Report of The Advisory Group on Transparency in Monetary and Financial Policies

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CHAPTER 1

INTRODUCTION

1.1 Developments in the international financial system and discussions on the international financial architecture have focused attention on the need to evolve sound standards. There is now increasing international convergence that transparency of monetary and financial policies is an important element in the evolution of such standards. Transparency is now regarded not only as an aspect of good governance and promoting credibility, integrity and, in the ultimate analysis, accountability for policies, but as a positive contribution to putting the operations of financial institutions on a sound footing. Indeed, the perceived lack of transparency has been suggested as a proximate cause of the South East Asian currency crisis of a few years ago. In this context the IMF evolved a *Code of Good Practices on Transparency in Monetary and Financial Policies* which was adopted by the *Interim Committee (September 1999)* and recommended its adoption by various countries. In order to deal with various aspects of relevance to India, the Reserve Bank of India (RBI) set up, in December 1999, a *Standing Committee on International Financial Standards and Codes.* A number of Advisory Groups were also constituted to go into specific aspects. The present Advisory Group on *Transparency in Monetary and Financial Policies* was set up with Shri M. Narasimham as Chairman and Shri S.S. Tarapore as member, with the following terms of reference :

(i) To study present status of applicability and relevance and compliance in India of the relevant standards and codes.

(ii) To review the feasibility of compliance and the time frame within which this can be achieved given the prevailing legal and institutional practices in India.

(iii) To compare the levels of adherence in India, *vis-a-vis*, industrialised countries and also emerging economies particularly to understand India's position and prioritise actions on some of the more important codes and standards.

(iv) To chalk out a course of action for achieving the best practices.

1.2 The Memorandum setting up the Advisory Group is at Annex I.

Methodology

1.3 The Advisory Group undertook a detailed scrutiny of the IMF Code of Good Practices on Transparency in Monetary and Financial Policies essentially from the viewpoint of India's compliance with the Code. The Advisory Group also had the opportunity of studying the *IMF Supporting Document to the Code of Good Practices on Transparency in Monetary and Financial Policies (May 2000).* In addition, the Advisory Group surveyed the experience of select countries in putting in place "best practices". The Group also made an assessment of India's compliance with these international standards and has chalked out a roadmap indicating how India could move towards conforming with these Codes. The Advisory Group recognised that its work would impinge on other Advisory Groups and in this context held discussions with some of the other Groups to have a better appreciation of the areas of overlap and the overarching of interrelated policies. Underlying the Advisory Group's approach is the need to adapt the Code to the particular circumstances in India and balance the benefits and costs of applying the Code in the Indian context. The Group recognises that the degree of transparency which would be desirable would need to be modulated to suit evolving market conditions and as such an attempt at excessive precision could be counterproductive.

1.4 The Advisory Group recognises that transparency is crucial for the stability and soundness of the financial system. The Advisory Group's examination is not merely in relation to the international code but to address some issues relating to extant legislation/regulations which may need to be altered to move towards a convergence with international codes. In some cases rapid adherence to international codes would be detrimental as the prerequisites of a well developed financial market are clearly lacking and, therefore, there is a need for phased measures.

Outline

1.5 The Advisory Group has attempted to chalk out a framework for transparency in monetary and financial policies to enable India to attain international standards. Chapter 2 examines the overall concept and content of transparency and attempts to outline the broad contours of transparency. Chapter 3 endeavours to undertake a critical evaluation of India's compliance with international codes. The experience of select countries is set out in Annex II. The *process* of policy formulation is discussed in Chapter 4 while Chapter 5 attempts to set out how greater transparency could be introduced in policy *formulation* which would enable a better evaluation of policies. The summary and recommendations are set out in Chapter 6.

Acknowledgements

1.6 The Advisory Group benefited greatly from the detailed interactions it had with Deputy Governor, Dr.Y.V.Reddy, who not only provided vital inputs into the thought processes of the Goup but also provided full support to the Group in its working. The Advisory Group is indebted to the large number of RBI officials who provided unstinted support to the Advisory Group. In particular, the Advisory Group would wish to convey its appreciation of the contributions by the Convenor of the Group Shri K. Kanagasabapathy (Adviser-In-Charge, Monetary Policy Department), Dr.Himanshu Joshi (Director, Monetary Policy Department), Smt.Shyamala Gopinath (Chief General Manager, Department of External Investments and Operations), Smt.Usha Thorat (Chief General Manager, Internal Debt Management Cell) and Shri Anand Sinha (General Manager, Department of Banking Supervision).

