Duvvuri Subbarao: Central bank governance issues – some RBI perspectives

Comments by Mr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the meeting of the Central Bank Governance Group, Bank for International Settlements, Basel, 9 May 2011.

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1. Thank you for this opportunity to speak on some central bank governance issues from the perspective of the Reserve Bank of India (RBI). I will raise some specific issues. But before getting into them, I want to make two broad comments about the mandate of the Reserve Bank and our systems of autonomy and accountability. That will give you the broad context for appreciating the specific issues that I will raise later.

RBI's mandate

2. RBI has a mandate that is wider than is typical of central banks. The preamble to the RBI Act, 1934[1] describes its main functions 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."* This preamble indicates the two core functions of the Reserve Bank: (i) issue of currency; and (ii) monetary authority. The Act also entrusts other functions to the Reserve Bank such as regulation of non-bank financial institutions, management of foreign exchange reserves, management of sovereign debt – by statute in respect of central government and by agreement in respect of state governments – and regulation of forex, money and government securities markets and their derivatives.

3. The legal mandate for our other key functions and responsibilities comes from specific statutes:

- The Banking Regulation Act, 1949 together with the RBI Act, gives us the power to regulate and supervise commercial banks and cooperative banks.
- The Foreign Exchange Management Act, 1999 empowers the RBI to regulate the foreign exchange market.
- The Payment & Settlement Systems Act, 2007 mandates RBI to regulate and supervise the payment and settlement systems.

4. All the statutes put together make the Reserve Bank a full service central bank. We are the issuer of currency and are the monetary authority. We regulate and supervise banks, non-bank financial companies and segments of the financial markets. We are the banker and debt manager to the Government. We are the gate keepers of the external sector. We regulate and supervise the payment and settlement system. Being both the monetary authority and banking sector regulator gives us also the principal responsibility for financial stability.

[1] The legislation to establish a central bank for India was passed in 1934 and the Reserve Bank of India came into being a year later in 1935. The Bank was set up on the basis of the recommendations of the Hilton Young Commission. Earlier in 1913, John Maynard Keynes who served as an officer of British Administration in India, had proposed a "State Bank" to be set up in India, which was to engage in both central banking and commercial banking functions. Keynes proposed that the Bank be run by a Central Board consisting of the Governor, the Deputy Governor, a representative of Government and three or more non-voting assessors.

5. Even as the Reserve Bank's statutory mandate is wide compared to that of other central banks, what really sets us apart is the key role the Reserve Bank has had in driving India's development agenda. Several national level programmes such as those for the flow of credit to the agriculture sector and for small and medium industries were initially designed and implemented by the Reserve Bank. The apex national institutions for agriculture credit (NABARD), industrial finance (IDBI) are offshoots of what were once departments within the Reserve Bank. The Reserve Bank has been at the forefront in nurturing institutions and developing financial markets in India – the money market, the foreign exchange market and the government securities market. Efforts in recent years have focussed on enhancing the depth, integrity, transparency and efficiency of these markets.

6. The Reserve Bank pioneered the Lead Bank Scheme in 1969 whereby a designated bank in each district coordinates the flow of credit from all institutions in the district in support of the district credit plan. The Reserve Bank also issues directions and monitors the priority sector lending scheme, whereby all commercial banks are required to set apart a prescribed share of their total advances to priority sector. In recent times, the Reserve Bank has been leading the effort towards financial inclusion and financial literacy with the aim of eventually providing all households in the country meaningful access to the formal financial sector.

Autonomy and accountability

7. My second introductory comment is about autonomy and accountability. Neither the RBI Act nor any rules lay down a formal accountability mechanism. In the absence of a specific formulation, the fallback is on the general principle underlying a democracy – which is to render accountability to the parliament through the Finance Minister. The Reserve Bank assists the Finance Minister in answering parliament questions that pertain to its domain. Besides, the Standing Committee on Finance of Parliament summons the Governor for testimony on specific issues including legislations under consideration.

8. As regards autonomy, the Reserve Bank has not been accorded autonomy under the statute. The RBI Act lays down that the Central Government may give directions to the Bank, from time to time, after consultation with the Governor, where considered necessary in public interest.

9. To an untutored observer, the above arrangements present a picture of a central bank with limited autonomy, and that too enjoyed at the pleasure of the Government, juxtaposed with relatively loose systems of accountability.

