The book is a compilation of 23 speeches delivered by Y V Reddy during his five-year tenure (beginning September 2003) as Governor of the Reserve Bank of India (RBI). The period was eventful not for India alone but for the global economy as well. Reddy came in at a time when India’s economy was on a high growth path, getting progressively integrated with the surging global economy. His departure from the RBI had no less dramatic a backdrop, coinciding with the global meltdown. The impact of the meltdown has, however, not been as severe on India as it might have. And for this credit must go to a very large extent to the deity then presiding at the RBI.

The speeches selected give us an insight into the thoughts that had gone into formulating Reddy’s stance as the RBI governor on some of the important policy issues of the day. Though many of these have been in the public domain for long, they nonetheless have a very special significance. The speeches bring out, with clarity and transparency, the governor’s careful and judicious regulatory approach to developments in banking and in the financial markets, and his commitment to growth with stability. While no one questions the supremacy of the political government of the day, the fabric of a democratic polity can be preserved only if its key institutions discharge courageously the responsibilities reposed in them. Reddy deserves compliments for bringing out the relevant speeches so soon after his retirement, offering opportunities for public debate and discussions on the issues concerned.

**Leaning against the Wind**

Reading through the essays, especially in the light of the context that has been thoughtfully presented in each case, the major areas of differences with the political government of the day are easily discernible, though, in keeping with the traditions of a central banker, these have been couched in polite understatements. These differences were often, as Reddy puts it, “in the nature of creative tensions with a notable beneficial impact on the economy” (p 28). I would be doing injustice to the author if I did not highlight these differences.

First, liberalisation of the financial markets was a critical area where Reddy had been consistently advocating caution even as private financial market participants, egged on by the major Wall Street operators, had turned into strong lobbyists calling for rapid liberalisation on the plea that India was being denied the benefits of many new financial instruments that promoted efficiency in the markets. They were joined by operators in the real sector whose argument was that a cautionary policy was depriving them of the benefits of different types of financial instruments that could enable them to manage costs and risks better. The RBI and the government were both committed to a healthy development of the financial market, but Reddy, as governor, had been stressing, and quite often at that, on the need to maintain a proper balance between the different components of what goes on in the name of liberalisation. He was of the view that unless development of the domestic bond market was put on a firm footing, it would be premature to open it up to foreign investors. His particular concern was that, in the matter of the development of the bond market, the RBI, as the central bank of the country, had a stake, given its importance in the transmission of monetary policy and financing of infrastructure. In several areas, such as capital flows, the fiscal deficit and current account gap, there are well-known vulnerabilities in emerging market economies and the RBI was greatly concerned that we could be swept off our feet. It stuck to its conviction, even in the face of intense pressure from the political government to liberalise fast and thereby push up the growth rate. In hindsight, it is not difficult to visualise how pitiable a condition we would have found ourselves in if Reddy had succumbed!

The second issue, connected with discipline in the financial market as seen from the perspective of the central bank, was the rampant use (or misuse) of Participatory Notes (PNs). In 2003, the RBI had banned the operations of overseas corporate bodies of non-resident Indians in the Indian financial sector in view of the opacity of their activities. Expectedly, it was but logical for the RBI to make the next move, that is, to ban all inward investment flows that did not satisfy the “know your investor” criteria – the same criteria that were enforced on all transactions in the domestic financial sector. A hue and cry was raised when the RBI imposed an unequivocal ban on PNs (these notes are instruments issued by foreign institutional investors, or FIs, registered in India, but whose identities are surrounded by a good deal of opacity). The difference between the perception of the political executive and that of the RBI came out openly in the “Report of the Expert Group on Encouraging FII Flows and Checking the Vulnerability of Capital Markets to Speculative Flows” (appointed by the Ministry of Finance in September 2005). While the majority report accepted as unquestionable the investment and growth enhancing effects of FII flows, the view of the RBI, appended as a dissenting note, is worth noting:

...the issue of Participatory Notes (PNs) should not be permitted. In this context we should like to point out that the main concerns regarding the issue of PNs are that the nature of the beneficial ownership or the identity of the investor will not be known, unlike in the case of FIs registered with a financial regulator. Trading of these PNs will lead to multi-layering which will make it difficult...
to identify the ultimate holders of PNS. Both conceptually and in practice, restrictions on suspicious flows enhance the reputation of markets and lead to healthy flows. We therefore reiterate that the issuance of Participatory Notes should not be permitted.

