

CENTRAL BANKING PUBLICATIONS LTD

Quarterly Journal

CENTRAL BANKING

Interview: Y.V. Reddy

A reprint from
Central Banking Journal
Volume XV Number 1 -
August 2004

Now in its 13th year, Central Banking Publications continues to meet the demand for accurate and well-informed news and comment about the world of central banking, financial regulation, and international finance. Central Banking Publications also produces authoritative directories, research studies, seminars, training courses and on-line services. More information is available at www.centralbanking.co.uk

All rights reserved. No part of this article (text, data or graphic) may be reproduced, stored in a data retrieval system or transmitted, in any form whatsoever or by any means (electronic, mechanical, photocopying, recording or otherwise) without obtaining prior written consent from Central Banking Publications Ltd. Unauthorised and/or unlicensed copying of any part of this publication is in violation of copyright law. Violators may be subject to legal proceedings and liable for substantial monetary damages per infringement as well as costs and legal fees.

Central Banking Publications Ltd
6 Langley Street, London WC2H 9JA, UK
Tel: +44 20 7836 3607, Fax: +44 20 7836 3608
E-mail: info@centralbanking.co.uk
Website: <http://www.centralbanking.co.uk>

Interview: Y.V. Reddy

The governor of India's central bank explains his watchful approach to economic development and reveals how a financial crisis was averted after May's general election. Interview by Nick Carver.



Could I start by asking about your reaction to being appointed governor?

Well I was to have worked at the IMF for three years and I was looking forward to completing my term. I enjoyed the time at the Fund which was exciting. But the government suggested that I should come back to take this position and, having been in public service for 35 years, I am used to being posted to a job! But I like the institution – I worked at the Reserve Bank for six years, it treated me well, the government treated me well, the financial markets treated me well, the banking community treated me well, so I didn't have any misgivings about the job content.

India is seen as a future powerhouse of the world's economic growth. What is your role in ensuring that Indian growth continues?

All economic policy is governed by a number of considerations, but in particular political economy. The role of the central bank in this situation is within the overall parameters of economic policy. But I would say that as we go along we expect that the central bank would be able to gain more operational autonomy. If it gained more operational autonomy it would be able to give more confidence to the financial markets as well as enhance the quality of economic management. We have progressed significantly in terms of operational autonomy. The second area is macro policies and there I would emphasise harmony. In operations it is autonomy, but with economic policies harmony is extremely important. They are interrelated and both are needed in the interests of maintaining economic, financial and price stability.

There are a number of structural transformation measures as well. And a lot more intensive coordination between the Reserve Bank and the government will be required, such as in legislative changes. In a way, unlike in many developed countries, here the transition to a more developed economy has to be managed jointly in various ways by the different bodies responsible for public policy.

Turning to monetary policy, what is the Reserve Bank's mandate and how do you interpret it?

One aspect of the mandate is what is contained in the law and this is very pithy. In practice it is a dual objective, perhaps more akin to the Federal Reserve, of growth and price stability. But the relative emphasis to be placed on one or the other will depend on the context. So whether we emphasise growth (or availability of credit for growth) or we emphasise price stability will naturally depend on the context from time to time.

So this is at your discretion?

Essentially yes, it is at our discretion, but we have to be continuously in touch with the government to harmonise the policies. But there is something else, which has come to greater prominence recently after liberalisation, and this is the need for financial stability. While our objectives continue to be growth and price stability, the shorter-term policy reactions will have to take into account the conditions in the financial markets and whenever there is any serious threat to financial stability.

Would you like a more precise mandate?

Actually, we had a committee under a former governor, Maidavolu Narasimham, on transparency in monetary and financial policy. And it recommended that we should move to a more explicit inflation targetting, or something along those lines, with objectives to be specified either by law or by formal understanding. But the Reserve Bank's response so far has been that we are not very enthusiastic at this stage about dividing such a responsibility and pursuing such a particular objective. This is mainly for pragmatic reasons and also takes into consideration our level of development.

The pragmatic reasons are one that we are still vulnerable to a lot of shocks. Oil shocks are the most important; secondly are the monsoons. Now if vulnerability to shocks is still large, the inflation target has to be more in terms of core inflation and the non-core inflation is going to be small in relation to the totality. So monetary policy's capacity to cope with such shocks is limited. The second aspect is the measurement problem – the various inflation measures are not very integrated. And the third is the transmission mechanism – we still have a problem of financial markets being differentiated.