CHAPTER 2

OVERALL CONCEPT AND CONTEXT OF TRANSPARENCY

2.1 Traditionally, central banking policy formulation has been associated with an element of secrecy and indeed the hallmark of efficiency was often considered to be an unanticipated monetary policy. Such an approach was acceptable in a system where central banks were regarded as an arm of government and were not directly accountable to the public at large. Moreover, with tightly regulated systems, financial markets looked to the central bank for directions and markets behaved the way the regulators wanted them to function. But all this is changing. The world over it is being recognised that there is distinct advantage in the institution of autonomous central banks while the benefit of transparency is recognised generally. In the context of an autonomous central bank, transparency becomes imperative and in this context questions of transparency of policy formulation and operation and accountability have come to the fore. Adequate, timely and relevant information is a prerequisite for formulating effective policies. It is equally important for policy makers to be transparent in their operation so that uncertainties regarding intentions do not lead to destabilising market behaviour. With progressively freer markets, asymmetrical information between different participants in the market and between participants and the policy makers does not foster stability and soundness of the financial system. Financial institutions would be able to take rational decisions if they know the full background to policies and this would also help the better functioning of markets. While the policy maker cannot be expected to reveal the policy card ahead of policy action it is now generally accepted that well informed market participants contribute significantly to the improved functioning of markets and hence there is great merit in a conscious attempt to improve the extent of transparency in both policy formulation and operations. *Per contra,* opaque policies and ill-informed market participants contribute to sub-optimal policies and operations.

2.2 In the area of monetary and financial policies the need for greater transparency is set out in the *IMF Code of Good Practices in Monetary and Financial Policies* which emphasises the following four principles : (i) Clarity of roles, responsibilities and objectives of central banks and financial agencies. (ii) The processes for formulating and reporting of monetary policy decisions by the central bank and of financial policies by financial agencies. (iii) Making available to the public adequate information on monetary and financial policies. (iv) Accountability and assurances of integrity of the central bank and financial agencies. Effective transparency requires more than mere release of information; it requires an understanding of the analytical underpinning of policy action. Ultimately, the objective is not merely transparency but to improve the underlying content and quality of policies.

Concept of Transparency

2.3 The concept of transparency is contextual as it is intricately related to the legislative framework. For purposes of this Report, the Advisory Group has adopted the following concept of transparency. Transparency refers to an environment in which the objectives of policy, its legal, institutional and economic framework, policy decisions and their rationale, data and information relating to monetary and financial policies and the specifics of accountability of different agencies are provided to the public in an unequivocal and understandable manner and accessible on a timely basis. While good transparency practices for the formulation and reporting of monetary and financial policies help to contribute to the adoption of sound policies it should be added that transparency *per se* is not designed to offer judgment on the appropriateness or desirability of specific monetary or financial policies or their framework. The Advisory Group is of the view that the effectiveness of monetary and financial policies can be

strengthened if the goals and instruments of policy are known to the public and if the authorities can make a credible commitment to meeting these goals. In making available more information about monetary and financial policies, good transparency practices promote the potential efficiency of markets. Good governance calls for central banks and financial agencies to be accountable, particularly where the monetary and financial authorities are granted a greater degree of autonomy, and transparency enhances the credibility and integrity of the policy formulation process which should pass the test of public scrutiny. In making public the objectives of monetary policy, the central bank enhances the public's understanding of what it is seeking to achieve and it also provides a context for articulating its own policy choices, thereby contributing to a better appreciation of the monetary policy. Furthermore, by providing market participants with a clear perception of the considerations guiding monetary policy decisions, transparency about the policy process makes the monetary policy transmission mechanism more effective by ensuring that market expectations are formed more efficiently. By providing the public with adequate information about its activities, the central bank establishes a mechanism for strengthening its credibility by matching its actions to its public statements. Transparency by financial agencies, particularly in clarifying their objectives, also contributes to policy effectiveness by enabling financial market participants to better assess the context of financial policies, thereby reducing uncertainty in the decision making by market participants. Moreover, by enabling market participants and the general public to understand and evaluate financial policies, transparency is likely to be conducive to good policy making, which can promote systemic stability. Transparency would infuse confidence that decisions are taken in an objective manner even though they may be judgemental and discretionary. The obverse of transparency is full disclosure by market participants. Transparency should not be viewed as an end in itself but a necessary prerequisite of good governance as policy actions pass through, as mentioned earlier, the test of public scrutiny. Transparency should be viewed as a *post facto* phenomenon as it is not always possible for the authorities to share with the general public sensitive viewpoints and issues or give away advance information on policy action. Nevertheless, the importance of adequate communication for transparency to be effective cannot be over-emphasised.

Content of Transparency

2.4 The Advisory Group is of the view that clarity in the objectives of monetary policy is a prerequisite for any meaningful transparency in monetary and financial policies. It recognises that the objective of economic policy, of which monetary policy is a part, is the responsibility of government. The government, while setting out the framework of objectives, should, in the first instance, set out these objectives before the legislature and after approval by the legislature entrust to the central bank the task of attaining these objectives insofar as national policy is concerned. In this context it is important to clearly set out the *content* of transparency i.e. what should be disclosed by the central bank. While it is obvious that essential factual *data* inputs into the policy formulation should be disclosed, a question that arises is whether the *process* of decision taking should also be disclosed; this is particularly relevant as monetary policy has an element of judgement and discretion which could give rise to a diversity of views and also because there are complex and long lags in the impact of policies.

