

Y V Reddy: The virtues and vices of talking about monetary policy – some comments

Remarks by Dr Y V Reddy, Governor of the Reserve Bank of India, at the 7th BIS Annual Conference, Luzern, Switzerland, 26 June 2008.

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Governor Yilmaz, Professor Alan Blinder, Professor Benjamin Friedman, fellow-Governors, and distinguished academics,

I am honoured by the invitation from the Bank for International Settlements to be a discussant, for a Paper¹ by the eminent and respected scholar, Professor Alan Blinder. It is virtually impossible to add value to the comprehensive and incisive analysis of the subject in the Paper, which is on a subject of great relevance to central bankers. My comments will be basically to supplement or elaborate some ideas in the Paper, from a practitioner's point of view. To begin with, there will be select comments on each of the sections of the Paper keeping in view the Indian perspectives. The second part will highlight select issues, which appear to be especially relevant to monetary policy communication in emerging market economies (EMEs). The concluding part will pose some issues, which deserve debate in the search for what Professor Blinder calls "optimal" central bank communications policies.

Indian perspectives

Reasons for communication

There has been significant progress in India in enhancing communication and removing the mystique surrounding monetary policy. While in the pre-reform period, before the 1990s, the communication was relatively easy in a controlled environment, it has become a greater challenge in a market oriented environment particularly in the context of global financial market integration. The stake holders have become larger and wider and the monetary policy by itself in terms of operating framework and instruments has assumed increasing complexity. There is a clear recognition of the importance of market expectations in the conduct of monetary policy, partly influenced by academic work and partly by the demonstration effect of evolving practices among central banks. Perhaps, there are also other reasons for the demand for such enhanced communications in India; for example, increasingly greater transparency is demanded, as part of public policy, in almost all spheres of governance of the public sector, which includes the central bank. The media – we have six business dailies in English, apart from four business channels on television – exerts pressure, seeking information on many issues. In a way, there is both a supply side and a demand side to the communications by the Reserve Bank of India (RBI) on monetary policy aspects, in the context of evolving market expectations.

On the need for communications, we have no doubt that it enhances the effectiveness of monetary policy in a liberalized market environment. In fact, the experience in India shows that the need to communicate, by itself, compels far more rigorous thinking and analyses, as it is said that the best of learning comes from a compulsion to teach. The compulsions to communicate catalyse the processes to improve the quality of decision making and by providing a helpful feedback.

¹ Talking About Monetary Policy: The Virtues (and Vices?) of Central Bank Communication, Prof. Alan S. Blinder, May 8, 2008.

Democratic accountability, as a reason for better communication, is very valid for India also. But, improvements in communication have been taking place in the recent years without any formal recognition of the extent of RBI's independence. My personal feeling is that improved communication in regard to the thinking and the actions of the RBI has enhanced the *de facto* central bank independence while, *de jure*, there has been no noticeable movement in according greater independence.

Accountability to Parliament, the supreme body of elected representatives, is very important in the context of the functioning of a central bank in a democracy. In India, the RBI is accountable to the Parliament through the Ministry of Finance and thus its communication to the Parliament is through the Ministry. Whenever the views between the central bank and the Ministry converge, there should be no complexities. RBI is also summoned to give evidence before Parliamentary Committees, most often along with the officials of the Ministry of Finance. There are some occasions when the hearings of the committees are restricted to the RBI, generally when the Governor is called in. However, we are sworn to secrecy from making public our submissions to the Parliamentary committees, whereas the committee may make use of the material supplied by us, as considered appropriate. In a sense, the RBI's views, as submitted to the Parliamentary Committees, are not available in their entirety in the public domain.

It is quite possible that there are communications or signals, if not directions, from the Ministry of Finance often on issues relating to monetary policy or banking, a sector predominantly government owned. If these are consistent with those of the central bank, they reinforce the central bank policies, but if these are divergent, it poses a dilemma for central bank communication and to that extent a central bank may be constrained in freely articulating its policies.

These are some noteworthy features of communication in the context of democratic accountability to the Parliament in India.

Limits to communication

Based on my personal experience, it is possible to mention some limitations to making communication more effective in India. Most often, in any given context, the preferences of market participants may be different but not necessarily opposed to the public policy preferences. While transparency and communication in such circumstances helped in a re-ordering of the preferences, a surprise element in the decisions and timing of the communication was more effective when the public policy preferences and the market preferences were in virtually opposite directions. In the latter case, the communication of the reasoning for the actions, either concurrently or ex post, was found to be desirable.

