Kishori J Udeshi: Role of central bankers in an emerging economy like India

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Dr. Kanu Doshi was kind enough to leave the choice of topic for today's lecture, to be decided by me. I chose this topic as I consider it to be one which would perhaps be of interest to bright and young students and one of contemporary relevance. Although the role of central banking is extensively discussed in the literature on monetary economics, the role of central bankers has remained obscure as central bankers were traditionally meant to operate in anonymity and therefore their public accountability was unclear. Governor Dr. Y.V. Reddy highlighted this neglect of the central banker while adducing to a common perspective that 'the central banker is neither fish nor fowl; neither an academician nor a banker'. A serious research on why central bankers have been neglected brings to the fore several useful insights about the role of central bankers in general and in emerging countries in particular.

First, a principal reason for lack of focus on the role of the central banker is the common perception that the central banker involves itself only with the discharge of certain specialised and arcane functions. Such a perspective derives justification from extreme generalization of central banking functions, and a common set of instruments used for monetary control to achieve a common set of objectives such as price stability and sustained economic growth. Such a generalised perspective, however, lacks a serious appeal. Should we say that a central banker from a developed country is no different from that of a developing or emerging country? In particular, should we compare a central banker from United States, or United Kingdom with the central banker of a small underdeveloped economy.

Second, central banks are considered as monopoly institutions in their areas of activities. There is a common perception that it is only in a competitive environment that organisations and their managers can be evaluated in terms of distinctive and core competencies. Even though central banks are monopoly institutions, theoretical and empirical studies document the differential effectiveness of public policy, even though the same set of instruments are used across countries. Evidence shows that economic policies may be more effective in some countries but less effective in others. In the context of central banks, styles of monetary management differ significantly across countries due to differences in socio-economic-technological-institutional environment.

A third viewpoint is that central bankers perform only macro-level functions and thus, do not have a feel of micro-level operations. This viewpoint is erroneous. Central banks sometimes do have to engage in micro-level functions.

Central banking functions

Modern day central banking extends far beyond the domain of traditional functions such as currency management, banker to Government and promoting financial soundness. These re-orientations have been the natural corollary of pursuing monetary policy measures that are focused on definitive, well-defined and quantifiable objectives.

Central banks in emerging economies differ from their counterparts of developed countries in several ways. In some developed countries, central banks are vested only with the conduct of monetary policy. In most emerging countries, central banks, besides monetary policy, also shoulder the responsibilities of debt management, and regulation/supervision of banks and financial institutions. Even in regard to the conduct of monetary policy, central banks in emerging economies have to contend with several objectives, and distinct trade-offs as compared with some developed countries which pursue a single objective of price stability. While pursuing multiple objectives, and managing complex trade-offs, central banks in emerging countries assume the responsibility of looking after the interests of several agents including depositors, intermediaries, government, business, and external trade. In regard to choice of instruments, given the level of market development, and multiple objectives, emerging countries cannot entirely rely on single instrument such as interest rates. Rather, central banks in emerging countries prefer a judicious mix of interest rates, cash reserves, and other instruments. The most striking feature of central banking in emerging countries pertains to their critical role in development of financial markets and active involvement in the institution building process.

Institution building

In the Indian context, the RBI, in consultation with the Government, has played a major role in institution building since independence. Efforts in this direction encompass RBI's contribution to development of commercial banking, development finance institutions in the areas of agriculture and industry, and specialised institutions for development of financial markets. After initiation of the economic reforms of the early 1990s, the role of RBI in the area of developing financial markets particularly the government securities, money markets and payment and settlement systems, have come to the fore. Moreover, in a global environment, with increasing integration of the international economy, the RBI's role as the regulator and supervisor of commercial banks and financial institutions has assumed a central place in promoting transparency and credibility of institutions and monetary and financial policies.