2.5 While viewing the feasibility of transparency it is useful to distinguish between objectives, strategy and instruments. It is universally acknowledged that there should be clarity while revealing the objectives but there are some concerns about the impact of greater transparency in revealing strategies and use of instruments. A mere articulation of objectives without some articulation of the strategies and choice of instruments would not help guide market expectations. Increased transparency in the setting out of strategies and the choice of instruments does have certain distinct advantages. The Advisory Group is of the view that greater transparency would compel the authorities to

bring about a greater degree of rigour in the formulation of strategies and choice of instruments and there are distinct advantages in a well-informed public debate on the objectives and instruments. When markets have a better appreciation of the central bank's strategy, economic agents can play a more effective role in equilibrating markets. Greater transparency in these areas can then be expected to bring about greater rigour in the process of policy formulation by the central bank, better public appreciation of policy decisions and more importantly a more expeditious policy transmission.

2.6 As the IMF Supporting Document points out, the focus of transparency practices should be on the *materiality* and relevance of information made available to the public. Moreover, transparency to be meaningful would require that conflicting regulations should be avoided. Again, the credibility of transparency would come under question if disclosures which are normally being made are held back on the ground that such disclosures could cause discomfort to the authorities.

Costs of Transparency

2.7 The benefits for countries adopting good transparency practices in monetary and financial policies have to be weighed against the potential costs. Where increased transparency in monetary and financial policies could endanger the effectiveness of policies, or be potentially harmful to market stability or the legitimate interests of supervised and other entities, it may be necessary to limit the extent of transparency. For instance, certain disclosures could adversely affect the decision-making process and the effectiveness of policies. Markets could be disrupted, the free flow of discussion by policy makers could be inhibited and there could be reluctance to formulate contingency plans. The Advisory Group recognises that there may be good reason for central banks not to disclose certain internal deliberations and documentation and near-term monetary and exchange rate policy implementation strategies. Additional concerns could be posed by some aspects of the transparency of financial policies. Moral hazard, market discipline and financial market stability considerations may justify limiting both the content and timing of the disclosure of some corrective actions and emergency lending decisions and information pertaining to market and entity specific conditions; illustratively, the central bank may not wish to contemporaneously make public its actions to prevent a panic run on a bank/institution, though *post facto* it would be a salutary measure to reveal its actions. Excessive insistence on transparency could encourage increased reticence in implementation of policies and the policy response lag could increase. In effect, the authorities have to display considerable finesse while drawing the line on disclosures.

2.8 While various factors may provide for legitimate caution in disclosures by the central bank, the Advisory Group cautions that these factors should not provide an excuse for opaque policies. In fact, the emphasis should be on making available to economic agents as much information as possible without disrupting markets and or individual entities.

Modulation of Transparency

2.9 The Advisory Group recommends that the monetary policy objectives, within the ambit of the broad mandate set by government with Parliament's approval, should be transparently set out in unambiguous terms. As regards strategies and choice of instruments the Advisory Group recommends that there should be a progressive movement towards greater transparency as ultimately it will elicit market support. The Advisory Group, however, does appreciate that excessive transparency regarding the future path of policy could be counterproductive; there is, nonetheless, merit in the central bank preparing the market to adjust to future policy changes by making available relevant information. Monetary policy is only an aspect of overall economic policy and, therefore, there is need for convergence in policies as also transparency in other aspects of economic policy.

CHAPTER 3

CRITICAL EVALUATION OF INDIA'S COMPLIANCE WITH INTERNATIONAL CODES

3.1 This chapter attempts a broad brush approach to evaluate critically the transparency of monetary and financial policies in India against the backdrop of the Code of Good Practices adopted by the IMF. The RBI's policies and operations largely conform to the IMF Code, but there are clearly a number of areas where improvements need to be made before India can be said to be fully compliant with the IMF Code. A code by code evaluation would not be meaningful and a holistic evaluation would provide a better focus on areas where changes are necessary.

3.2 Over the years the RBI has developed a tradition of providing extensive data on monetary and banking indicators, information on the external sector including liabilities and assets, exchange rates and exchange market operations, foreign exchange reserves and the RBI balance sheet. Extensive analysis is provided in its various reports which bear up well in comparison with similar reports released by central banks in developed countries. Moreover, the RBI, while announcing various measures, has progressively developed a practice of providing a detailed assessment of the macro economic backdrop and the rationale of its policies. Furthermore, the Governor and Deputy Governors in their speeches not only explain the extant policies but also explore issues at the frontiers of policy. The release by the RBI of the document *Macro Economic and Monetary Developments in 1999-2000* issued with the *Statement of Monetary and Credit Policy for 2000-2001 (April 27, 2000)* is a step in the right direction and the RBI should persevere with further improvements in such presentations. As such, in the area of *dissemination* of information and the *rationale* of policies the RBI could be considered as being in accord with international best practices though there could be scope for further improvement, especially in providing precision to the monetary policy mandate and revealing of the process of monetary policy formulation. The Advisory Group recommends that the process of communicating the policy process, albeit on a *post facto* basis, needs to be institutionalised. The Advisory Group is, however, of the view that there is a need for greater transparency in the *policy formulation process* which is discussed in some detail in the rest of this Report.