10. The reality, however, is quite different. RBI in effect functions with a functionally autonomous mandate and there has been no instance so far of the Government exercising its reserve powers to issue a directive. This is all the more remarkable since the interaction between the Government and the Reserve Bank is closer and more frequent than is typical in other countries, and this draws from the key role of the Reserve Bank in financial sector reforms and economic development. But this close relationship has not spilled over into the Government encroaching on the Reserve Bank's autonomy in making monetary policy and regulatory policy.

11. The systems of accountability too are not loose contrary to what the formal picture might suggest. Since we are not an inflation targeting central bank, there is no formal memorandum of understanding (MOU) or a "Results Agreement" between the Government and the Reserve Bank. Nevertheless, we render accountability for our performance on inflation. We explain the rationale for our monetary policy stance quite extensively. Importantly, the Governor addresses a press conference following each policy review in order to disseminate the specifics of the policy and the expected outcomes, and to respond to questions from the media. This is followed by structured interviews in the print and electronic media. Our latest initiative in the dissemination process is a post-policy

teleconference with researchers and analysts where the Governor and the Deputy Governors respond to questions from them.

12. For most of the other important, non-monetary policy decisions, it has now become standard practice for the Reserve Bank to consult with stakeholders and call for feedback on the draft policy before a final decision is taken.

13. One of the determinants of rendering accountability is the quality of accounting standards and of financial reporting and disclosure. The RBI complies with best practices in accounting, and marks to market its holdings of domestic and foreign currency assets. However, only realised gains are recognised as income. Disclosures provided in the Annual Report of the RBI are fairly comprehensive and provide disaggregated analysis in respect of all major balance sheet heads including reserves and income and expenditure.

14. The sum and substance of this is that RBI renders accountability not as a matter of compliance with a specific provision of law but as a matter of self-discipline required of a responsible public institution, and this self-discipline has over time got enshrined into a code of conduct.

15. After these introductory comments on the mandate of the Reserve Bank, and our systems of accountability, let me turn to some specific governance issues.

Formulation of monetary policy

16. Monetary policy decisions are made by the Governor. There is no formal committee structure like the FOMC of the Fed or the Monetary Policy Committee (MPC) of the Bank of England. The Governor holds structured consultations with the four Deputy Governors and they constitute an informal MPC although a committee structure is not enjoined under the law or the rules. By its very nature there is no voting in this committee and the final call is that of the Governor.

17. We do have a Technical Advisory Committee (TAC) on Monetary Policy that acts as a proxy policy committee, but it is advisory in nature. It comprises the Governor as chairman, the Deputy Governor in charge of monetary policy as the vice chairman and other three Deputy Governors as members. Besides, the committee has five external members, two of whom are experts from the Central Board of the Bank while the other three are drawn from a wider pool. The external members are nominated by the Governor. They give specific recommendations on policy options and these are minuted. We have recently started putting the minutes of the meeting in the public domain, including specific recommendations, without directly identifying members with their advice.

18. Ahead of each quarterly monetary policy announcement, there is also an extensive process of structured consultation by the Governor with banks, financial market representatives, trade bodies and industry associations. We also convene a meeting of economists and analysts twice a year, ahead of the annual policy in April and the second quarter policy in October.

19. Finally, close to the policy decision, an established practice for the Governor is to meet the Prime Minister and the Finance Minister informally, give them an assessment of the macroeconomic situation and indicate to them his proposed policy stance. This is only a matter of courtesy, and the process has not impinged on the autonomy of the Reserve Bank in monetary policy making. The consultation with the Finance Minister, in particular, should be seen as an avenue for fiscal-monetary coordination, since on a reciprocal basis, the Finance Minister too takes the Governor into confidence on the fiscal stance ahead of presenting the budget to the Parliament.

20. An issue that comes up often is that even as the current system is working, whether we might be better served by having a formal MPC with its majority advice becoming binding. My own view is that we should be moving towards an MPC system, but in a phased manner.

There are some pre-conditions to be met. First, the central bank should be given legally-backed formal autonomy. Second, in a situation where inflation dynamics are more often dictated by supply side elements, the central bank's ability to control inflation is restricted. An MPC mechanism in such a situation can weaken the coordination between the Government and the Reserve Bank. However, when our financial markets deepen further, operating procedures improve and monetary transmission becomes more efficient, shifting to an MPC system becomes a realistic option.

Inflation targeting

21. Inflation targeting, by its very nature, is an issue in central bank governance. The defining features of an inflation targeting central bank are a precise mandate, a single instrument (the policy interest rate) in its armoury, a single minded devotion to achieving this target and a principal-agent relationship with the Government.

22. The Reserve Bank is not an inflation targeting central bank. Nevertheless there is an influential view that our economy will be better served if the Reserve Bank becomes one. The argument is that inflation hurts much more in a country like India with hundreds of millions of poor people and that the Reserve Bank will be more effective in combating inflation if it is not burdened with other objectives.