We have something like a desirable inflation rate, which is indicated as part of the annual statement. This is developed through informal consultations with government. There is no specific inflation target formally, but that is an important point which is kept in view.

Does this do enough to anchor expectations?

Yes, we believe so for two reasons. Firstly if you recall in India, by and large, unlike many other emerging-market countries where inflation targetting is advocated, there has been no hyperinflation. For us, particularly from 1950 onwards, political and economic considerations made the government very jittery the moment inflation touched two digits. They always try to keep it below 10%. Secondly, until about four or five years ago inflation expectations were hovering around 8-9% and today there is evidence to show that expectations are down to 5-6%, and inflation has been around 4-5% in recent years.

What are your main tools for monetary policy?

In the past generally it was direct instruments – the reserves instruments, but slowly as our financial markets have developed we have been able to move significantly from direct to indirect instruments. Without in any way giving up the ability to use reserves as instruments, the current dependence is very much on indirect instruments. We operate basically at the shorter end of the money market, through open market operations especially repo and reverse repo. More or less the interest rate corridor is 4.5-6% at the short end.



The Reserve Bank of India

The Reserve Bank acts as debt manager for the government. In a country like India is this role best kept inside the central bank?

If you recall, many of the central banks in the old days did have the government debt management function; a more recent trend is to separate it out. In 2001 the policy intention to separate was indicated by the Reserve Bank. But it was indicated also that while in principle we want to separate out the debt management function, we would like fiscal consolidation to have made progress before that. When there is fiscal dominance there is clearly an advantage in close coordination between the various wings of policy.

Could you say a bit more about “fiscal dominance”?

I mean that a large amount of savings is going to finance the fiscal deficit. The Reserve Bank is the debt manager for the central and the state governments. And together the fiscal deficit is 9-10% of GDP – it is large. Debt management of this

magnitude has a major impact on monetary management. Therefore the first step is to try to reduce the fiscal deficit so that the debt office is able to function independently – by that I mean it should be able to handle the debt without causing disruption to monetary policy. Secondly, the financial markets have to develop sufficiently to be able to absorb the debt management dynamics. Yet the process of developing the financial markets has started only quite recently, in the last five or six years. Thirdly, legislative changes are required in the way that debt is managed, and we have made some proposals on that. So separating debt management from the central banking is a medium term plan.

Is this role coordinated with monetary policy?

I wouldn't say it is coordinated, but certainly the impact of such a large borrowing programme on the financial markets and on the monetary balances has to be taken into account.

What are your priorities for developing debt markets?

We have been articulating the various measures needed. One, we have promoted a clearing corporation for money, debt and foreign exchange markets. Second, in terms of institutional investors, the Reserve Bank has set up and promoted some institutions to handle the debt markets, which we subsequently have sold. We have introduced a primary dealership system in an extensive way, and also promoted self-regulatory organisations. We have had a major developmental role in developing the debt markets.

And in private sector debt?

Not really. However to the extent that the dominant holders of the debt are banks, the financial assets of which we regulate, the prudential requirements in some sense can be tailored. So the growth of corporate debt market is in some sense influenced by the prudential regulations of the Reserve Bank.

Can the Reserve Bank encourage holdings through its prudential regulations?

Let me put it this way: we can encourage a better type of debt.

To what extent is India's financial and banking system still constrained by controls and regulations?

Firstly, you have to see how far we have come in the last ten years or so. Most of the banks have both public and private ownership now, and most of them are listed on the stock exchange so they are subjected to stock market discipline. Ownership has become diversified. Secondly, the presence of

foreign banks has increased and, thirdly, the presence of private banks has increased. There is much more intense competition. So that has also resulted in substantive change.

As we go forward there are two things I would note. One is that in terms of our regulatory/supervisory set-up we have moved significantly from micromanagement to more prudential regulations. We should go further in this direction. Secondly, the most critical issue for the banking system is the loan recovery process. The atmosphere in the credit markets whereby you would be in a position to recover loans – that has to be improved as does the legislative framework, its implementation and the judicial process whereby this can be effected. That is the major issue facing the banking industry.

What are your priorities now as governor regarding liberalisation of the banking and financial sectors – will the gradual process continue?

