

Duvvuri Subbarao: Of economics, policy and development

Remarks by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the Release Function of Dr I G Patel's book "Of economics, policy and development", Mumbai, 16 July 2012.

* * *

There are many privileges of being the Governor. Among them is releasing the books by former Governors. It is a privilege to which I attach a lot of value, something which I prize.

Newton

Because the occasion demands it, I must repeat what I said at the Reserve Bank's Platinum Jubilee.

Those of you who have had some exposure to the history of science would know that Sir Isaac Newton was an intellectually arrogant man. When his friend and rival, Robert Hooke wrote to him, applauding him for his law of gravity, Newton, for all his arrogance, wrote back with uncharacteristic humility:

"If I have been able to see a little further, it is because I am standing on the shoulders of giants."

That is a statement I can relate to. As the Governor of the Reserve Bank in these exciting times, I owe an intellectual debt of gratitude to all the extraordinary men who led this great institution through several challenges, and made a mark in the economic history of India. Among the most distinguished of them is Dr. I.G. Patel. I am proud and privileged to be in the same lineage as him.

Special occasion

I did not know Dr. Patel personally. He was already in the top echelons of the Government when I joined the civil service; when he was the Governor of the Reserve Bank I was a junior officer in the Government of Andhra Pradesh. Much to my loss, our paths never crossed. This association with late Dr. Patel, of releasing his book, posthumously – vicarious, as it may be – is therefore very special for me.

OUP

I want to thank Oxford University Press for giving me this privilege.

Ms. Alaknanda Patel

Those of you who have known Mrs. Alaknanda Patel will, of course, relive some memories, through interaction with her today. Over the last few years, I have developed a close friendship with her. I have always been impressed by her intelligence, charm, vivaciousness; and have been touched by how much she loves all of us in the Reserve Bank and the efforts she makes to maintain her bond with the Reserve Bank even after all these years.

Alaknanda, your presence here means a lot to all of us in the Reserve Bank.

The book

This book “Of Economics, Policy and Development” is a collection of largely unpublished papers by Dr. Patel.

- They cover a wide canvas
Money, finance, trade, balance of payments, economic development and international political economy issues.
- They cover a wide time span
Articles written when he was a young economist at the IMF to articles and papers written after Dr. Patel evolved as one of leading public intellectuals of the country.
- They span a vast intellectual spectrum
 - Papers with deep academic orientation
 - Articles with profound practical policy implications

What is common across all of the articles/papers regardless of the topic is deep scholarship, sharp intellect and above all an abiding concern for public interest.

Ideas and issues resonate even today

What has struck me as I browsed through the book is that several of the ideas and issues that Dr. Patel addressed resonate even in today’s context, both at home and around the world.

I will comment on some of the ideas that he raised.

I. Monetary policy

In one of the articles, Dr. Patel reviews the evolution of monetary policy in the post-war years compared to the pre-war years. He writes:

“The supreme test of monetary policy lies in its ability to control the supply of money in such a way that growth in prices is checked without retarding the growth in production.”

The essence of that sentence is that checking growth in prices without retarding production; that is the quintessential growth versus inflation debate that is playing out even today.

A relevant question in this context is the following:

“To what extent is the Reserve Bank acting consistent with Dr. Patel’s dictum of controlling prices without hurting production?”

By far the most strident criticism against the Reserve Bank has been that even after persistent and prolonged tightening of monetary policy – by raising interest rate 13 times – we have not been able to restrain inflation. On the other hand, we stifled growth.

So the question is has the Reserve Bank failed in following the dictum that Dr. Patel prescribed?

I don’t believe so.

In fact I will argue that the Reserve Bank’s action is fully consistent with Dr. Patel’s dictum of trying to protect growth with price stability.

Let me explain.

- Inflation is inimical to growth. There cannot be much disagreement on that.

- Low and stable inflation is an essential pre-condition for securing medium-term growth. Only in a situation of price stability can consumers and investors make informed decisions.
- The Reserve Bank's monetary stance has been aimed at restraining demand and at managing inflation expectations.
- Admittedly, monetary tightening has resulted in some sacrifice of growth in the short-term. That is an inevitable price to pay for price stability. But the sacrifice in growth is only in the short-term. In the medium-term, there is no trade-off between growth and inflation.

Philips curve

Another facet of this growth-inflation debate that has played out in the recent period has been the growth-inflation trade-off in the context of the Philips curve.

- The argument is that we can raise growth by tolerating higher inflation. This is misguided.
- Relationship between growth and inflation is non-linear.
- There is a threshold level of inflation.
- Below the threshold, may be, there is a trade-off between growth and inflation.
- Above the threshold, there is no trade-off between growth and inflation, higher inflation actually leads to loss of growth. With WPI inflation at 7.25 per cent and CPI inflation in double digits, we are way above the threshold.
- What is the threshold level of inflation? That maybe around 5 per cent. Inflation today is above the threshold.

