Reserve Bank of India – Making a Difference to Everyday Lives

Dr. Duvvuri Subbarao, Former Governor, Reserve Bank of India

First of all, my sincere thanks to Professor Kailash Sarap and Dr. W.R. Reddy, Director General, NIRD&PR, for inviting me to deliver this special lecture in memory of late Shr. S.R. Sankaran, organized under the S.R. Sankaran Chair.

S.R. Sankaran - a Legendary Civil Servant

During my long career, I have had the privilege of giving many memorial lectures, but this one today is very special. All the previous lectures were in memory of notable people, for sure, but people I didn't know personally. But today's lecture honours the memory of a person I had known personally. Shri S.R Sankaran was a legendary civil servant who earned a formidable reputation for his uncompromising commitment to improving the lives of the poor and less privileged. He was, and remains, a role model for any civil servant who wants to ‘make a difference'. 'Making a difference' is indeed the theme of my lecture today; in particular, I will focus on how the Reserve Bank of India (RBI), which I had the privilege of heading for five years, makes a difference to the everyday lives of people in the country.

RBI - A Mysterious Institution

People usually think of the RBI as a mysterious institution, a monolith, housed in an imposing air-conditioned office building in central Mumbai, inside of which people do queer things unconnected with everyday life. This stereotype view is wrong and misleading; on the contrary, what RBI does makes a difference to everyday life even though people may not realize it.

Recalling his visits to rural primary schools while touring across the country as RBI governor, Dr. Subbarao said that school children used to innocently ask him, “Why don’t you print more money? If only you did that, India too would become a rich country.” This question is reflective of the widespread impression that all that the RBI does is print currency and all that the governor does is sign currency notes. Of course, the RBI prints and distributes currency, but it does a lot more besides. It formulates the monetary policy, it is the gatekeeper of the external sector, it regulates and supervises banks and other financial institutions and financial markets, it regulates the payment and settlement system, it is the bankers’ bank, it is banker also to the central government and state governments, and, more importantly, it plays a crucial role in the country's economic development.

RBI Making a Difference

What difference do these actions and policies of the RBI make? These actions and policies of the RBI influence the prices that people pay in the market, the interest they receive on their bank deposits, the EMI they have to pay on their house loans, on how easily they can transfer money from one bank account to another and indeed the quality of service that people receive in banks.

Making Monetary Policy

Even as this is a wide array of functions, the core responsibility of the RBI, like that of every central bank in the world, is to maintain price stability. Price stability does not mean constant prices. In fact, economies do need some inflation, but that inflation has to be low and steady. The main instrument that the RBI uses to achieve price stability is the interest rate, more particularly, the repo rate. The repo rate is the interest rate that banks are charged for their overnight borrowing from the central bank. By calibrating this single, short term interest rate, the RBI expects to guide and influence the entire interest rate structure in the economy. That in turn impacts demand and supply in the economy and thereby the inflation conditions.

The task of monetary policy is complicated by the fact that interest rate also affects growth and financial stability. The three objectives of price stability, growth and financial stability are congruent in the long term, but there could be some conflict in the short term. Thus, for example, stimulating growth might demand softer interest rates whereas combating inflation requires a tighter interest rate. The challenge of monetary policy is to optimize across all these goals so that the economy is on an optimal long term growth path.

To illustrate the dilemmas in making monetary policy, Dr. Subbarao recalled a town hall meeting that the RBI held in Chennai in early 2010. The occasion was the Platinum Jubilee celebrations of the RBI and the governor and deputy governors were on a nationally televised show answering questions on RBI and its functions from the town hall gathering. Midway through the meeting, Dr. Subbarao took an unscheduled audience poll as it were, asking people to chose between the two goals of low inflation and faster growth. The audience was equally divided. But even in that roughly equal division, there was a striking pattern. The younger people in the audience predominantly voted for growth while the middle class, middle aged people opted for inflation. This was to be expected. The younger people prioritized growth because they were looking for jobs and career progression whereas the middle aged people, largely weighed down by concerns about balancing household budgets, expectedly expressed a preference for inflation control. This division, he said, was illustrative of the judgement call that the RBI has to make in calibrating monetary policy to meet the conflicting demands and preferences of different segments of the population.