23. This argument is contestable. Inflation targeting is neither feasible nor advisable in India, and for several reasons. First, in an emerging economy like ours, it is not practical for the central bank to focus exclusively on inflation oblivious of the larger development context. The Reserve Bank cannot escape from the difficult challenge of weighing the growth-inflation trade off in determining its monetary policy stance.

24. Second, the drivers of inflation in India often emanate from the supply side which are normally beyond the pale of monetary policy. In particular, given the low income levels, food items have a relatively larger weight in the consumption basket in India compared to advanced economies and even many emerging market economies. We have three consumer price indices each covering different segments of the population with the weight for food ranging between 46–70 per cent. Monetary Policy, as is well known, is an ineffective instrument for reining in inflation emanating from supply pressures. It is unrealistic, under these circumstances, to expect the Reserve Bank to deliver on an inflation target in the short-term.

25. An alternative that is put forward is that we could target core inflation rather than headline inflation. That is not a feasible solution either. An inflation index, with half the basket excluded from it, hardly reflects reality. Moreover, the exclusion of food from the core index can be justified if average food inflation is the same as the average non-food inflation. If food inflation is higher, as is typically the case in many low income countries including India, then we would be underestimating inflationary pressures on a systemic basis. That would mislead policy prescriptions.[2]

26. Even if, for the sake of argument, we settle on inflation targeting, we have a problem about which inflation index to target. The headline inflation index is the wholesale price index (WPI), and that does not, by definition, reflect the consumer price situation. However, getting a single representative inflation rate for a large economy with 1.2 billion people, fragmented markets and diverse geography is a formidable challenge. The recent introduction of CPI-Urban and CPI-Rural is welcome, but it still does not solve the problem of heterogeneity.

[2] In our case, over the last six years average food inflation (8.7 per cent) has been more than double of non-food inflation (4.0 per cent).

27. Finally, a necessary condition for inflation targeting to work is efficient monetary transmission. In India, monetary transmission has been improving but is still a fair bit away from best practice. There are several factors inhibiting the transmission process such as an asymmetric relationship between depositors and banks, administered interest rates on postal savings that are not adjusted in line with prevailing interest rate trends and rigidities in the financial markets. All these factors dampen the efficacy of monetary signals and complicate the adoption of an inflation targeting regime in India.

28. Importantly, there is a political economy argument too against the Reserve Bank becoming an inflation targetter. The intellectual basis for central bank independence draws from Rogoff's conservative central bank construct. The construct is based on the assumption that governments tend to favour growth and employment while central banks, left to themselves, would seek to lower inflation. Precise inflation targeting formalizes this arrangement and dilutes the scope for interference in each other's domain. Such independent policy pursuits by the Government and the central bank, it is contended, serve the best interests of the national economy.

29. This assumption does not hold in the case of India because societal tolerance in India for inflation is low. Given the compulsions of democracy and the large population of poor, any government in India has always to be, and indeed has been, sensitive to price stability even if it means sacrificing output in the short-term. So, the argument of divergence of natural preferences as between the government and the central bank that underpins the inflation targeting framework does not hold in the case of India. Indeed both the Government and the Reserve Bank have to factor in the short-term growth-inflation trade off in their policy calculations.

Macroprudential regulation and supervision

30. One of the important lessons of the crisis is that a collection of healthy financial institutions does not necessary make for a healthy financial system, and consequently that microprudential regulation and supervision at the individual institution level have to be complemented by macroprudential regulation at the systemic level to guard financial stability. There are several debates that have surfaced centred around this issue including, what should be the ambit of macroprudential policies, what are the instruments to be used, should macroprudential concerns be part of the monetary policy calculus, which institution or institutions should be given the responsibilities for macroprudential supervision and what should be the arrangements for coordination. All the above questions raise several governance issues with political economy dimensions.

31. Consider the context. As part of the post-crisis reforms of regulatory architecture, there is an increasing trend of entrusting macroprudential supervision to central banks as an additional responsibility. Where central banks already have this responsibility, it is being more explicitly defined.

32. All policy decisions, as much as they are based on analytical constructs, eventually involve making judgements. But judgement plays a bigger role in formulating macroprudential policies. This is so because formalizing the analytical framework for macroprudential policies, demanding as it does defining the metrics for identifying systemic risk and identifying the appropriate instruments, is conceptually more challenging than is the case for other policies.