Dr. Patel's dictum about maintaining growth with price stability is the quintessential objective of monetary policy.

- That is something that we are deeply conscious of and that is something we are adhering to in the Reserve Bank even today.

II. Communication challenges

The second issue I want to talk about is communication challenges. There is a paper by Dr. Patel and I quote a sentence from the paper:

“Apart from communicating its own slant on national and international trends, there are three special areas which need attention. The first is the glamorous but elusive area of what the Central Bank communicates and how it does so in relation to its specific responsibility for monetary and foreign exchange policy; the second is communication on issues in regard to its regulatory functions; and the last is communication with the government of the day, including Parliament.”

Oxymoron

I am deeply struck by this statement by Dr. Patel. Not so much by the content, not so much by the context, but by the fact that Dr. Patel chose to say it at all. Because in the time that Dr. Patel wrote this communication by central banks was an oxymoron.

As Dr. Patel himself admits:

“I belong to an age when central bank governors, like children, were supposed to be seen, not heard. Although they were allowed to smile in public, they had to emulate Mona Lisa and maintain an aura of mystery.”

How is the Reserve Bank today going to be evaluated on the basis of Dr. Patel's exhortation to be more meaningfully communicative.

Alan Greenspan – the doyen of communication!

It would be blasphemous to speak about central bank communication without first paying tribute to the doyen of communication – Alan Greenspan. So let me get on with it.

I will not of course tell you the joke about his marriage proposal to his future wife. That's hackneyed.

Greenspan is notoriously famous for transforming central bank communication to an art form. In 1987 shortly after he took over as Chairman of the Federal Reserve, he said, “Since I've become a central banker I've learned to mumble with great incoherence. If I seem unduly clear to you, you must have misunderstood what I said.”

After nearly 15 years on the job, in October 2001, Greenspan took a complete U turn saying that, “Openness is more than just useful in shaping better economic performance. Openness is an obligation of a central bank in a free and democratic society. Transparency of our activities is the means by which we make ourselves accountable to our fellow citizens to aid them in judging whether we are worthy of that task”.

IG Patel – prescient

By commenting on communication, much before central bank communication became an intellectually fashionable issue, Dr. Patel had been remarkably prescient.

Let me comment on contemporary perspectives on communication policy.

Why is central bank communication important?

Over the last two decades, central banks have moved towards clearer communication and greater transparency. This has been driven by several motivations.

First and foremost, central banks have realized that open and transparent communication enhances policy effectiveness by way of achieving expected outcomes. This shift in central bank theology from deliberate obscurity to greater transparency actually reflects a shift in the theory of monetary policy.

Robert Lucas

Up until the early 1990s, monetary policy was strongly influenced by Nobel Laureate Robert Lucas' argument that monetary policy affected real variables, like growth, only if the policy changes were unanticipated. This encouraged obscurity over openness and clarity. However, lost in the debate after Lucas' statement was the message that monetary policy always affected nominal variables like inflation, even if fully anticipated.

Two Nobel Laureates

In the 1980s, two economists, also Nobel winners, Finn Kydland and Ed Prescott, argued that fully transparent rules rather than discretionary policy were more efficient and credible.

This was the beginning of the push towards rules over discretion and greater central bank transparency.

Change in US Fed

The most eloquent illustration of this shift from obscurity towards transparency is the change in the communication strategy of the US Fed. It is hard to imagine from today's perspective, but prior to 1994, the US Fed did not disclose the Fed Funds Rate; the market was supposed to infer the rate from the timing, sequencing and magnitude of the FED's open market operations.

In sharp contrast, today the Fed not only announces the rate but also gives a clear indication of future policy trajectory.

Communication as policy – extended period

Sometimes, communication, instead of being a vehicle for policy, becomes the policy itself. Drawing yet again from the US experience during the crisis, the Fed realized that its repeated announcement of keeping rates low 'for an extended period' led markets to reach a certain inference on what "extended period" could mean. In this context, some policy analysts argued that a step that the Fed should modify the language of the statement to communicate to investors that it anticipates keeping the target Federal Funds rate low for a longer period than what the markets were factoring it to be. In fact, the Fed did just that – by saying explicitly that the low interest rate regime will last into 2014, much more specific than what the market wanted.

Yet another factor that has motivated central banks into placing larger emphasis on communication is their hard earned autonomy in the years before the crisis. Central banks have increasingly embraced more open communication to counter the criticism that an autonomous central bank comprising unelected decision makers was inconsistent with a democratic structure.

Communication in Reserve Bank

In the Reserve Bank, we have tried to improve communication not only on monetary policy but across the entire spectrum of our mandate. We have made efforts to demystify the Reserve Bank.

We continue to make explicit efforts to improve the communication of the Reserve Bank.

- i. Streamlined the policy documents
- ii. Forward guidance – manage the risk that market does not ignore the conditionality and interpret the guidance on an irrevocable commitment.
- iii. Post-policy press conferences and interviews
- iv. Teleconference with analysts
- v. Dissemination through our regional offices
- vi. On all areas, even extending beyond monetary policy, we put out Discussion papers – New Bank licences – Most extensive communication exercise.