Dr. Subbarao referred to the inflation targetting framework adopted by the Reserve Bank during the tenure of his successor Governor Raghuram Rajan. Under this framework, RBI is enjoined to deliver inflation of 4 percent within a tolerance band of 2% on either side; in other words, inflation has to be in the range of 2%-6%, but centered around 4%. While commending the many benefits that an inflation targeting framework can potentially deliver, Dr. Subbarao expresses reservations about whether it will work effectively in India. According to him, inflation targeting framework is effective when inflation arises from demand pressures which is typically the case in mature industrialized economies. On the other hand, in India, inflation is more often triggered by supply shocks such as a spike in the global price of oil or rising food prices because of a drought or flood. Monetary policy is less effective in controlling inflation arising from supply side pressures which might pose challenges in delivering on the inflation target.

Dr. Subbarao added that it is too early to evaluate the efficacy of the inflation targeting framework adopted by the RBI and that we will have to see how it unfolds and operates when macroeconomic conditions turn challenging.

Printing and Distributing Currency

After outlining monetary policy challenges, Dr. Subbarao went on to explain RBI's function of printing and distributing currency. He said that in the past, central banks around the world conformed to the gold standard which meant that they issued currency only equivalent to the amount of gold reserves held by them. While the gold standard imposed discipline and delivered stability, in practice it proved to be too restrictive. After the Great Depression of the 1930s, central banks abandoned the gold standard with the result that the currency they now issue is 'fiat' currency – money not backed by gold or any other precious metal, but by the promise of the governor that the currency will be honoured. Dr. Subbarao also noted that the promise of the governor on the currency has significance; in some sense, it is an honour code for the RBI to maintain the purchasing power of the currency by ensuring that inflation does not get out of hand.

Demonetization - November 2016

Dr. Subbarao said that the currency printing and distribution function of the RBI came into high profile following the demonetization of high value currency by the government in late 2016. Piecing together all that’s been said and written, we now know that demonetization had four objectives—(i) to attack black money; (ii) to attack counterfeiting of currency notes; (iii) to attack crimes like terrorism and drug trafficking which were being financed by black money; and (iv) to encourage a shift from a cash-intensive economy to a cash-light economy.

Demonetization, Dr. Subbarao noted, attracted both intense criticism and enthusiastic praise. The critics said that demonetization was a thoughtless move as it brought India’s huge informal economy to a grinding halt affecting the livelihood of millions of people. The government plunged into demonetization without adequate preparation with the result that cash dried out even as people stood in lines for days on end to exchange the voided currency for legal tender. Besides, the critics argued, people who amassed black money hardly ever stashed it in the form of cash; they invariably converted it into gold or foreign currency or invested it in real estate. To believe therefore that demonetization would unearth black money was mistaken. On the other side of the spectrum, there were people who praised demonetization as a necessary strong arm measure to eliminate the huge cauldron of black money, which was at the root of all the corruption and poverty in the country.

Dr. Subbarao said that the question of whether demonetization was good or bad defies a binary answer. The economy paid huge costs – not only were millions of people subjected to enormous hardship and pain, but we also lost GDP growth roughly to the extent of a full percentage point. This was a huge sacrifice at a time when India in fact needed to accelerate its growth rate in order to reduce poverty.

The costs of demonetization, we have been told, were all in the short term; the benefits would flow in the medium term by way of faster growth, higher tax yields, lower corruption and improved service delivery. We will have to wait and see whether the cost benefit calculus of demonetization will, in fact, turn out to be positive.

