

Evolving Role of Central Banks

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It gives me great pleasure to be here at the LBSNAA for the inauguration of this Phase V mid-career programme for IAS officers. I have many pleasant memories of this premier training institution where I had come after joining the IAS in the year 1980. I am thankful to Shri Sanjeev Chopra, Director of the Academy and members of the Faculty for having invited me to address such an august gathering.

2. I am sure each one of you has worked hard and achieved many milestones over the path of your long careers. Where you stand today is perhaps the most important juncture in your career as you prepare for even higher roles and responsibilities in the Indian administrative structure. I understand that most of you would have spent around 28 to 31 years in the service. From now on you would be occupying top positions in central and state governments. At these levels, you would be responsible for policy making as well as guiding implementation of major programmes and schemes. You have to carefully weigh and assess the suitability of various policy options and advise the government on the way forward. While discharging your role at such high positions, it is very important to remember two quotes from the father of the nation, Mahatma Gandhiji: (i) *“Be the Change that you wish to see in the World”*; and (ii) *“Recall the face of the poorest and the most helpless man whom you may have seen and ask yourself, if the step you contemplate is going to be of any use to him”*.

3. In senior leadership positions, you will have the power to make a difference in the lives of the people of this nation. Equally, you would have the power to make a difference in the lives of individuals whom you lead. Be sure to be their mentor, guide and inspire your team to dedicate themselves to the service of the nation. My advice to you would be to work towards introducing systematic changes in the functioning of our bureaucracy at various levels to further improve the delivery of public schemes and policies. More importantly, adhering to transparency and elimination of corruption should also be your top priorities.

4. As policy formulation of any kind is a learning process, policy makers are often guided by past experiences. Therefore, today I have chosen to speak on the topic of “Evolving Role of Central Banks”.

Evolution of Central Banks

5. Since the beginning of central banking, which goes back at least to the 17th century with the establishment of the Swedish Riksbank in 1668, the role and functions of monetary authorities have undergone several changes. Some of the oldest central banks were set up with the primary objective of providing war time finance to governments and managing their debts. Since then, their role has evolved over time in line with the changes in economic systems. They have now transitioned into modern day central banks which function with the objective of supporting sustainable economic growth through the pursuit of price and financial stability.

6. In the case of India, the Hilton Young Commission (1926) recommended setting up of the Reserve Bank of India which was to be entrusted with pure central banking functions. There is, however, a long

history, which can be traced back to 1773, of the efforts to set up in India a banking institution, with some elements of a central bank. Consequently, the Reserve Bank was set up, and it commenced operations from April 1, 1935 with the Reserve Bank of India Act, 1934 providing the statutory basis for its functioning. It was originally set up as a shareholder's bank, which was nationalised later in 1949. Since then, its role has evolved over time from supporting the planned development of the economy to a full service central bank.

Role of Central Banks during Global Financial Crisis

7. Let me now elaborate on the role of central banks during crisis period. While it is true that crises lead to reforms, experience shows that other extraneous and complex factors can lead to future financial crises. For instance, despite learning lessons on inadequacies of regulation and supervision in many emerging economies during the East-Asian crisis of 1997, the occurrence of global financial crisis of 2008 originating from advanced countries could not be avoided. While macroeconomic vulnerabilities derived from large current account deficits, fiscal imbalances, excessive leverage and inadequate regulation and supervision of financial institutions were some of the most common features of this crisis, it was of truly global nature with much more intensity and depth.

8. Given the speed of transmission of the impact of global financial crisis across countries, central banks were once again at the forefront of policy response. This time, however, typical monetary policy responses of central banks were not enough to curb the turmoil in financial markets. In the summer of 2007, major central banks began with traditional monetary policy tools and reduced the interest rates. The economic

situation, however, deteriorated precipitously and central banks were not left with much headroom in their traditional policy tool kit to preserve domestic financial stability. Thus, central banks – particularly in advanced economies – took recourse to quantitative easing through unconventional policy measures to contain systemic risks, shore up confidence in the banking system and arrest economic slowdown. These policy measures were unconventional in terms of instruments and operational targets.¹ Undoubtedly, the quantitative easing adopted by central banks was one of the boldest policy experiments in the modern history of central banking. Another unconventional measure was the use of negative policy interest rates, though for achieving different objectives. The impact of these unconventional monetary policies is well known by now as large amount of liquidity created in the international financial system was channelled to EMEs in search of yield, creating boom and bust cycles in those economies.