Communication is not pre-commitment

Pre-commitment is generally useful on many occasions as part of monetary policy communication. I have two observations based on our experience in this regard. First, in highly uncertain conditions, a conscious view needs to be taken on the virtues of pre-commitment. Second, even when there is a pre-commitment and some reversal was needed at some stage due to unforeseen circumstances, a detailed and timely explanation for deviating from the assurance helps clarifying the situation. Further, degrees of pre-commitment may vary from a "vague but indicative" to "a definitive time-table", and our choice has varied depending on the circumstances.

What to communicate

On what to communicate, Professor Blinder refers to four different aspects of monetary policy; namely, overall objectives and strategy, motives behind a particular decision, the economic outlook and future monetary policy decisions. Most difficulties in putting these into

practice arise in regard to the *future monetary policy decisions*. Our effort in this regard has been to explain the stance of the monetary policy that would govern the future, which is done currently at quarterly intervals. The emphasis of this communication is on presenting information and analyses, that allows the market participants to draw their own inferences, but the RBI desists from giving any explicit forward guidance.

The RBI is not only responsible for monetary policy but also for banking regulation, and for management of the external sector and the government debt. Further, the content of communications relates not only to policy changes but also to the path of structural reforms, including legal reforms. In our periodical communications we have adopted a format of presenting the monetary policy and developmental and regulatory policies in two distinct sections in our annual and mid-term reviews; while the first quarter and the third quarter communications are confined to monetary policy. Cross-references are no doubt, inevitable. These are in addition to various other forms of communication – regular or ad hoc, and formal or informal.

Central bank communication is generally perceived as synonymous with pronouncements on monetary policy. In fact, a central bank's dilemma is more pronounced with regard to communication of supervisory issues. On supervisory matters, the central bank communicates to the common person and does not confine necessarily to a specialized audience like financial markets or financial institutions. These market players with knowledge and skills can absorb such communication in the right spirit though they may have specific business interests. What the general public desires to know may at times be at a variance from what the market players would like to be disclosed. The dilemmas of a supervisor, especially in a country like India are even more complex on account of the level of financial education.

Strategies and content of communication may have to be different for meeting the challenges to financial stability as compared to maintaining price-stability. In India, several measures, monetary as well as administrative, were undertaken to meet the threats to financial stability while complementary or parallel recourse was taken to communications. Some illustrations are: a speech in Goa in August 1997 to "talk down the rupee"; reassuring statements on market developments in the context of Asian crisis combined with a package of measures, in tranches in 1997 and 1998; pre-emptive measures in mid-1998 in the context of crisis in Russia; reassuring statements issued in the context of border conflict in 1999; a combination of liquidity injection and reassuring statements along with measures in the context of the 9/11; and in 2005, to explain the impact of the redemption of the India Millennium Deposits, to the extent of US dollar seven billion, on the foreign exchange markets. There could also be occasions where the central bank may not react to certain instances, for example when some sanctions were imposed on India. But, these decisions are taken thoughtfully and consciously after duly taking into account the need and market sensitivity. In brief, we take recourse to open market operations, open mouth operations, and open only eyes and ears operations in regard to threats to financial stability.

How to communicate

The public-face of the RBI in regard to formal communications is the Governor, but the Deputy Governor who deals with the subject also interacts more actively, more frequently and in greater depth with the media. These are in addition to the legal reporting requirements and several other documents that are placed in public domain at periodical intervals. In the absence of a formally constituted Monetary Policy Committee, this arrangement works well in terms of communicating with coherence, clarity and credibility.

On the impact of RBI's communication on financial markets, the most notable contribution has been in generating a better understanding, debates and sensitivities among the market participants and analysts, of the issues involved in money, finance and macro-stability. This process has been critical for India partly because the legacy of a planned economy required

un-learning as well as re-learning and partly because the financial sector reform process as well as the context has been somewhat more unique to India than in many other EMEs.

Predictability

On the predictability of the monetary policy decision in India, I am not aware of any research work on the subject. Let me therefore take recourse to anecdotal evidence. Since 2004, RBI has been withdrawing monetary accommodation, strengthening prudential requirements and emphasizing risks to price as well as financial stability. Most market participants seemed to have conditioned, at least until recently, their expectations of monetary policy response on what they considered to be the standard practice in advanced economies. As a result, for some time in the past, the RBI acquired an unwarranted reputation of always surprising the markets, prompting me to quip at one stage that “the financial markets always surprise me with their expectations from the RBI”.

As regards the forms of central bank communications, our experience is that formal, structured and periodic statements are normally valued significantly, but there is a markedly heightened interest in speeches and comments in times of unexpected global or domestic developments.