Monetary policy

Most central bankers presently enjoy independence in choosing their policy instrument and have used it to rely on setting short-term interest rates. As a logical offshoot, many central banks in emerging markets are giving more exposures to pursuing price stability as one of the main objectives of monetary policy. In the RBI, there is a Financial Markets Committee (FMC), which meets daily before the opening of the markets and at times more frequently, when the situation warrants. The FMC reviews the liquidity and interest rate situation in financial markets and advises top management on the course of action that would be required by RBI during the day. This institutionalised framework helps the RBI to take an integrated view on all-important decisions having an impact on financial markets.

Economists have long debated as to what should be the objective(s) of monetary policy. In most developed countries, monetary stability, defined as the price stability, constitutes the dominant objective of monetary policy. In emerging economies, central banks have to contend with several concerns; price stability, sustained growth, financial system's stability, stable exchange rate, and operating objectives of liquidity management. The animated discussion on central bank objectives ranges broadly between single objective and multiple objectives. Such discussion entails a generic analysis of advantages and disadvantages of single or multiple objectives, and the nature, and scope of central banking organisation, which differs across the country groups of developed and emerging countries due to significant difference in socio-economic-technological-institutional environment.

Adoption of a single objective of monetary policy by central banks is based on the arguments that (i) monetary policy should concentrate its instruments on one objective, free from any policy trade-off, thereby strengthening the implementation of monetary policy; (ii) a single objective promotes transparency, accountability and independence of monetary policy; (iii) a single objective is more realistic in a deregulated and globalised economic and financial system; and (iv) it is easier to observe the channels of transmission, and therefore, easier to determine the 'right' instruments. Since a central bank's monetary policy actions could involve several implications for the economy as a whole, the counter-arguments against a single objective derive from the fact that (i) economic objectives should be achieved simultaneously (in harmony), and a single objective may disrupt that harmony; (ii) monetary policy by itself may not be able to bring down inflation further and other wings of policy have to be deployed.

The case for multiple objectives for central banks entails "co-ordination" of a range of policies and thus, a spectrum of objectives. The principal reason as to why central banks in emerging economies have to contend with multiple objectives, or at least dual objectives of price stability and economic growth derives from the concerns of socio-economic-political systems. James Tobin, a Nobel laureate economist, argued that since central banks form an integral part of government, they cannot dissociate from the major objectives of the society, which includes sustained economic growth and price stability. William Poole, a revered central banker viewed that economic growth is a citizens' objective and central bankers too are citizens.

Currency management is one of the most important traditional function of central banks in most countries. Central banks serve as a service provider to issue and distribute currency notes and coins. In most developed countries, high degree of homogeneity in the society as reflected in the culture, language, tastes and preferences of the public and the efficient distribution of income could induce a homogenous pattern of currency demand and thus, facilitate to achieve better currency management as compared with that of developing countries. In developing countries, significant diversity in socio-economic development across regions induce completely different currency preference of the public across regions, and across demographic segments, thus, entailing dynamic and complex currency management tasks for central bankers. What is noteworthy is the way in which technology has been harnessed to bring about improvement in currency management. The RBI performs the role of currency management with the objectives of ensuring adequate availability of coins and notes and maintaining the quality of notes in circulation. This is done through its 18 Regional issue offices/sub offices and a wide network of currency chests, repositories and small coin depots spread across the country. In pursuance of the Clean Note Policy, efforts are being made to improve the quality of notes in circulation.

In most emerging markets including India, central banks manage Government debts. Quite apart from the need to decide on issues such as the kind of auctioning, the types of securities to be auctioned and the maturity profile of the securities, there remains the issue of the extent of support that the central bank and commercial banks should extend to the Government borrowing programme. This is important from not only the point of view of deepening the Government securities markets, but also in terms of its the flow and cost of credit to the commercial sector. As adviser to Government, central bankers need to interact intimately with the Government on fiscal policy matters and provide a unified and coherent signal to the market on the macro policy stance. In recent years, central banks have become pro-active in the area of structural reforms.