RBI as the Regulator

Apart from being the monetary authority, the Reserve Bank is also a regulator. It regulates and supervises commercial banks, non-bank financial companies and large segments of the financial markets. There are other regulatory bodies in the financial sector: the Pension Fund Regulatory and Development Authority (PFRDA) for provident funds, Insurance Regulatory and Development Authority (IRDA) for insurance and Securities and Exchange Board of India (SEBI) for capital markets.

Regulation is informed by two objectives: preserving financial stability and protecting consumers. Straight forward as this might seem, regulation calls for mature judgement. Regulators, for example, can run a very tight system. That will preserve stability, but it will also choke innovation. On the other hand, they can run a *laissez faire* regime; that will encourage innovation and improve efficiency, but it can also expose the financial system to instability. Getting the right balance over time is the central challenge of regulation.

Development Objectives of RBI

The Reserve Bank has several development objectives. In order to ensure flow of credit to small borrowers and lead sectors, it mandates priority sector lending whereby banks are required to ensure that a minimum proportion of their overall lending goes to priority sectors like agriculture and small and medium industries. RBI regulates the lead bank scheme whereby credit flow is planned and monitored at the district level across all the districts in the country. Over the last twenty years, microfinance has grown and expanded, providing income earning opportunities to millions of low income families. Although not without excesses, India's microfinance has contributed to improving the livelihood of millions of families and importantly empowered women. RBI has played a lead role in nurturing, developing and regulating the microfinance sector.

Financial Inclusion

Finally, financial inclusion has been the flagship development programme of the Reserve Bank over the last decade. The objective is to provide access to the formal financial system to every household in the country. The starting point is to see that every household has a bank account. The primacy that the government attaches to the JDY (Jan Dhan Yojna) programme is indicative of the development gains that can come from financial inclusion. From the experience of the last several years, we have learnt a lot about how to further financial inclusion. Even as progress is satisfactory, the agenda ahead is huge and challenging. Financial inclusion means not just giving poor households a bank account, but also making sure that the bank account becomes opens up opportunities for improving incomes. The government and the RBI run a variety of schemes and offer a host of incentives to deepen financial inclusion. Those are all necessary, but what is also required in order to make financial inclusion an effective instrumentality for poverty reduction is that all the agencies and personnel involved in financial inclusion understand the sociology and psychology of poverty.

Keep Your Ear Close to the Ground

Recalling his association with former Prime Minister Dr. Manmohan Singh, Dr. Subbarao said that when he called on the former after being appointed governor, Dr. Singh gave him just one piece of advice—"keep your ear close to the ground". Dr. Singh told Dr. Subbarao that as governor of the RBI, it is possible to get lost in numbers and statistics such as credit growth, money supply and interest rates, and forget in the process, that there are real people behind every decision that the Governor makes. Every decision that the Governor makes affects the livelihood of millions of people across the country. It is important therefore, for the Governor to base his decisions not just on economic analysis and financial numbers, but also on an understanding of the grassroots situation in the country. In short, it is important to keep one's ears close to the ground.

It is this trait of keeping his ear close to the ground that made S R Sankaran the legendary civil servant that he was. He lived and worked by a demanding and uncompromising value system and left an enduring legacy. He remains a true role model for civil servants today.

About the Author

Dr. Duvvuri Subbarao served as Governor of the Reserve Bank of India for five years (2008-13). Prior to that, Dr. Subbarao was Finance Secretary to the Government of India from 2007-08 and Secretary to the Prime Minister's Economic Advisory Council 2005-07.

Dr. Subbarao joined the Indian Administrative Service (IAS) in 1972, topping the highly competitive civil services entry examination in that year. As a career civil servant, he worked in various positions in the state government of Andhra Pradesh and in the federal government of India. He was a Lead Economist in the World Bank (1999 - 2004).

Dr. Subbarao studied at the Indian Institute of Technology, Kharagpur and later at the Indian Institute of Technology, Kanpur. He went to Graduate School at Ohio State University and later was a Humphrey Fellow at MIT studying Public Finance.

Dr. Subbarao is currently a Distinguished Visiting Fellow at the National University of Singapore.