Constitutional/Legislative Issues

3.3 Before addressing the issues of transparency of the policy formulation process it is necessary to focus attention on certain structural issues which emanate from the Constitution and legislative matters relating to the RBI. Under the extant provisions it is the government which is accountable to Parliament and in turn the RBI is accountable to the government. The *National Commission to Review the Working of the Constitution* is, reviewing various aspects of the Constitution and, *inter alia,* issues relating to money and finance are also under consideration and as such the present Advisory Group has not attempted an examination of constitutional issues. The Advisory Group, however, hopes that the National Commission would, address the relevant constitutional issues as they apply to the RBI.

3.4 The RBI is not directly accountable to Parliament and as such any presentation by RBI before a Parliamentary Committee is only by way of a supportive role for government officials deposing before a Parliamentary Committee. It is only in the case of issue specific, rather than general, inquiries that RBI officials are directly summoned by Parliamentary Committees, in contrast to the United States where Congressional testimony by the Federal Reserve is the practice.

3.5 The preamble to the RBI Act entrusts the Bank with core objectives of (i) issue of bank notes, (ii) keeping of the reserves to securing monetary stability and (iii) operating the currency and credit system to the country's advantage. The RBI Act enjoins responsibilities to the Board on the maintenance of government accounts, the management of public debt, exchange management and control, formulation and implementation of monetary and credit policy, regulation and supervision of banks and non-bank financial intermediaries.

3.6 While the Act provides adequate powers to the RBI to use various instruments of monetary policy, there is no provision for a systematic and transparent setting of objectives of monetary policy. This is in keeping with the then prevalent ideas, at the time the RBI legislation was enacted, which did not include transparency. In the absence of a clear-cut legislation on the process of setting out monetary objectives, what has evolved is a system of vague and opaque objectives which, quite often, conflict with other arms of overall economic policy. Under the present system, the setting of objectives by the government to the RBI is not made public, and in fact is not even set out in a confidential exchange of written correspondence. The Advisory Group is of the view that there is need for a transparent setting of objectives of monetary policy by the government and if the government finds these objectives as having certain adverse effects it can always alter the objectives, but it should be done in a transparent manner and made public and placed on the Table of the House and the government should seek Parliamentary deliberation of the objectives. This would then reduce the possibility of counterproductive conflict between the government and the RBI.

3.7 The present RBI Act sets out, in rather general fashion the responsibilities of RBI regarding monetary policy. The Advisory Group emphasises that the present RBI Act is anachronistic and there should be an early move to amend the RBI Act to give sharper focus to the objectives of monetary policy. Transparency in monetary policy and greater responsibility and accountability for the RBI will be meaningful only if there is legislative amendment of the RBI Act to provide the necessary autonomy to the RBI to fulfil its responsibilities. Monetary policy is only one arm of economic policy and it necessarily has to be consistent with the overall economic policy which in the Constitutional set up is government's responsibility. In this context the Advisory Group recommends that the objectives of monetary policy should be set out by the government, as part of its overall economic policy package, and the government should be obliged to seek Parliamentary debate for these objectives as also any changes in these objectives thereafter. It is recognised that there could be a differentiation of strategic objectives for the longer-term and the shorter-term and at different times there may be a need to alter the relevant priority of one or other objective. There are merits and demerits in a single objective *vis-a-vis* multiple objectives but the essence is that the objectives, whatever they be, should be disclosed by the government and be reported to Parliament for consideration; this would make for a clear delineation of government and RBI responsibilities.

3.8 The RBI Act had been legislated in the context of tightly regulated and underdeveloped money, securities and exchange markets. The Advisory Group recommends that legislative changes should be considered to facilitate the emergence of an independent and effective monetary policy and ensure that market development can be fostered, unconstrained by legislative infirmities, while at the same time providing for expeditious adverse action by RBI to deal with violations of the regulatory framework.

3.9 The Advisory Group is of the view that under the RBI Act, the RBI should be given a clear and explicit mandate and then be held responsible for the use of instruments of monetary policy to achieve those objectives. While delineating the responsibilities of the RBI the Advisory Group is of the view that it would be necessary to provide, through legislative amendments, reasonable security of tenure to the Top

Management of RBI. This is essential if the RBI is to be clearly assigned specific responsibilities in the conduct of monetary policy and be accountable for the same to the wider public.

3.10 The Finance Minister Shri Yashwant Sinha in his Budget Speech for 2000-01 has said :

> "In the fast changing world of modern finance it has become necessary to accord greater operational flexibility to the RBI for conduct of monetary policy and regulation of the financial system. Accordingly, I intend to bring to Parliament proposals for amending the relevant legislation."