33. Possibly because of this judgement dimension, among central banks that are new to macroprudential regulation and supervision, there is an apprehension that performing this task will make them vulnerable to political interference. There is also an unstated fear that once a culture of political interference into central bank business gets a foothold, it will rapidly "spillover" into all areas of central bank business, including monetary policy, and thus erode the much prized autonomy of the central bank.

34. The Indian experience does not bear out this apprehension. Macroprudential regulation and supervision have historically been a part of the Reserve Bank's mandate. Yet there have been no instances of political influence on the macro prudential policies of the Reserve Bank acting in its capacity as the regulator. In fact, the Reserve Bank enjoys as much autonomy over its regulatory decisions as it does on its monetary policy decisions, and the political system has not tried to influence the Reserve Bank's stance.

35. Indeed, in spite of India being a vigorous democracy with very little that remains outside the political domain, the political system has respected the Reserve Bank's autonomy over its domain. This is a testimony of the credibility and reputation that the Reserve Bank has earned for its professional integrity. The political system has an incentive in keeping it that way.

Debt management office

36. The RBI Act mandates the Reserve Bank to be the debt manager of the Central Government. The Reserve Bank also manages the debt of state governments by mutual agreement as provided in law. There is now a proposal to shift this function out of the central bank, and this has generated a debate around several governance issues.

37. To set the context for this debate, it should be noted that the Reserve Bank has an impressive track record in debt management. Even as the Government's borrowing had gone up both in absolute and proportional terms, it has managed to complete the borrowing programme in a cost efficient manner. With the average maturity of government debt at around 10 years, India has one of the longest maturity profiles in the world, which proved to be a source of major strength and comfort during the crisis.

38. It could be argued that public debt management in India has been effective because the Reserve Bank, which is the monetary authority, is also entrusted this task. Nevertheless, the progress on fiscal consolidation by the Government in the years before the crisis suggested that there could be operational efficiencies to be gained by shifting debt management to a separate Debt Management Office (DMO). The Government has accordingly set up a middle office of the DMO and is proposing to move forward with a Public Debt Management Agency of India Bill.

39. There is need to reconsider the content and pace of this process in view of the revised circumstances post-crisis. The case for shifting debt management function out of the central bank is made on several arguments such as resolving conflict of interest, reducing the cost of debt, facilitating debt consolidation and increasing transparency. These advantages are overstated.

40. The most potent of these arguments is the one relating to conflict of interest. The other arguments pertain to mechanics of debt management which can be said to be model neutral. Let me, therefore focus on the conflict of interest issue.

41. The primary conflict which is generally associated with a central bank managing sovereign debt pertains to the one between its inherent responsibility as the monetary authority, and its obligations as a debt manager. In particular, it is argued that the central bank will be biased towards a low interest regime in order to reduce the costs of sovereign debt even if it compromises its anti-inflation stance. A similar conflict may also distort the open market operations of the central bank.

42. The above arguments, though valid in some countries, fail to recognize that in countries such as India, given the large size of the government borrowing program, sovereign debt management is much more than merely an exercise in resource raising. The size and dynamics of government borrowing program has a much wider influence on interest rate movements, systemic liquidity and even credit growth through the crowding out of private sector credit demand. Management of public debt, therefore, has necessarily to be

seen as part of broader macroeconomic management framework involving various tradeoffs. Once this is recognised, the centrality of central banks in this regard becomes quite evident. Only central banks have the requisite market pulse and instruments to aid in making contextual judgements which an independent debt agency, driven by narrow objectives, will not be able to do.

43. Also, it is not that these conflicts would disappear merely by shifting debt management out of the central bank. In fact resolving those conflicts could become much more complicated leading to inferior outcomes. This is because even after the separation, the central bank would continue to be expected to manage the market volatility and market expectations arising out of government borrowing.

44. Admittedly, a few years back, the challenges of managing the above conflicts in the then prevailing context seemed to weigh in favour of separation of debt management from the central bank. The constraining factor, even then, was the high fiscal deficit. The fiscal position, which was improving in the years before the crisis, got off-track during the crisis. The Government is making attempts to get back on to a path of fiscal consolidation post-crisis. The difference as far as the Reserve Bank is concerned is that the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 in place which prohibits the Reserve Bank's participation in the primary auction for Government securities. A separate mechanism for conveying monetary stance in the form of repo and reverse repo rates under the Bank's Liquidity Adjustment Facility (LAF) has been put in place in 2000. Furthermore, in a situation of excess capital flows requiring forex intervention from the Reserve Bank and the consequent sterilisation through issuance of Government bonds by the RBI, the coordination of debt management with monetary operations needs to continue. This makes the case for separation much weaker in the revised circumstances.