The Indian case provides an excellent testimony towards this point. The strategy of financial reforms, was worked out in close coordination with the Government, and undertaken in appropriate sequential steps and synchronised with real sector reforms. This was all the more relevant in the Indian scenario where the Government has a significant stake in the banking system and consequently, any disruption in the financial structure could have significant budgetary implications. The RBI has undertaken wide-ranging reforms to deepen and widen the financial markets - money market, Government securities market and foreign exchange market. These markets have become vibrant and competitive.

Central bankers, in the present era, rely on a combination of policy measures in their day-to-day operations. They undertake combinations of actions primarily to provide signals about their policy stance to market participants. Reforms of the tools of monetary policy have therefore gained prominence. Such reforms have been made possible by the growing emphasis on indirect instruments of monetary control and the de-emphasis on direct instruments of policy. Open market operations, in such a milieu, have grown in importance. Interest rate flexibility is another tool. A major instrument of statutory pre-emption, such as the Cash Reserve Ratio has been progressively de-emphasized and instead, short-term instruments, such as the Repo Rate and in the medium-term, instruments such as Bank Rate have become important. Likewise, in several instances, the Statutory Liquidity Ratio (SLR), an erstwhile important prudential measure, has increasingly been scaled down. The idea inherent in these transformations in the approach to monetary policy is to provide banks with maximum freedom in their portfolio choice, without losing sight of the risks in asset accretion, and to provide opportunity to ensure that their resource allocation is optimal. Given the concerns of an emerging economy, certain portion of banks resources are often prescribed to be allotted under the ‘priority sector norms’; but in this case as well, the range of activities covered under priority sector has been expanded to provide greater choice to banks. And let us not forget the central bank’s authority and power of “moral suasion” which can act as a supervisory and regulatory force, even when no explicit oversight of the financial system is in place.

Liquidity determination is the key to the efficiency of the actions of the monetary authorities. As the economy increasingly opens up, the interactions between domestic and external markets are expected to impinge on liquidity as much as the growth impulses from within the economy. Liquidity however is not static, in view of the speed of transactions and settlements and the sharp increase in financial innovations. Since liquidity is a function of both domestic monetary policies as much as external sector policies and debt management strategy, modern day central bankers are confronted with the enviable task of balancing a tightrope walk to ensure that the economy remains on track.

As bankers to banks, central bankers tend to exercise considerable discretion and rarely go by straightjacket rule-based methods. While the ‘lender-of-the-last’ resort function of the central banks continues to be important, in addition, the central bank provides access to refinance facilities and a whole host of services, as in the matter of payments and settlement, funds transfer, settling of government securities through the NDS and the like.

Another area where central bankers of emerging countries have assumed new responsibilities pertains to managing the economy in response to external developments in the context of globalisation. Deputy Governor Dr. Rakesh Mohan has rightly pointed out that globalisation has offered several benefits as well as a host of challenges. In an increasingly global environment, countries have to adapt to greater internationalisation of economic policies. In this regard, central bankers in emerging countries have to be alert to international developments and acquire skills in the areas of international banking, international finance and economics, international regulations and international relations in order to function effectively while managing the monetary and financial conditions of the economy.

In the area of banking soundness, central banks in emerging markets have become major initiators of activity. Financial supervision, whether on-site or off-site, has assumed prominence in the face of market imperfections and ensuring depositor protection. It is widely recognised that the Asian crisis was to a large extent, the outcome of lax supervisory standards pursued in these crisis-ridden economies. The soundness of banks and other non-bank entities depend not only on the operation of these entities, but also the efficacy of the supervisory process. In this context, the *Core Principles*, enunciated by the BIS in 1997, have quickly become a benchmark and we in the RBI are by now, compliant with most of these *Principles*. In view of the growing risks that banking entails and the scarcity of supervisory resources, many central banks are increasingly moving towards a risk-based approach to supervision in order to ensure optimum utilisation of supervisory resources. Following recent advancements, central banks have developed macro-prudential indicators in order to monitor the health of financial entities within the overall economic environment in which they operate.