The Advisory Group is gratified to note this commitment and urges that early action should be taken on the intention set out in the Budget Speech to amend the relevant legislation to accord greater operational flexibility to the RBI for conduct of monetary policy and regulation of the financial system.

CHAPTER 4

PROCESS OF MONETARY POLICY FORMULATION

Fiscal Responsibility Act

4.1 There is a strong interaction between the RBI's responsibilities in the areas of monetary policy and internal public debt management. With the large fiscal deficit in recent years and the consequent large market borrowing programme of the government, there has been, for many years, an overarching of debt management policy on monetary policy. The large monetisation of the fiscal deficit and below market clearing interest rates on government paper significantly attenuated the effective functioning of monetary policy. In the process, the monetary policy function has become somewhat subservient to debt management. This is compounded by the fact that the RBI statutorily acts as the fiscal agent of the government in managing the public debt. In such a system there could be overt or covert pressures from the government to monetise the debt, to accommodate the borrowing programme by easing liquidity and softening interest rates.

4.2 Assigning the debt management policy function to the RBI puts the RBI into a direct conflict of interest situation as between debt management and monetary policy. In such a conflict it is the effectiveness of monetary policy which is a casualty. Interest rates are one of the most powerful instruments of monetary policy and the Advisory Group recommends that the determination of interest rates should be exclusively a monetary policy function.

4.3 The Advisory Group hopes that the proposed legislation for a Fiscal Responsibility Act would, *inter alia,* clearly delineate the responsibilities of fiscal policy and monetary policy. Transparency in fiscal policy and monetary policy are clearly interrelated. In this sense, autonomy of the RBI is the obverse of a Fiscal Responsibility Act.

Separation of Debt Management and Monetary Policy

4.4 A majority of central banks are prohibited from participating in the *primary* issues of government debt and it is time that the RBI falls in line with this general practice. The Advisory Group recommends that there should be well calibrated legislative measures to separate debt management and monetary policy functions.

4.5 The Advisory Group urges that the government should set up its own independent *Debt Management Office* to take over, in a phased manner, the present debt management functions discharged by the RBI. The payments and settlement function should, however, continue with the RBI. The separation of debt management and monetary management would bring about greater transparency and more effective monetary management as the RBI would then orient its use of instruments to meet the monetary policy mandate set out to it rather than the present situation in which debt management overarches on monetary management. The Advisory Group recognises that separation of debt management and monetary policy is a necessary but not a sufficient condition for an effective monetary policy which would also require a reasonable degree of fiscal responsibility.

Transparency, Accountability and Autonomy of the RBI

4.6 The traditional argument in favour of an autonomous central bank is that the power to spend should be separated from the power to create money. The type of autonomy which is required would be one where the central bank would periodically report to the legislature in contrast to a situation wherein its policy decisions are under continuous scrutiny by the government. The Advisory Group is of the view that what the RBI needs, by way of autonomy is headroom to operate monetary policy and this it would have once debt management is separated from monetary policy and the fisc is

in reasonable balance. The RBI would continue to have a role in maintaining orderly conditions in the government securities market by operating in the *secondary* market *via* its open market operations which is an important instrument of monetary policy.

4.7 The RBI would need to prepare itself for the details of transparency. While the devil is in the details this should by no means inhibit the RBI from accepting the challenges posed by increased transparency. In this context the RBI and government should evolve a blueprint for the process of monetary policy formulation. The Advisory Group recommends that over a phased period as debt management is gradually distanced from monetary policy the government and RBI should progressively work towards greater clarity in publicly setting out the *objectives* of monetary policy. The RBI should evolve a move to greater transparency is setting out the *process* of monetary policy formulation so that accountability of the RBI can be properly assessed. Again, during the phased period the RBI should sharpen its instruments to make them effective and in particular it needs to hone its skills of open market operations.

Single Versus Multiple Objectives

4.8 There is great comfort in a multiple objective approach in that precision is not required in defining the objectives and the RBI in turn does not have much accountability as it juggles with the almost impossible task of fulfilling contradictory objectives and as such accountability is blurred. The Advisory Group recommends that with a view to moving towards a more transparent system it would be best to veer towards prescribing to the RBI a single objective while the government could have for itself a clearly set out hierarchy of objectives for which it could use its other instruments of policy. Indian monetary analysis and the public perception thereof suffers greatly from the ailment of contradictory principal objectives. For instance, as a large continental economy great store is laid, and appropriately so, on the independence of monetary policy but at the same time we expect to have an independent exchange rate policy. Basic monetary analysis would indicate that a country that wants an independent monetary policy cannot have an independent exchange rate policy and *vice versa.* Again, there is a popular belief that both interest rates and money supply can be controlled. There is a confusion of instruments and objectives and the Advisory Group recommends that, apart from erudite analysis, which is incomprehensible to the public at large, there is much merit in the authorities clarifying issues in monetary and financial policies in simple language intelligible to the general public.