45. In the Indian context, there is the added complexity of managing the debt of the states. The sensitivity of the states to entrust debt management to an agency of the Central Government also needs to be kept in view given the political-economy dimensions of our federal structure. This is all the more important since market borrowings have emerged as the dominant source of deficit financing at the sub-national level. Taken together, the borrowing by states has attained a critical mass vis-a-vis the absorptive capacity of the market. That makes it imperative to harmonise the market borrowing programmes of the Centre and the States. Separation of the Centre's debt management from the central bank will make such harmonisation difficult.

46. Thus, on balance, as long as there are institutionalized mechanisms to negotiate various tradeoffs in a given context within the overarching objective of achieving monetary and financial stability, separation of debt management from central bank seems to be a sub-optimal choice. Even internationally, the emerging post-crisis wisdom recognizes the interdependence between the functions of monetary policy, financial stability and sovereign debt management and the need for close association of the central bank with sovereign debt management.

Responsibility for financial stability

47. The Reserve Bank's mandate for ensuring financial stability arises mainly from its mandated functions of regulator of the banking system, regulator and supervisor of the payment and settlement systems, regulator of the money, forex, government security and credit markets, banker to the banks, as also the lender-of-the last resort. This unique combination of responsibilities for macroprudential regulation and microprudential supervision, together with an implicit mandate for systemic oversight has allowed the Reserve Bank to exploit the synergies across various dimensions. The micro-level information coming from supervision of individual institutions has been a valuable input for shaping the macro perspective. On the other hand, the broad understanding from

macroprudential regulation has been effective in instituting prudential safeguards at the micro institution level.

48. Financial stability is explicitly entering the objective function of central banks post-crisis. In the Reserve Bank though, we had all along pursued financial stability as an important objective. Indeed, one of the main reasons the impact of the crisis on India has been blunted is because the Reserve Bank tightened the provisioning norms and risk weights for sub-sectors that experienced rapid credit growth in the years before the crisis such as real estate and consumer credit.

49. In India, there are other market regulators besides the Reserve Bank such as the Securities and Exchange Board of India (SEBI), the Insurance Regulatory and Development Authority (IRDA) and the Pension Funds Regulatory and Developmental Authority (PFRDA) who contribute to the building block for financial stability. Nevertheless the Reserve Bank has played an apex role by tradition and by the fact that it regulates banks in a financial system that is bank-dominated. The channels of interconnection between banks and other financial sector entities are within the regulatory perimeter of the Reserve Bank.

50. Though the Indian financial system weathered the global financial crisis relatively unscathed, there was enhanced focus on the regulation of financial system in India too in the wake of the global financial crisis. While the post-crisis debate in most countries was on the reform of the regulatory architecture, and what responsibilities to entrust to the central bank, the focus in India was on coordination amongst regulators. With a view to establishing a body to institutionalise and strengthen the mechanism for maintaining financial stability, financial sector development and inter-regulatory coordination, in December 2010, the Government constituted the Financial Stability and Development Council (FSDC) to be chaired by the Finance Minister. The FSDC is to be assisted by a Sub-Committee to be chaired by the Governor, RBI. This Sub-Committee has replaced the erstwhile High Level Coordination Committee on Financial Markets (HLCCFM) under the chairmanship of Governor, RBI. While constituting the FSDC, the Government held out a clear assurance that the setting up of the FSDC will not in any way erode the autonomy of the regulators.

51. In terms of governance structure, the two-tier framework of FSDC and the Sub-Committee presents an interesting case. The crisis has clearly demonstrated the need for explicit delineation of responsibilities for financial stability across agencies and the protocol for coordination among such agencies. The crisis has at the same time brought forth the critical stake of the sovereign in ensuring financial stability – the spillover costs in a crisis have to be borne by the governments. In the Indian context, the proposed FSDC structure attempts to strike a balance between the sovereign's objective of ensuring financial stability to reduce the probability of a crisis and the operative arrangements involving the central bank and the regulators. While the Sub-Committee under the Governor, RBI is expected to evolve as a more active, hands-on body for managing financial stability in normal times, the FSDC would have a broad oversight and will assume central role in crisis times.

52. Since the Reserve Bank has historically been a macroprudential regulator, not all the governance issues surrounding financial stability that have emerged post-crisis are new to us. Nevertheless, there are always unknown unknowns and the system should be able to respond to them. Now that the regulatory architecture of the FSDC is in place, it is important for the Government and the regulators in India to develop conventions and practices which will serve the goal of preserving financial stability without eroding the autonomy of the regulators.