rate, credit aggregates, asset prices and exchange rate channels. The interest rate channel emerges as the dominant transmission mechanism of monetary policy. Nevertheless, it is fair to regard the credit channel as running alongside the interest rate channel to produce monetary effects on real activity. Changes in interest rates by the monetary authorities also induce movements in asset prices, which generate wealth effects in terms of market valuations of financial assets and liabilities. With the increasing integration of the Indian economy with the global economy the significance of exchange rate channel has increased. In the recent period, a fifth channel – expectations – has assumed prominence in the conduct of forward-looking monetary policy in view of its influence on the traditional four channels.

In a market-oriented economy, policy signals are transmitted through an integrated and efficient money, government securities and foreign exchange markets combined with a robust payments and settlement system. The RBI has therefore, been engaged in developing, widening and deepening of various markets and institutions. Development of these markets has been done in a calibrated, sequenced and careful manner such that these developments are in step with those in other markets in the real sector. The sequencing has also been informed by the need to develop market infrastructure, technology and capabilities of market participants and financial institutions in a consistent manner.

A wide range of regulatory and institutional reforms were introduced in a planned manner over a period to improve the efficiency of financial markets. These included development of market micro structure, removal of structural bottlenecks, introduction / diversification of new players / instruments, free pricing of financial assets, relaxation of quantitative restrictions, better regulatory systems, introduction of new technology, improvement in trading infrastructure, clearing and settlement practices and greater transparency. Prudential norms were introduced early in the reform phase, followed by interest rate deregulation and gradual lowering of statutory pre-emptions. These policies were supplemented by strengthening of institutions, encouraging good market practices, rationalised tax structures and enabling legislative and accounting framework.

Going forward, a judicious mix of appropriate policy, strong macro economy and a sound and resilient financial system would be necessary as the Indian economy moves up in the ladder from an emerging market economy towards a more mature economy. As development of financial markets is an ongoing process, initiatives to further deepen and widen the various segments of financial markets would have to be continuously pursued. As the economy ascends a higher growth path, with greater opening up and financial integration with the rest of the world, the financial sector development in all its aspects will need further scaling up

along with corresponding measures to continue regulatory modernisation and strengthening. Since the overall objective of maintaining price stability in the context of economic growth and financial stability will remain, the effort will be to harmonise the deregulation and liberalisation of financial markets with the domestic developments in real as well as fiscal sectors and global developments in international financial architecture. The medium-term framework is to keep developing the financial markets, preserving the integrity of financial markets and thereby, improving the transmission of monetary policy impulses.

VI. Constraints on conduct of monetary policy

The reform period in India is characterised by gradual but impressive improvements in effectiveness of monetary policy. High growth along with price and financial stability has been maintained while improving the sophistication and effectiveness of monetary policy. There have been three important constraints on conduct of monetary policy even within the existing legal framework but these are being gradually overcome.

First, the fiscal dominance which, no doubt, is getting reduced, impedes the efficient conduct of monetary policy. Progress in this regard is conducive to improved monetary management.

Second, the predominance of publicly-owned financial intermediaries as well as non-financial public enterprises has created a blurring of the demarcation between funding of and by the Government *vis-à-vis* public sector as a whole. The joint family approach to public sector still persists to a significant extent.

Third, despite significant progress, the maturation of financial markets is yet incomplete which also reduces, at least partly, the effectiveness of monetary policy instruments.

It is essential to recognise that there has been considerable alleviation on all fronts. Fiscal deficits are being progressively reduced though the total public debt as a proportion of GDP is still high by global standards. Share of wholly publicly owned financial intermediaries is reduced though share of institutions with public sector character remains high. The financial markets especially money, forex, government securities and equity markets, are noticeably well developed now. There is scope for further improvements in reform of financial markets but the progress in this regard is linked to improvement in fiscal management and the dominant public sector in financial intermediation especially their governance and risk management skills.

With progressive deregulation and development of financial markets, available empirical evidence suggests some improvement in the pass-through from policy rates to lending and deposit rates. Interest rates are emerging as a more potent instrument of monetary policy than before. In this context, however, the continued existence of administered interest rates distorts the interest rates structure and blunts its efficacy in monetary policy transmission. Currently, several of administered interest rates are prescribed over a range of deposit and lending activity, roughly accounting for a third of overall banking business in India. While bank term deposit rates stand deregulated, small savings and provident funds continue to be administered, thereby imparting a degree of rigidity to the interest rate structure. In recent times, there has been some tendency to widen the net of administered interest rates to cover bank loans for agriculture. While such a tendency may not be an unlikely outcome, given the predominance of publicly-owned financial intermediaries, it needs to be recognised that the current system of pricing of bank loans appears less than satisfactory. There is a public perception that banks' risk assessment and risk management processes are less than appropriate and sub-optimal and that there is under pricing of credit for corporates, while there could be overpricing of lending to agriculture and the small scale industries. In addition to formal prescription of interest rates, public sector banks which account for over seventy per cent of banking assets in a bank-dominated economy are called upon by the majority shareholder to discharge social obligations to reflect public policy priorities, through continuous interaction and periodical reviews with chief executives.

In a way, moral suasion, the traditionally potent weapon with a central bank may, on occasions, be exercised by the government to sub-serve public policy, broadly defined. While the initiatives in the public sector, in some cases, add to the effectiveness of monetary policy intent, they could operate in the opposite direction also, especially when the perceptions and relative weights accorded to credit expansion, price stability and financial stability by the government and RBI significantly differ. In a financial system, where banks play a dominant role in non-banking activities also, the transmission of monetary policy through both credit and monetary channels is also impacted in this environment.

In brief, the operation of monetary policy in India has to be oriented around the predominantly public sector ownership of the banking system. This plays a critical role not only in the transmission of monetary policy signals but also in other public policy considerations which may overlap or even dominate monetary policy objectives.

VII. Concluding remarks

To conclude, the role of RBI has been redefined through gradual evolution and adaptation, along with some statutory changes, and not through any radical restructuring. Further, while assessing the autonomy of the RBI, one should recognise that RBI is not a pure monetary authority but is responsible for several other functions also, as a central bank. The developments in the recent past lead one to the conclusion that, *de facto,* there has been enhancement of the autonomy of the RBI.

As regards monetary policy framework, the objectives remained the same but the framework has been changed from time to time in a gradual fashion in response to the evolving circumstances. Contextually, there are three important issues in the conduct of monetary policy viz., the assessment of potential output, the measurement of unemployment and appropriate measure of inflation.

While the policy tries to cope with these issues, a combination of instruments is necessarily used in a flexible manner to meet these complexities. Every effort has been made to improve the transmission channels especially through the financial markets, and through regulatory and institutional reforms. In addition, there are some constraints in the conduct of monetary policy, in particular, the fiscal impact, predominant public ownership, prevalence of administered interest rate, etc. While these challenges and dilemmas persist in the Indian context, every effort is made by the RBI to meet the broader objectives set forth, from time to time.

Let me conclude by thanking Professor Vyas for giving me this opportunity to be with you. I enjoyed being here despite the onset of uncertainties in my travel back to Mumbai due to disruptions caused by the monsoon conditions in Mumbai.

Thank you.

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