India is not an inflation-targeting country. The democratic pressures have proved to be a disciplining force so far, and its record over five decades is reasonable relative to most developing countries. Further, the two groups of commodities that carry a large weight in the consumption basket, namely food and fuel, are subject to supply shocks, making it difficult to identify a “core” that could be meaningfully targeted. Yet, there are suggestions, mainly from the academia, for inflation targeting but there is little or no support for it in political economy.

There is a reference in the Paper to paying some attention to communication with the general public. In India, we recognize that communication is not neutral to the target audience. The RBI communicates with various types of audiences – researchers, analysts, academicians, media persons, entities regulated by the central bank, other central bankers, rating agencies, international or multi-lateral bodies, and players in the financial markets. The RBI also endeavours to communicate with other special audiences, such as, urban and rural women and men, senior citizens, defence personnel and even school children. Let me illustrate with a communication initiative that RBI has undertaken two years ago. The Ombudsman Scheme for banks was revised recently and hence, the objective was to inform the widest section of our population. A Press Release might not have fully served the purpose. So, a decision was taken to issue an advertisement in print media – for which the content was indeed common but the languages differed. It was interesting to note that while the 15 leading Hindi newspapers with a larger circulation at 8.1 million and a far larger readership at 87.0 million helped us reach an audience that was almost five times larger than what we could have reached if we had advertised in leading English newspapers which are 17 and have a combined circulation of 6.3 million and readership of 17.9 million. In fact, in India, 54 leading non-English newspapers have a circulation of 21.4 million and a readership of 197.2 million. Given this experience of ours, we made the RBI website available apart from in English and Hindi, which are official languages of the Union Government, in 11 other national languages spoken by a large section of the population. Further, the RBI last year launched a Financial Literacy Project to educate the common person who is generally not financially literate. The project aims at imparting information and knowledge about banking, finance, and central banking to the common person in her’ or his own language. The material published under this project is, therefore, also made available in 11 major Indian languages apart from English and Hindi through a multi-lingual website.

These illustrations fully endorse what Professor Blinder has said in his Paper “In the end, central banks derive their democratic legitimacy and hence their cherished independence from the consent of the general public”

Select issues relevant to EMEs

Let me attempt a few generalizations on the subject, keeping in view the EME perspectives.

First, it is not very clear whether the empirical research on the subject referred in Professor Blinder's paper has adequately covered EMEs. For example, BRIC countries (Brazil, Russia, India and China), South Africa, Indonesia, Saudi Arabia etc., are emerging as significant players in the global economy. Are their experiences different from those researched so far?

Second, the government happens to be a significant player in many EMEs, especially in the financial sector. In the circumstances, should communication with financial markets, which should admittedly be two-way for optimal results, exclude communication by/ with the government? Naturally communication by/with the government, by its very nature, will have a differential and, at times, overlapping impact. But how does it affect the independence of the central bank and its policy effectiveness? This dimension poses a challenge for communication policy.

Third, the education function of central bank communication, that Professor Blinder referred to, may be more important in EMEs. In fact, such a function may enlarge the role of a central bank in the EMEs, when it carries credibility. In this regard, let me quote from an undelivered speech of a distinguished central banker² on the subject.

"Communication is not just about transparency. It is also about education, guidance and steering things in the right direction. In this, the central bank can be an honest broker between the government and the public and even the parliament."

In fact, a central bank can influence changes in public policy that are relevant to monetary and financial policies. For example, at the cost of modesty, let me quote Mr. Tarapore, a respected central banker.

"... when the definitive history of India's policy on gold is written up, the speech by Dr. Y. V. Reddy, Deputy Governor, Reserve Bank of India, at the World Gold Council Conference on 28 November 1996 will stand out as a watershed as it is perhaps the only speech by a senior Indian official which squarely takes on issues on gold policy and it will be appropriately recorded as a forerunner of major policy change".³

Fourth, relative to many other institutions in the public sector, central banks in many EMEs happen to have professional skills, experience and objective and independent thinking which can be drawn upon by the government, especially during the process of reform, in particular reforms in the financial sector. Structural changes involving institutional and legal changes in EMEs may need active inputs from the respective central banks. How do theory, practice and expectation of a transparent and independent central bank reconcile with these practical compulsions?