Yes, but I make a distinction between deregulation and liberalisation internally, and integration with the global economy. We have progressed significantly both in terms of domestic liberalisation and external integration. There are likely to be significant gains by pushing ahead with consolidation within the banking industry: improving systemic efficiency, and improving corporate governance within the financial sector. Moving towards more integration within the financial sector would be a high priority.

As far as integration with international capital markets is concerned, there one has to take into account broader considerations in terms of public policy: the fiscal situation, the adequacy of financial sector development, the possibility of real sector shocks, of oil price hikes and so on. So one has to take a more comprehensive view because we want to benefit from the efficiency gains of such an integration, while avoiding the destabilising elements that are there in terms of volatile international capital flows from other countries.

What is India's approach to the new Basel Accord and what will be the benefits of implementation?

We have taken a principled stance, and this goes back to Basel I, that we would like full harmony with international standards. But we will not blindly follow them. We would like to apply it while taking account of our circumstances. In some areas we go even further than what the details say, but we aim to be broadly in line. The pace of implementation will also depend on national considerations.

Even as the Basel II debate was going on, India was closely involved in the various fora leading to the final accord. And we have clearly indicated our intention to adopt and be supportive, but to implement in a way that suits us. Our latest policy statement requested various banks to prepare their response to these requirements. They are fairly well placed to manage this.

The new Basel Accord is much more complicated than the existing accord. How much will it cost the private sector and the Reserve Bank to implement?

It is true that there will be costs borne by the banks and central bank. But as we implement, it is quite possible that with stronger international presence we will be encouraged to go quicker. The banks have been advised to do the detailed impact analysis. We have to minimise the cost, but these cost considerations will not come in the way of implementation; yet they'll influence the pace, the appropriateness, and pattern the way in which the accord has to be implemented in India.

The Reserve Bank of India's foreign exchange reserves have doubled in the last two or three years. Do you see this as continuing indefinitely or is there a level that is adequate?

Basically, the reserves are the results of several factors. An accretion to reserves may happen as a result of operations in the foreign exchange market which in turn may depend on the flows, which in turn may depend on the management of the capital account. We have to recognise that in countries like India, which have a less than fully liberalised capital account, there is management of the capital account. Within the parameters of the management of the capital account, certain flows occur. We have to look at the accretion of reserves in the context of the management of the capital account and the exchange rate.

India has been the recipient of very large capital inflows. Has the Reserve Bank attempted to sterilise these inflows and, if so, can it go on doing this successfully?

Like all other aspects of economic policy there are trade-offs. And these trade-offs have to be taken on board. What policy you adopt in terms of intervention and in terms of sterilisation will depend on the context. But the Reserve Bank of India is fully equipped with the instruments of sterilisation because of the introduction of the market stabilisation scheme. Whether we will have to use these instruments will depend on the nature of the capital flows, the investment activity, the absorptive capacity, and the impact on key prices.

What are the areas of concern – what about the short-term foreign debt?

The most important element in the management of the external sector is the external debt and short-term debt. Now, total reserves are about the same level as the total external debt of India and short-term debt is a very small part of that. There is no vulnerability on that side. Yes there have been increases in portfolio flows, but even if you take the aggregate portfolio flows they're still a fraction of our reserves. I wouldn't consider that as a source of vulnerability. Portfolio flows account for an

important part of our equity markets so, in that sense, they could yet influence the equity markets.

The BIS's annual report recounted China's experience of trying to sterilise inflows leading to increases in monetary aggregates, fueling inflationary pressures. Does that sort of scenario concern you?

We are definitely following the developments closely, but what is important is that we see that the growth of broad and narrow money has not been very large. It has been marginally more than what we forecast but then GDP has been higher than we estimated. These are variables that have to be monitored carefully – always – and they are being continuously monitored. But at the moment, our emphasis would be to watch out for an increase in credit and investment activity.

How would you describe your level of technical and real independence?

Actually, compared to what might appear from the legislation and the formal structures, the Reserve Bank has a significant degree of freedom in terms of operations.

Do you think that the law should be changed to reflect this?