Regulatory Response to the Crisis

9. From a supervisory and regulatory perspective, the crisis revealed some significant fragilities in the system. Basel Committee on Banking Supervision (BCBS) succinctly summarised these weaknesses: an excessive build-up of on and off-balance sheet leverage, accompanied by a gradual erosion in the level and quality of the capital base; insufficient liquidity buffers; a pro-cyclical deleveraging process; and the interconnectedness of systemic institutions through an array of complex transactions². The global regulatory response which took shape in the form of the Basel III framework focussed on increasing the level and

¹ For instance, these included lending to financial institutions, targeted liquidity provisions for credit markets, outright purchases of public and private assets, purchase of government bonds and forward guidance.

² Basel Committee on Banking Supervision (2010): [“Basel III: A global regulatory framework for more resilient banks and banking systems”](#), December.

quality of capital, constraining bank leverage, improving bank liquidity and limiting pro-cyclicality, along with adding macro-prudential elements to regulations.

10. Keeping up with the traditionally prudent approach, India's implementation process for Basel III reforms has been somewhat more stringent in terms of schedule as well requirements. Domestic factors and policy priorities continue to guide the Indian approach to financial sector regulation. Thus, the Reserve Bank has put in place the frameworks of capital requirements, countercyclical capital buffer (CCCB), leverage ratio, Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)³. More recently guidelines on large exposures were issued which became effective from April 1, 2019.

11. Another episode of stress witnessed across EMEs including India was during the taper talk period of mid-2013. The Indian economy was vulnerable due to the then prevailing high inflation of around 10 per cent and large current account deficit at 4.7 per cent of GDP. The Reserve Bank resorted to a host of policy measures including monetary tightening, restriction on gold import, special dollar swap window for public sector oil companies, special concessional swap window for banks for attracting Foreign Currency Non-Resident (Bank) deposits, increase in overseas borrowing limit of banks, and raising FII investment limit in government debt.

³ To be implemented from April 1, 2020

What do we Learn?

12. Though there is no unique solution to these policy issues confronting the global economy, we could clearly draw three broad inferences:

- (i) First, as we have discussed earlier, central banks' role is important, both during normal as well as crisis times. While mandates for central banks broadly remain the same during both normal and stress periods, the weightage attached to competing objectives and the choice of policy instruments become crucial in the crisis periods.
- (ii) Second, communication by central banks is very important which may be different in crisis times than in normal times. Not only it helps convey decisions in a more transparent way, it also signals the present and future policy stance of central banks. In fact, unconventional monetary policy measures undertaken by central banks during the crisis period worked mainly through the confidence and signaling channels. The US Federal Reserve's statement on December 16, 2008 provided a clear forward guidance for the markets. On the other hand, only a mere hint of monetary policy normalisation by the US Fed (popularly known as taper tantrum) in May 2013 triggered portfolio outflows from some emerging market economies (EMEs)⁴. This led to high volatility in equity, debt and currency markets. In fact, such market volatilities in EMEs could have been avoided through clear advance

⁴ Mainly on five emerging-market countries, viz., Brazil, India, Indonesia, South Africa, and Turkey (which were referred to as the 'Fragile Five')

communication on calibrated withdrawal of monetary policy accommodation.

In the Indian context, the Reserve Bank communicates its monetary policy decisions in terms of changes in the 'Policy Repo Rate' and 'Stance' based on an assessment of the current and evolving macroeconomic situation. The stance of the monetary policy is communicated as neutral, accommodative or calibrated tightening in consonance with the mandate of achieving the medium-term inflation target of 4 per cent \pm 2 per cent, while keeping in mind the objective of growth. The Reserve Bank's approach to communicate the policy stance is to explain it with rationale, information and analysis to enable market participants and stakeholders to have better clarity about the Reserve Bank's assessment of the evolving situation.

- (iii) Third, the global financial crisis was also a testimony to the fact that coordination of policies both at the global and domestic level is important for macro-financial stability. It is only through better coordination between central banks and between monetary and fiscal authorities in the domestic sphere that adverse consequences of spillovers and spillbacks could be contained. The fact remains that as most policy makers (monetary and fiscal) have domestic mandates, international cooperation may be hard to engender if international outcomes militate against domestic policy preferences. Therefore, success of coordination will depend on deft calibration of policies by major stakeholders.