Fifth, the issue of financial stability is of great significance and enormous complexity for central bankers in the EMEs. These economies vary considerably with regard to their fiscal, current account, openness to external sector, and dependence on oil-earnings or oil-imports. Yet, the analysts in the financial markets often treat them as a group, presumably because the EMEs are perceived to be high-risk and high-reward destinations for financial capital. That characteristic makes them more vulnerable to volatility in capital flows, sometimes for reasons other than economic fundamentals in the country concerned. As the title implies, the

² Dr. I G Patel's address to the SAARC Governor's meeting on Communication in Central Banks, which was scheduled for December 2004, but was cancelled due to tsunami.

³ Excerpts from Mr. Tarapore's address at the Gold Banking Seminar of the World Gold Council, New Delhi, August 2, 1997.

EMEs are emerging from one state to another, namely, from less market orientation to greater market orientation, and are thus, in a state of transition. Consequently, the central banks in the EMEs, in their pursuit of financial stability, have additional challenges. First, to manage the transition in their own economies, which has socio-economic as well as political dimensions; second, to keep a watch on the sentiments affecting foreign capital flows – which could change for reasons other than domestic.

The challenges for communication policy are considerably more complex for the central banks in the EMEs for some other reasons. More generally the style and content of communication in EMEs has to evolve over time consistent with progress in financial sophistication. Further, in a globalised world, the communications by a central bank in advanced economies have a great impact on financial markets in EMEs. Communications, including scope for pre-commitment in policy, may have to factor-in these complexities.

Some issues for debate

Before concluding, I should admit that Professor Blinder's Paper has provoked some thoughts that warrant further debate and I will mention them briefly.

First, communication is a two-way process and it is all about sharing of information. Market functionaries and agents have an equal role in enhancing their disclosure of data and information. But, studies seem to focus on one-sided communication from the policy makers. How far non-transparent and asymmetric markets could adversely affect the policy effectiveness of central banks? The recent sub-prime turmoil is a clear case in point. This may be worth examining.

Second, while discussing independence of central banks how do we capture the *de facto* elements as distinct from the *de jure* elements? While it is true that the distinction is specific to the overall governance in public sector in each country, there may be an explanation for divergences between the two that may either reinforce or undermine the credibility of communication. Further, there may be different degrees of independence that are being exercised in practice and it might be interesting to try and understand how these could be captured in future studies.

Third, the exercise of independence has generally been discussed in the context of price stability. The issue becomes more complex when threats to financial stability are faced, since crisis management, as distinct from prevention, requires coordination or at least consultation with the government, both in terms of actions and communication. This is particularly relevant if quasi-fiscal costs are involved. The more complex issue of managing the conflicts between price and financial stability goals on some rare occasions warranting consultation or coordination with the government, is another issue.

Fourth, how much of the recent empirical evidence is adequate to give credit to effectiveness of monetary policy by central banks relative to say, globalization of trade in goods and services? At this stage, I must share with you one concern about the credibility bonus earned by an effective communication policy that I had expressed in 2006.

"Is it possible that such "hands on" and "very successful" communication by many central banks with regard to maintaining financial stability have resulted in under-pricing of risks by the private sector, or in a distinct lowering of aversion to financial risks? Is it possible that this credibility bonus is partly responsible for the upward pressure on the housing and equity prices becoming a global phenomenon?"⁴

⁴ Keynote address at the Regional Seminar on Central Bank Communications sponsored by the International Monetary Fund, held at Mumbai on January 23, 2006.

Fifth, is it possible to envisage intermediate arrangements between an individualistic and a mandated Monetary Policy Committee? We may have an example of such an intermediate arrangement in India. We have an Advisory Committee on Monetary Policy, consisting of Members drawn from non-executive independent Members of the RBI Board and outside experts, to aid the decision making process. This arrangement enables participation without diluting the coherence, credibility and the flexibility – especially in regard to communication.

Professor Blinder, in a paper on 12th December 2005⁵, referred to four prototypical central bank decision making systems namely: individual central bank governor (e.g. Reserve Bank of New Zealand); autocratically-collegial MPC (e.g. Federal Reserve System); genuinely-collegial MPC (e.g. European System of Central Banks); and individualistic MPC (e.g. Bank of England). Perhaps India would be a fifth prototype placed somewhere in the middle of the above four, in terms of proximity to the classic decision maker of economic theory. It could be called individual central bank governor – voluntarily collegial (Reserve Bank of India).

Finally, in the debate on accountability and independence, it may be useful to be clear as to whom the central bank is primarily accountable to. If a central bank does not enjoy independence, the question of its direct accountability will not arise. Broadly speaking however, do central banks tend to focus of late, more on accountability to financial markets, by design or by necessity, rather than say to the government, or the real sector, or the public at large?

Thank you.

⁵ Monetary Policy by Committee: Why and How, Alan S Blinder, December 12, 2005.