4.9 The conflict of single versus multiple objectives can be resolved by a refocussing on objectives and instruments. Illustratively, in a multiple objective approach a government would like to achieve a high real growth rate, a low inflation rate, a large market borrowing programme, a low interest rate, moderate growth of money supply a healthy growth of foreign exchange reserves and a rock stable exchange rate. If indeed such a mix of objectives is set for the RBI there would be a complete obfuscation of objectives and transparency would be absent and as such accountability would suffer. It should, however, be possible to set out a *single* monetary policy objective and the other ancillary objectives can provide a backdrop for the government against which the single objective could be set for the RBI. Illustratively, the government can, as is done in the UK and New Zealand, unequivocally set out to the RBI a medium-term inflation objective, say over a prospective three year period, and while fixing this objective take cognisance of other objectives and the government can retain the right, with Parliamentary endorsement, to reset the single objective in the light of evolving developments. What is important, however, is that the initial statement and consequent resetting of the objective should be done transparently and the rationale of the change should be fully explained. For instance, a war or a devastating drought or other major natural calamity or a severe external shock could warrant the resetting of the single objective. For purposes of credibility, however, frequent resetting of the objective, for a particular period, should be the exception rather than the rule. If the issue regarding the

objective of monetary policy is satisfactorily resolved, the stage would be set for greater transparency in the *process* of monetary policy formulation. For this process to be meaningful it would, however, be imperative for the government to ensure transparency in the setting out of objectives of overall economic policy.

CHAPTER 5

TRANSPARENCY IN POLICY FORMULATION

5.1 The Advisory Group appreciates the fact that the transitional path to greater transparency, accountability and autonomy in monetary policy would not be without problems but the benefits in terms of efficiency of monetary policy are so great that such a transition necessarily has to be made. India is not a unique case facing transition problems. The Advisory Group, after studying the working of the monetary policy formulation process in a number of countries, has come to the conclusion that the US, UK and South Africa experience holds considerable relevance to the Indian situation. The Advisory Group recognises that it would be neither feasible nor desirable merely to mimic the policy formulation process in other countries. The RBI should have a well defined monetary policy formulation framework with the procedures being clearly laid out. This would also need a viable institutional framework within which monetary policy decisions are made in a transparent manner.

Constitution of a Monetary Policy Committee

5.2 The present RBI Act does not provide for any Monetary Policy Committee and it would not be possible, under the extant legislative framework, to set up a Committee independent of the RBI Board. It would, however, be possible to take a cue from the institutional framework worked out while setting up the *Board for Financial Supervision* (BFS). The Advisory Group recommends that, even without any legislative changes, the RBI should set up a *Monetary Policy Committee* (MPC) as a Committee of the RBI Central Board. There could be a seven member MPC consisting of the Governor, the three Deputy Governors and three other members drawn from the RBI Central Board; concerned Executive Directors and Departmental Heads dealing with monetary policy, internal debt, exchange rate management and economic analysis could be permanent invitees. The tenure of non-executive MPC members could be coterminous with that of the Central Board Directors, i.e. four years, with a clause for reappointment. There should be a convention under which the members are appointed for different periods to ensure periodic new appointments while ensuring continuity. The members of the MPC should be knowledgeable in the areas of macro economics, monetary analysis, central banking policy and operations and banking and finance. More importantly, to ensure against any conflict of interest, the three Board members who would be on the MPC should be independent professionals. It would be desirable to *ab initio* delineate the role of the non-executive members *vis-a-vis* the executive members; moreover, the question of information access and staff support as between non-executive and executive members should be addressed upfront to head off any inherent conflicts. The Advisory Group recommends that the MPC be set up early so as to give the MPC some time to work out its modalities and to undertake a few trial runs before the formal procedures are put in place starting from say the next financial year.

Setting of Objectives and Instruments of Monetary Policy

5.3 An increasing number of central banks have adopted inflation targeting as their ultimate policy objective and there is greater transparency in such countries as objectives and performance gain greater credibility. Monetary policy, however, works with relatively long lags of 18-24 months and hence the policy has to be formulated based on an assessment of conditions which are expected to prevail 18-24 months after the policy is announced. The appropriateness of monetary policy cannot be judged by the current situation. Given the monetary policy lag, the need for preemptive action is not easily appreciated and, therefore, the RBI has to effectively communicate to the public that its policy actions are to have prospective relevance. While *ex post* transparency is a precondition for assessing accountability, what is also vital is *ex ante* transparency in that

the RBI needs to explicitly state what it is setting out to achieve and the instrumentality of attaining the objectives. It is, however, legitimate to surprise markets with unanticipated policy action. The Advisory Group recommends that the Government of India should consider setting out to the RBI a single objective for monetary policy viz. the inflation rate, as has been done by a number of governments abroad. The inflation rate target could be defined, illustratively, as an average over say a three year period starting from a back year. The inflation target should be a range, say an average over a stipulated period and with tolerance limits and when the inflation rate is outside the tolerance limits it should warrant a tightening or relaxation of monetary policy as appropriate. While setting the inflation target it would be best to use the inflation rate as reflected in, say the Wholesale Price Index (WPI) the terms of which are widely understood. The principal objective should be clearly set out to the RBI by way of a *public* statement as to the responsibility of the RBI. While doing so, the government could also make public its other objectives which have been taken into account while setting out the principal objective of monetary policy.