**Conduct of Monetary Policy**

Third, conduct of monetary policy is an area where traditionally there have been differences between the government and the RBI on what is desirable and what is feasible. With the progressive globalisation of the Indian economy, in the real as well as financial sectors, it was not unexpected that differences would crop up between the ruling political regime pushing for as fast and as high a growth rate as possible, and the central bank responsible for ensuring that such growth proceeded within an acceptable inflationary regime and a stable financial environment. Of course, there was and could be no disagreement in principle on the broad objectives, but when it came to the nitty-gritty of specific policy measures, differences in perception were bound to occur. These should not be dismissed as mere technical differences; the differences are rooted in the way in which ruling political regimes perceive the course of development in their own country. Should the country follow in the footsteps of the systemically important economies in the world, in particular the US, in both style and substance? Should it follow an autonomous monetary policy and the kind of growth and price stability that go with it? Or should we opt for a nuanced approach, allowing for the opening up of the financial sector and liberalisation of the regulated framework, but continuing to persist with several interventions in the areas of lending and interest rates? The RBI’s thinking on this subject has been spelt out clearly in the speech titled “Globalisation of Monetary Policy and the Indian Experience” that Reddy, as the governor, delivered at the Bank of International Settlements in June 2005 (chapter 12).

Fourth, there were policy differences on the opening up of the banking sector soon after Reddy’s assuming office. The budget speech of the finance minister for 2003-04 announced a slew of proposals that indicated a fundamental shift in the ownership pattern of our domestic banking institutions. The existing regulation in the Banking Regulation Act, 1949 restricting voting rights to 10%, irrespective of the investor’s shareholding, was proposed to be done away with, signifying that, in government’s judgment, it was no longer necessary to cling on to the objective of diversified shareholding in commercial banks. The intention was to throw open the ownership of our domestic banks to foreign investors up to 74%.

Clearly, the government was bowing to the pressure from the global financial markets (with support from many of our gullible politicians), whose argument was that our banks should be made to face global competition and be forced to function under stiff competitive conditions at the global level, as otherwise they would remain adolescent institutions. Prima facie, a very laudable objective, but, inexplicably, the political government chose to leave unaddressed several vital concerns surrounding this. If our domestic banking sector is to stand on its own in an intensely competitive global market, should it not be given adequate time to develop appropriate business models? And most importantly, should not the government own up its responsibility of creating adequate preconditions that would enable the banks to come up to market expectations? Not doing what we are competent at, and instead invoking the assistance of foreign banks is an abdication of public responsibility in an area that is at the heart of our economic system. It was only right and proper that the RBI struck a dissenting note. The RBI governor stuck to his views; he brought out the concerns, openly and transparently, and created opportunities for them to be discussed on the basis of well argued and well documented policy papers. This to my mind is one of the many remarkable achievements that Y V Reddy has to his credit as an RBI governor.

**Independence and Accountability**

Against the background of these differences, the oft-debated issue of independence of the central bank comes up. It is well understood and well accepted that coordination between government and the RBI is a must, but this may not necessarily mean complete agreement in all matters. In a parliamentary democracy, where the political government is responsible for the decisions that it takes, there will necessarily be differences “in analyses, approaches, judgments and instrumentalities”, as Reddy explains (p 240). This has been the way the RBI has been functioning since its inception; de jure it has not been accorded the same kind of autonomy that central banks in some industrialised countries enjoy. Having said that, Reddy concedes that post-1991 reforms, the RBI is coming to enjoy a progressively higher degree of autonomy… Since 1991, there has been a gradual and mutually agreed-upon progress towards greater autonomy in matters relating particularly to financial markets and the conduct of monetary policy (p 240).

True, the RBI has gradually come to acquire much greater institutional pre-eminence than what it enjoyed in the earlier decades, thanks to the development of active financial markets and the practices of central banks in the systemically important economies. Since the reforms era began, successive governors made significant contributions towards redefining the role of the RBI as the dynamics of global financial markets kept changing constantly. Debates on independence and accountability of central banks have to be appraised in the specific economic and political contexts of the countries concerned.

At the extreme end we have Germany where certain principles of economic policy are as sacrosanct as central bank independence, a concept that has its origins in the hyperinflation of 1923. The principle behind independence is that the central bank would pursue a government mandated objective with discretion on how to achieve it. Today, the democratic legitimacy of central bank independence is being called into question. This contrasts with the past decade when adulation reached absurd proportions. In early June this year, German Chancellor, Angela Merkel, made a vitriolic attack on the world’s three biggest central banks, this in a country where the cardinal rule is that a chancellor should never discuss, let alone criticise, monetary policy. Such unconventional outbursts against economic theocrats are understandable: questioning central bank policies that have allowed to go unchecked excessive infusion of liquidity, fuelling the
creation of asset bubbles and encouraging excessive leverage within and beyond the financial sector, cannot but provoke redefinition of the roles and responsibilities of central banks. But, although central banks failed to prevent the crisis, the solution does not lie in political control: politicians’ lust for control is no guarantee of better economic management; they will remain, as always, too vulnerable to short-term pressures. In one of the speeches made in June 2008 at the Bank of International Settlements, Switzerland, Y V Reddy makes a prescient remark:

If a central bank does not enjoy independence, the question of its direct accountability will not arise. Broadly speaking, however, have central banks of late been tending to focus more on accountability to financial markets, by design or necessity, rather than to the government or the real sector or the public at large? (p 257, emphasis added).

