Do central bank governance arrangements need to be altered?

D Subbarao[1]

Thank you Jaime.

You can tell the story of this crisis in several ways. It can be told as a tale of global imbalances, of hubris in the financial system, of a failure of economics or of economists or of faulty regulation or of flawed incentives. It can also be told as a story of failure in the governance structures of central banks, and this is the story we are trying to construct in this panel discussion.

As a preface to my comments, I have put together what I believe are lessons relevant for central bank governance. Admittedly, there is no full consensus on these lessons, but at least, I think they provide a point of departure for debate and discussion. I will not go into them because we have been discussing them over the last one and a half days.

It's difficult to be original as the last speaker in the last session of a conference. All that's worth saying has been said, and what's not said is not worth saying. But all that is said has not been said by me, so I will say it.

Actually, I struggled a little bit to decide what I could say that would add value, and I thought I would present problems about governance structures from the perspective of the Reserve Bank of India. As central banks go, the Reserve Bank of India is a full-service central bank: we are the monetary authority, regulator and supervisor for banks and non-bank financial companies and important segments of the financial markets. We are the debt manager for the government, we are the regulator of the payment and settlements system; we have development and growth objectives, we are responsible for financial inclusion and we are the gatekeeper for the external sector.

The mandate of Reserve Bank of India is derived from convention rather than a narrow definition in law. Of course, there is a law that defines what the mandate is, but that is so broad that it permits anything that a central bank can reasonably do. There is no formal arrangement with the government nor is there any form of an MOU or results agreement. Indeed accountability too is not for precisely defined targets but for loosely defined outcomes. The other functions that we perform also follow from specific acts.

Indeed, what is surprising is that, for years, nobody remarked on the fact that the Reserve Bank enjoys a broad mandate that follows from conventions rather than strictly defined rules. In the wake of the crisis, though, there is debate in India too, on two questions. Whether the central bank's mandate should be more explicitly defined? And whether and how regulatory architecture should be restructured reflecting the lessons of the crisis? Drawing from those two questions, I want to make three comments about governance structures.

The first comment is about inflation targeting. The Reserve Bank of India is not an inflation targeter. However there is an influential view in India that we will serve the economy better if we become a pure inflation targeter. The argument is that inflation hurts much more in a poor country like India where hundreds and millions of people are poor and that the Reserve Bank

[1] Reserve Bank of India.

of India will be more effective in combating inflation if it is unburdened of other responsibilities.

In my view this is contestable. I believe that inflation targeting is neither practical nor desirable in India. There are several reasons. Let me go through them quickly. First, in an emerging economy like India, it's not practical for the central bank to drive a single objective oblivious of the larger developmental context. We need to balance between price stability, financial stability and growth. Second, the drivers of inflation more often than not are from the supply side. Food for example has a weight between 45% and 70% in the inflationary indices, and if inflation emanates more frequently from the supply shocks, it's beyond the pale of monetary policy. Third, we have a problem about which inflation index to target. We have one wholesale price index and four consumer price indices. It is the WPI that comes out more frequently and with a shorter lag, but it does not reflect consumer price inflation. It is indeed, very difficult to get a single representative inflation for a country of 1.2 billion people with fragmented markets and diverse geography.

Also, a necessary condition for inflation targeting is that your monetary transmission has to be effective, and we have problems in India about the monetary transmission. It is certainly improving but we are still not up to acceptable standards because of administered interest rates, the asymmetric relationship between banks and depositors, illiquid bond markets and large government borrowings. So our effectiveness in inflation targeting is necessarily compromised. And finally we have the problem of capital flows. Large and volatile capital flows have implications for liquidity and hence for inflation. Our effectiveness as an inflation targeter will be eroded by the task of capital flow management.

For all these reasons, it's neither practical nor feasible for the Reserve Bank to be an inflation targeter and I believe the governance structures will have to reflect that.

The second comment, I want to make is about financial stability. As in most other countries, the responsibility of the Reserve Bank for financial stability is implicit rather than explicit. We too are struggling with questions that are by now very familiar and I do not want to go into them. But, I only want to say that our model of regulatory architecture and mandate definition of central bank provides, I believe, a strong case for the central bank to have a wide mandate that also includes financial stability and macro- and microprudential supervision.

As Jaime mentioned, in the period 2002–2006, in India we noticed an unusual build-up of credit flowing to certain areas, notably to commercial real estate, to financing consumption, and to capital markets. Sensing this, the Reserve Bank tightened the norms by way of provisioning and risk weights. I believe that's one of the factors that were responsible for insulating India from the worst impact of the crisis. As we got into the crisis, we reversed some of those measures. So the Reserve Bank has a history and a legacy of using macroprudential tools for managing asset price build-ups. What the Indian experience shows is that there are important synergies to be gained by, first, entrusting the responsibility for bank regulation and supervision to the monetary authority, and, second, for co-locating macro- and microprudential supervision preferably in the central bank. I admit that this is by no means a fail-proof arrangement and there are significant trade-offs, but the cost-benefit calculus is decidedly biased towards a single authority with broad mandate.

The challenge, of course, is to ensure that there is information flow between departments which do bank regulation and supervision and the monetary department. What we need to build is not Chinese walls that prevent all flows of information but semi-permeable membranes that allow osmosis of information.

The third comment I want to make is about coordination with the government. Like everywhere else, in India too there are concerns about the independence of the central bank. I must add, though, that concerns arise not from a sophisticated understanding of how monetary policy should be conducted independently from short-term political compulsions, but from a larger negative perception that there is political interference in almost everything, and that's not value adding. Nevertheless, there is still a debate on the autonomy of the central bank even if it is somewhat limited. The debate arises from two concerns. The first is about the fiscal dominance of monetary policy and the second is the familiar issue that came into sharp focus during the crisis, that coordination and consultation with the government on financial stability issues may actually spill over into the monetary policy domain. Both these concerns are justified, but I believe they are exaggerated. On fiscal dominance, yes, there was a dominance in the 1970s and 1980s but, starting from the 1990s, there has been a continuous process of abatement of fiscal dominance; and there have been legal provisions by way of terminating the egregious practice of the central bank monetising public debt; of the government voluntarily accepting fiscal responsibility through an enactment. So those developments have reduced, although not completely eliminated, fiscal dominance and yielded space for monetary policy autonomy.

There is an argument made in the context of fiscal consolidation about the principle of Ricardian equivalence. The argument goes that current fiscal deficits mean future tax increases and that, in the face of the fiscal deficits, people actually increase their savings thereby offsetting the putative benefits of government borrowing and spending. Regrettably that doesn't happen in India. Indeed the discipline that a public discourse or public view can bring on the government fiscal stance is very weak. Then there is the other issue about the spillover of government influence from financial stability issues to the monetary policy domain. I can't rule out that possibility. Monetary policy and policies for financial stability often overlap and it can be the case sometimes that monetary policy action is required to manage financial stability. It may not be possible to build impregnable Chinese walls between the two. So I think there is a risk there.

To sum up, I have made three comments with reference to the governance structures of central banks. The first comment was by way of explaining why the Reserve Bank cannot be an inflation targeter. The second comment was about the synergies that flow from entrusting the responsibility for financial stability to the central bank. Finally, I commented on the necessity for the central bank of coordination with the government and how the governance structures will have to ensure that such coordination does not dilute the autonomy of monetary policymaking.

Thank you very much.