5.4 The Advisory Group recommends that once the single objective is set out, the remit of the MPC would be clear and the RBI should be given unfettered *instrument* freedom and held fully accountable for attaining this objective. The RBI should not be held accountable for the other objectives though the government should retain the right to alter the principal objective in the light of unfolding developments. The credibility of the entire exercise would, however, require that the resetting of the principal objective is undertaken only under exceptional circumstances and with a transparent public statement giving the rationale for resetting the principal objective.

5.5 If the principal objective is set out in terms of an inflation mandate, and the RBI is able to achieve it, this would be the best contribution that monetary policy could make towards longer term stable growth of the economy. Again, keeping the inflation rate low would contribute to exchange rate stability. In this sense the principal objective approach would be quite consistent with the attainment of other objectives of overall economic policy viz. growth and exchange stability.

5.6 There is some merit in having an overriding provision under which the government can give a directive on monetary policy to the RBI but this should be in writing and in specific terms, and applicable for a specific period; this should require Parliamentary endorsement after being placed on the Table of the House.

Procedures of the MPC

5.7 The Advisory Group suggests that there should be a *monthly* meeting of the MPC on a predetermined date, such as the last Wednesday of the month. The Committee of the Board has a tradition of a predetermined weekly meeting. To facilitate the deliberations of the MPC the RBI should undertake the preparation of position papers on monetary policy, debt management, external sector developments and the overall macro economy. The RBI has, over time, progressively tried to hone its analytical skills and while it would be difficult immediately to emulate the depth of analysis, as in say the UK, or the US, the RBI can progressively enhance its capabilities so that in a 3-5 years period it should be able to come upto the best international standards of analysis and disclosure of the policy process.

5.8 With monthly meetings of the MPC a convention should develop wherein the RBI should time its measures immediately after the MPC meeting and even when no measures are envisaged there should be a short statement on the decisions of the MPC immediately after the meeting. It would be desirable to avoid, as far as possible, policy action in between MPC meetings so that the markets are not in a state of perennial suspense; of course in unusual circumstances the RBI should retain the freedom to act between two MPC meetings.

5.9 As stated earlier the MPC would be a Committee of the Central Board and in the ultimate analysis the Central Board would bear the responsibility for RBI actions. The

Advisory Group would urge that the RBI should develop a healthy tradition of accepting the recommendations of the MPC save in very exceptional circumstances and in such cases the RBI should publicly justify its actions.

5.10 A legitimate question that arises is what should be disclosed by the MPC. It is clear that the facts should be disclosed but for credibility, the Advisory Group is of the view that there should also be a gradual revealing of the course of discussions leading up to the formulation of policy and there should be timely release of this information as is done in the US, the UK and certain other countries. While undertaking such disclosures there has to be finesse to ensure against market disruption as a result of disclosures. Ultimately, market depth and resilience and greater disclosure are interactive and the thrust should be on working towards greater transparency, but such a move could be well calibrated over the next 3-5 years.

5.11 While a short statement should be issued immediately after the meeting of the MPC, the Advisory Group recommends that if the MPC is set up say in 2000-01, the minutes of the meeting of the MPC should be made public from 2001-02 twelve weeks after the meeting; with satisfactory experience the lag could be gradually reduced to eight weeks from 2002-03 and to four weeks from 2003-04. From 2001-02 there should be a very brief release of the minutes giving the broad thrust of the discussions and the decisions. From 2002-03 the minutes could be made somewhat more detailed. From 2003-04 the minutes should be not only more detailed but reveal the number of votes for or against key decisions and the alternative viewpoints should be revealed anonymously. The Advisory Group recommends that after sufficient experience is gained, and the assessment is that greater transparency in setting out differences in views and the rationale expressed by members would not be disruptive, at an appropriate future date, the individual names of member of the MPC for or against a decision could be revealed. Meanwhile what could be revealed is how the official and non-official members voted. The working of the MPC should be seen as a *collegiate* approach rather than a *hierarchical* approach. The minutes and related documents which are put in the public domain should contain, apart from the decisions, the key assumptions and rationale of policies. The Advisory Group recognises that the extent of disclosure would need to evolve in keeping with the changes in the policy formulation process. It is essential to ensure that transparency *per se* does not inhibit the free flow of deliberations in the MPC and, therefore, the extent to which the proceedings are made public would need to be undertaken with due finesse and in a phased manner.