High quality regulation and supervision, which contribute directly to improvements in operating efficiency, are beneficial for emerging countries since efficiency in the allocation of resources to most productive sectors cannot be achieved and sustained without achieving operating efficiency. Regulation and supervision of institutions is, however, not a simple task especially in the Indian context as it involves a large network of banks and other financial institutions and their large number of branches spread over the entire country. Banks and their branches too involve a wide network of inter-action with different market segments owing to diversified portfolios in a deregulated environment. In this context, central bankers have to be highly skilled, vibrant and most dynamic in order to be effective in regulation and supervision.

In several countries, central banks assume a pivotal place in the payments and settlements system. As financial transactions become increasingly complex, there arises the need to harness financial markets to fully exploit the advances in information technology and communications networking. Some important research studies show that a relatively large involvement of the central bank in the financial system contributes to financial development. For emerging countries, the central bank involvement in the payment system enhances financial development. There is a considered view that an efficient payment and settlement system contributes to operating and allocation efficiencies of the financial system and thus, overall economic growth. Payments and settlement systems in emerging countries involve several features, which are distinct from that of developed countries.

One of the guiding principles followed by RBI in the reforms in the payment and settlement systems has been the need to provide for a safe, secure and efficient systems. RBI has identified the Systemically Important Financial Intermediaries (SIFI), which have the propensity for systemic risks. The introduction of screen based trading in Government securities following the delivery versus payment model in the form of Negotiated Dealing System (NDS) was a milestone in this regard. The commencement of foreign exchange clearing by the Clearing Corporation of India Ltd. aimed at net settlement of the foreign exchange transactions is a major step forward, which has brought about more efficiency and safety. The RBI has also embarked upon the introduction of a Real Time Gross Settlement (RTGS) System for settlement of inter-bank and customer related funds transfers on a real time mode. Going beyond technological upgradation, the issue also remains of formulating an appropriate legal framework, in which transactions could take place in a safe, sound and secured manner. The growth of e-transactions and 'digital signatures' is a case in point.

As you would be aware, the challenges to central bankers in the present day are manifold and I venture to list out a few for this discerning audience. First the challenge of financial sector liberalisation. While competitive financial markets no doubt aid in efficient allocation of resources, failure or even disruptions in one segment of the financial sector can have serious 'contagion effects' throughout the rest of the economy. Thus central bankers need to be vigilant and alert to domestic and external developments.

There also remains the challenge of ensuring soundness of financial institutions. The supervision of the financial system is getting increasingly complicated with the growth of 'one-stop-banking' and conglomerates as well as off-shore financial activities operating in multiple segments of the financial markets, leading to blurring of distinction among the various segments themselves. Repeated financial crises across the world have provided graphic evidence of the fact that financial disruptions can engender serious output costs. In this context, the need for effective supervision can hardly be underscored.

In conclusion, central banking is passing through challenging yet exciting times. While developments within the country charter its transformation, the experience of other countries provides invaluable lessons in the approach to promote growth, whilst maintaining price stability.

All in all, the life of a central banker is one of anonymity, staid and boring. It is only in moments when the going is tough that central bankers emerge from isolation and lean against the wind to battle splenetic insurmountable odds. Central bankers choose their profession because they are driven by a commitment to public service, which they hold dearer to themselves irrespective of financial remuneration. The conduct of central banking inherently involves the ultimate good of the society. An inappropriate choice of instruments or targets can lead to large losses of macro-economic well being. Ultimately, all citizens are stake holders in the central bank. Former Governor, Dr. Bimal Jalan rightly referred to central banks as the public's own institutions. Every central banker is conscious of operating at the apex of the financial system and at the centre of the macro-economic management, continuously balancing risks against every policy action. In this sense, a central banker has to possess certain unique qualities - integrity and professionalism of the highest order, finely honed analytical skills, the capability to take decisions under difficult circumstances, a thorough knowledge of the manner in which the economy functions, adaptability and a dynamism with which to respond to a life of continuous change and challenge. What is more they have to avoid partisanship and command public support. Together, these attributes distinguish a central banker as a leader and manager of people, situations and money, always dedicated to service to the nation. No wonder that central bankers are called priests at the temple of money.