Issues in the Current Context

13. Even after more than a decade of global financial crisis and six years after taper-tantrum, the global economy is still not on a stable growth path. Following an upward swing in 2017, there has been growing evidence that global growth and trade is weakening. Unsettled trade tensions and developments around Brexit are imparting further downside risks to the outlook. While signs of weakening world industrial production and trade volume were discernible in early 2019, other business confidence indicators have also dampened in many OECD countries. Taking cognisance of these factors, projections of world growth for 2019 have been revised down by the IMF, World Bank and the OECD in their latest assessments. Likewise, global trade is projected to expand at a moderate pace in next two years in line with the subdued investment outlook for many major economies.

14. While the global economy is still to recover to the pre-crisis growth path, India has continued to exhibit robust growth driven by consumption and investment demand in the last three years. However, in more recent period, we have seen a loss of speed in the second half of 2018-19 as some drivers of growth, notably investment and exports, slowed down. On the supply side, activity in agriculture and manufacturing moderated sharply. It is expected that the end of political uncertainty associated with an election season and continuation of economic reforms would lead to a reversal of the current weaknesses in some of the indicators in our economy.

15. To reinvigorate growth by improving investment climate, a healthy financial sector, inter alia, plays an important role. In this context, the Reserve Bank has accorded high policy attention to reform both banking

and non-banking sectors. We have been taking several steps to strengthen the regulatory and supervisory frameworks in order to increase the resilience of the banking system. New guidelines have been issued for resolution of stressed assets, which will sustain the improvements in credit culture.

16. In the non-banking sector, the Reserve Bank has recently come out with draft guidelines for a robust liquidity framework for the NBFCs. We are also giving a fresh look at their regulatory and supervisory framework. It is our endeavour to have an optimal level of regulation and supervision so that the NBFC sector is financially resilient and robust. The Reserve Bank will continue to monitor the activity and performance of this sector with a focus on major entities and their inter-linkages with other sectors. The Reserve Bank will not hesitate to take any required steps to maintain financial stability.

17. We are also taking a number of steps to improve commercial viability of Urban Co-operative Banks (UCBs). These steps include proposed establishment of an Umbrella Organisation and a Centralised Fraud Registry for UCBs and governance reforms at the board level. We are also encouraging voluntary merger and consolidation in the sector to help reduce operating costs, diversify risks and economise on capital.

Interplay between Inflation and Growth Objectives

18. At the end, let me highlight the role of the Reserve Bank in the context of the mandate under the Reserve Bank of India Act, 1934: *“to regulate the issue of Bank notes and the 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 mandate has been interpreted over time as to maintain price stability, financial stability and economic growth with the relative emphasis between these objectives governed by the prevailing macroeconomic conditions. This role of the Reserve Bank has been restated as per the amendment in the RBI Act in May 2016 according to which “*the primary objective of the monetary policy is to maintain price stability while keeping in mind the objective of growth*”. Therefore it has been our endeavour in the Reserve Bank to ensure price stability under the flexible inflation targeting regime and simultaneously focus on growth when inflation is under control.

19. In a flexible inflation targeting framework, a delicate balance needs to be maintained between Inflation and growth objectives. The relative emphasis on inflation and growth depends on prevailing macroeconomic scenario, inflation and growth outlook and signals emerging from incoming data. Post global financial crisis, it has been recognised that price stability may not be sufficient for financial stability and therefore financial stability has emerged as another key consideration for monetary policy, though jury is still out as to whether it should be added as an explicit objective of monetary policy. The fact remains that though the focus of monetary policy is mainly on inflation and growth, the underlying theme has always been financial stability.

Concluding Observations

20. While India emerged relatively unscathed from the global financial crisis, there should be no room for complacency. As a member of the several multilateral institutions, India actively participated in post crisis reforms of the international regulatory and supervisory framework under the aegis of the G20 and the Basel Committee. India remains committed

to adoption of international standards and best practices in a phased manner, calibrated to our domestic conditions, wherever necessary.

21. From the perspective of the Reserve Bank, we will continue to focus on effective communication and coordination with all stakeholders to achieve broader macroeconomic objectives of price stability, growth and financial stability.