Dilemmas in communication

It is not as if more communication is better communication. Even as central banks are becoming more communicative, they are struggling with dilemmas:

- i. What do we tell?

- ii. How do we tell?
- iii. How much do we tell?

Dictum to central banks used to be what mothers across cultures and across time have always told their children –

“If you can’t say anything nice, don’t say anything at all.”

But the drive for transparency has changed that. Now the dictum is: “hold back information only if it is absolutely necessary to hold it back.”

It is a struggle that we fight every day.

For example, the Financial Stability Reports –

- True picture of the financial sector
- But that could trigger a disruptive reaction and even panic
- A situation that could be managed and contained can implode

That is a challenge that we in the Reserve Bank contend with, not about what to disclose but about how much to disclose and in what form to say it.

III. Responsibility of the Governor to Speak Up

I will now talk about the responsibility of the Governor. I quote from Dr. Patel:

“But the point is, when such vital questions arise, the Governor cannot just be inactive. He is a public servant with loyalty to the country and the Constitution – not just to a government in transit. And yet, he cannot behave as if every issue is of great import. He has to choose his ground and be discreet above all. Without offending the government he can start a debate and steer the argument in a certain direction. His ultimate defense is democracy and the tradition of free debate.”

In short what Dr. Patel said was, don’t nitpick. Pick your battles. Once you have picked your battles, fight those battles valiantly.

I want to pay a tribute to all my predecessor Governors who have followed this dictum. Several important reform measures in the country and policy initiatives owe their origin through the debates generated by the Governors. Of course, they are articulating the institutional wisdom of the Reserve Bank.

Over the last four years we have tried to raise a number of issues in the public domain because we believed that they needed to be debated:

- role and responsibility of the Reserve Bank for financial stability.
- the importance of protecting the independence of the central bank and indeed of all regulators.
- the importance of being earnest about fiscal responsibility.
- setting exemplary standards for corporate governance.

Government and the Reserve Bank are not adversaries. They share common goals. I think some disagreement is natural. There are disagreements with the Government, there are disagreements between the Government and regulators and public policy institutions. We know that wisdom arises out of disagreement and debate. What we need is a wise mechanism for distilling wisdom out of this disagreement.

Dr. Patel rightly says that the ultimate defence for the Governor and of course the Reserve Bank is democracy and tradition of free debate.

Central banks render accountability – particularly important because central bank officials are unelected and therefore have no electoral mandate. We take decisions that affect the entire country. So we must be sensitive to render accountability for our actions and the results of those actions.

IV. Advising the Advisers

The final point I want to talk on is advising the advisers. There is a short piece in the book, it is actually a book review that Dr. Patel wrote about Government advisers. That struck a chord with me.

It is about role and responsibility of government economists and their influence on public policy. Particularly important because Dr. Patel was among the first of economic advisers in the Government.

Dictum to economists in government has always been: “focus on objective analysis and give competent, unbiased and professional advice. Do not worry about political feasibility.”

What struck me while reading this is that this is precisely the value system taught to civil servants:

- Your job is to advise the political executive on policy and to implement that policy diligently.
- You shouldn't be biased by politics
- Indeed you shouldn't be biased by any extraneous consideration
- Give your professional advice and let the political executive decide

With over 35 years experience as a civil servant, I am beginning to be sceptical about this paradigm. Is it not too strait jacketed?

Should the civil servant limit himself to giving objective advice or should he also be concerned about its feasibility?

If the civil servant suggests options that are totally infeasible, they are not adding value. They are only making life more difficult for the political executive.

New theory – you give honest, dispassionate advice. But in doing so, be sensitive to the democratic feasibility of the solution you suggest.

I am not saying that civil servants should be politicised or be less than honest. Only saying that they should suggest practical, workable, democratically feasible solutions.

Question in the context of Dr. Patel's piece is

- Is the code of conduct for government economists any different from that for bureaucrats?
- In other words, should government economists also tailor their advice based on feasibility, or leave that to be determined by the bureaucracy and the political executives?

Conclusion

I have commented on a few issues raised by Dr. Patel

- i. the objective of monetary policy
- ii. communication challenges of central banks
- iii. responsibility of the Governor to generate public debate on vital public policy issues

iv. the code of conduct for government advisers

These articles have been written over a long period –

i. World has changed

ii. World views have changed

iii. India has changed

iv. The Reserve Bank has changed

v. Economics has changed

Value system

What has not changed in all this flux is the value system that must guide public servants.

It is that value system that Dr. I.G. Patel embodied in full.

The Reserve Bank is proud of the legacy left behind by Dr. Patel and is delighted to renew its association with him through this book launch.

Congratulations to the editors

Dr. Deena Khatkhate

Dr. Y.V. Reddy

Thanks once again to Mrs. Patel and Oxford University Press for this opportunity.