**Strengthening Regulatory Reform**

In order to strengthen our systemic capability to counter any future crisis, a consensus has to emerge on two critical issues: first, how to catch and rein in potential bubbles before they threaten the whole system. This essentially boils down to the idea that regulation should focus much more on systemic risks instead of assuming that a sound system can be built simply by supervising individual institutions. In the financial system, problems with any individual institution can have externalities, particularly when these are large, interconnected and highly leveraged institutions. From all indications it appears that the next few months may see drastic changes in financial services regulations as the US, the United Kingdom and the European Union try to tackle the causes and the fallout of the global crisis. Plans are moving forward to tighten the rules on everything from hedge funds and over-the-counter derivatives to mortgages and basic bank capital requirements.

Second, recent events have underlined the need that a lead body has to be in place to receive feedback from a host of key institutions and regulators to keep a close and continuous watch over market movements and orchestrate the process of policy responses. EU leaders are considering plans to create a pan-European board to monitor systemic risks as well as a College of Supervisors that would provide for greater consistency among national bank supervisors and resolve disputes among countries. The UK is also having a fresh look at the problems of institutional co-ordination: Is the existing tripartite system that was set up more than a decade ago, dividing power among the Bank of England, the Treasury and the Financial Services Authority, adequate or should the Bank of England be invested with more powers, as its governor wants, so that it can act as the lead systemic regulator? Effective coordination among different regulatory authorities is an issue that is gradually assuming greater importance than ever before. In India some steps were taken to have a coordinating forum under the aegis of the governor of the RBI. What have been the experiences? Is this mechanism adequate? Does it need to be given more teeth? Is there any regulatory gap that needs to be filled urgently? The speeches selected do not cover these issues except in passing.

**Tending Our Garden**

The Epilogue in the volume stands apart from the rest of the book. Nonetheless it is a masterly survey of the global financial crisis, seen from the perspective of a very successful central bank governor who had the unique privilege of steering the bank in the initial stages when the crisis had started brewing. In his analysis of the macroeconomic factors that brought about the global meltdown, Reddy has enumerated a list of interrelated factors that in one way or another contributed to the crisis, but it seems to me that, in his discussion on regulatory lapses, he has been discreetly polite. The core of what happened has been put out in a no-holds-barred editorial in the *Financial Times*:

This was not a failure of markets. It was a failure to create proper markets. What is to be blamed is a certain mindset, embodied not least by Mr. Greenspan. It ignored a capitalist economy’s inherent instabilities – and therefore relieved policymakers who could manage those instabilities of their responsibility to do so. This is not the bankruptcy of a social system, but the intellectual and moral failure of those who were in charge of it; a failure for which there is no excuse” (emphasis added, 12 May 2009).

While most the world is still focused on stimulating growth, Asian policymakers are increasingly fretting about new bubbles. In many of the Asian economies, there are concerns about inflationary potentials. In recent quarters, China’s growth spurt, a piece of good news by itself, seems to be coming at a steep price. The centrepiece of China’s macroeconomic strategy is an enormous surge in infrastructure spending funded by a burst of bank lending. Just about two years ago, the Chinese premier Wen Jiabao had warned that the Chinese economy was becoming increasingly “unstable, unbalanced, uncoordinated and ultimately unsustainable” (*Financial Times*, 29 July 2007). Is that economy sowing the seeds for future bubbles?

China had ordered its banks to make sure their mammoth lending spree funnelled money into the real economy rather than equities or real estate. Vietnam has already asked its banks to cap their credit growth. The Bank of Korea has shown its concern about rising asset prices. In India, the RBI has raised its inflation forecast to 5% higher than its medium term 3% – a signal that it is no longer in pure stimulatory mode. Reddy’s word of caution on determining the magnitude of fiscal and monetary stimulus is well timed. “There is need”, he says, “to respect the underlying inflationary pressures that persist in India”. Public policy must be able to draw on its strengths, and resist the temptation, as he puts it, “to excessively focus on measures recommended by global fora and ignore the unique features of the Indian economy”. We must be conscious of our strengths, but remain equally alert, as he emphasises, to some of the creeping weaknesses in the real sector.

In discussing the future, Y V Reddy has politely and with humility hinted that what he has left behind is a fairly strong financial system. He can perhaps look back with satisfaction and rightfully claim that, but for the contra-cyclical policies that the RBI had been consistently following and the cautionary regulatory steps that it had taken during his stewardship, we might have found ourselves in a deep mess. The uncharitable remark about his being a congenital dissenter is just that – plain uncharitable!

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