The way I look at it, and also in the case of fiscal responsibility, is that the more important thing is to have an agreement on policy. If you have an agreement on the policy and there is respect for policy, then it has as good an effect as the law. If I could give you a simple example; in the past the Reserve Bank had been monetising government debt on an automatic basis, whereas now we have an arrangement where we don't monetise in the normal course of business. The case of the market stabilisation scheme is similar. There are many things on which the government and the Reserve Bank are in agreement with each other. That kind of autonomy is being practiced. Whether it is at some stage blessed in law or not is not a matter of immediate concern.

But will these distance reality from the law?

The draft law is already pending and the law will sanctify what we are practising. Law is only one part of the relation between the central bank and government. It is not as if one can go to court against the other. A great amount rests on respect for each other and possible reputational risk for violating the law.

In that case it must help having a former central bank governor as prime minister as well.

Well, actually the president of India is an old central banker too! We have a president who was on the board of directors, and a prime minister who was governor. So in some sense we feel our

position will be better appreciated in the government. In the other sense, there are a lot of people in the government who know a lot more about central banking than perhaps we do!

India suffered a few days of stock market and exchange rate turbulence following the elections in May. Could you give our readers a brief account of what happened in the markets? How did the Reserve Bank react?

It was a Friday and the markets were under some stress. On the Monday, May 17, I think there was a “circuit breaker” which came up in the morning when trading was suspended for a time because of excessive price volatility. Our major interest was financial stability. So we were watching to see if the market turbulence spilled over into the foreign exchange market, bond markets or the money markets. The first step naturally as the turbulence in the equity markets came up – we don’t have any view of the equity markets, that’s a different ballgame all together – was to ensure that there was no transmission of panic from the equity markets to the other markets.



Y.V. Reddy greets his predecessor as governor, Dr Bimal Jalan

How did you do this - through a statement?

Initially through foreign exchange intervention. Once we were pretty confident that there was no spillover into other markets, we wanted to make sure that the payment and settlement systems were not affected. And that is when the statement comes into the picture. We operated at three different levels. One is that our officials said to the settlement banks that if they had any problem, they’d better get in touch because we have a backstop facility available for providing liquidity. Having informed the relevant participants that we are available, then, in order to avoid panic, a statement was made which said that as far as liquidity was concerned: foreign exchange liquidity no problem, rupee liquidity no problem. The indication of our willingness and determination to ensure financial stability was communicated in different ways to the active players. And then followed a statement which carried credibility for the system at large. Any idea that we should relax any of the prudential regulations was disregarded initially, but at the end of the day, when the index was significantly lower, we took the step of reducing the margins prescribed for lending against shares. We had hiked the margins when we thought the stock market was going too high, in January, and that hike was removed. The normal margin level was restored the next day.

What was the effect on the market?

It had a soothing effect. It did not try to change sentiment in the equity markets – this is not our business. But the policy certainly ensured that the system reacted appropriately without any great loss of confidence and that liquidity of both foreign exchange and rupees was available. Financial stability was maintained. But we took no view on the equity markets – that is the main distinction we have to make. And it so happened that it was a time of political transition and our impression is that our measures have been very well received in the country and in the capital markets.

You note in the annual policy statement for 2004-05 that it is “essential to pursue fiscal consolidation.” Are you confident that this can be achieved in the timeframe and the government deliver a balanced budget in 2007-08?

There are three elements of fiscal adjustment. One is what we call fiscal empowerment; the government should be able to mobilise enough financial resources to discharge its functions. The second is the quality of fiscal adjustment, obtaining value for money in fiscal expenditures. And the third is the deficit. The deficit is one of the three pillars. When we talk of fiscal consolidation, there are three pillars to this. The Reserve Bank has been persistent in emphasising the importance of all three. Handling the fiscal deficit is not an overnight matter. We are looking at it the medium term.

The deficit at 9% is quite high.

Yes, it is somewhat high, but our domestic savings are also quite high. To that extent, there is no vulnerability. But certainly we would be a lot more comfortable with a lower deficit.

You were appointed last year. What goals have you set yourself – what do you hope to see in the Indian economy at the end of your mandate in 2008?

I would say first that we should be able to get some relief to the sheer large number of poor people in the immediate term. We can make a beginning in some way. True, the central bank does not have a central role in that but it does have a modest role to play. Secondly, the way I see it, India’s huge labour force is an asset provided you are able to impart the skills to them. These are not really integral to monetary policy, but I want to make sure that the various activities of the Reserve Bank help the process. □