Transparency in Other Financial Policies

5.12 The present Advisory Group is conscious of the fact that the RBI has set up a number of other Advisory Groups which would, *inter alia,* deal with regulation and supervision, accounting disclosures etc. Since the terms of reference of the present Advisory Group cover monetary *and* financial policies the Group has also given some attention to those policies which have a bearing on monetary policy. The importance of adequate transparency and disclosure in the financial system has come to the fore particularly after the East Asian currency crisis where opacity in the banking sector was clearly identified as a contributory factor to the crisis. As mentioned in an earlier Chapter transparency is the obverse of disclosure, and just as it is necessary for regulators to be transparent, it is equally incumbent on the regulated institutions to be transparent. Internationally, there is a strong consensus emerging in favour of greater disclosure of the components of capital funds, accounting policies, valuation and the emphasis on risk management, assessment of capital adequacy on a consolidated basis and the internal capital allocation process. In this connection the BIS has set out several standards on supervision, transparency, loan accounting and disclosure practices, risk disclosures and accounting standards. While these issues would no doubt be considered in detail by other Advisory Groups, the

present Advisory Group recognises that these matters will impinge on monetary policy. Improved disclosures are a complement to the regulatory/supervisory process and ultimately provide for less supervisory intervention.

5.13 While the BIS *New Capital Adequacy Framework* is still under consideration the Advisory Group is appreciative of the fact that the RBI has applied itself purposefully to assess the impact of the proposed new norms for emerging countries and the need for caution while implementing these norms; moreover, the RBI has publicised its views on the matter to enable a wider understanding of the implications of the *New Capital Adequacy Framework.* This is in keeping with the move towards greater transparency.

5.14 The focus on disclosures is essentially from the perspective of the audited accounts. The Advisory Group is, however, of the view that there is inadequate attention to disclosure of *supervisory* information which could become a vital instrument of market discipline. Banks and other financial institutions owe it to their depositors to provide relevant information on performance in simple language easily understood by depositors. The present disclosure standards in India can, by no means be considered to be satisfactory. While stressing the need for greater disclosure the Advisory Group recognises the need for legitimate protection of proprietorial information. The need for greater disclosure becomes particularly relevant as there would, in future, be increased emphasis on capital requirements based on internal risk assessment.

5.15 The Advisory Group stresses that where there is regulatory forbearance it should be undertaken transparently. The Advisory Group stresses that as far as possible the regulatory regime should be rule based with minimum of discretion. Such a regime would obviously reinforce transparency. Excessive discretion is the antithesis of transparency.

5.16 An important issue relates to the transparency aspects of adverse action by the supervisory authority. Supervisory information is contained in Inspection Reports, ratings by the supervisor and formal enforcement actions taken, including the imposition of penalties, specific recommendations to management for action to curb risk taking and reduce costs etc., to turn around a bank under what is sometimes called a *Prompt Corrective Action Regime.* While such communications by the supervisor are not in the public domain, suffice it to indicate that since the early nineties in the US, the regulatory agencies are required to make public all formal enforcement actions imposed on banks. The experience has been that while such disclosures do have an impact on the volume of business of the concerned banks the disclosures have not been destabilising. In fact, these disclosures allow market discipline to work more effectively which adds to credibility and confidence in the system. While the US experience does not appear to have been replicated elsewhere, and publication of supervisory information is still being debated, suffice it to note that such disclosures are made to good purpose in Chile.

5.17 The Advisory Group commends the recent RBI initiative to release a *Discussion Paper on Prompt Corrective Action* (PCA) and it is hoped that after receiving appropriate feedback the RBI would put in place a PCA regime as part of a commitment to adopt the international best practices and comply fully with the *Core Principles of Supervision.* The PCA would, *inter alia*, cover parameters on the capital to risk assets ratio (CRAR), net non-performing assets (NPAs) and return on assets (ROA).

5.18 A pertinent issue is whether information on adverse action by the supervisor can be held back from the market. While supervisors would be wary of disclosing adverse actions, there would inevitably be certain signals which cannot be prevented from reaching the market. First, there could be leakage of information from within the concerned banks. Secondly, restrictions imposed by the supervisor could be discussed by market participants as portfolios change and the impact of various cost cutting measures cannot but be in the public domain as the banks comply with the supervisor's instructions. Thirdly, in the case of a bail out by the authorities it is difficult to envisage that it would be possible to keep such action under wraps. It is conceivable that proper

disclosure by the supervisor and the concerned banks would have less destabilising effects as against overreactions by markets based on speculative and incomplete information on the content of adverse action. The Advisory Group, therefore, urges that the regulatory/supervisory authorities in India should give early consideration to introducing, in a phased manner, a practice of disclosure of adverse action. The Advisory Group stresses that with predominant public ownership it is important to avoid the pitfalls of *regulatory capture* and this would, to some extent, be avoided by disclosure of adverse action. Moreover, in a situation where public ownership provides an anchor against panic reactions, disclosures *per se* are unlikely to be dislocative; on the contrary disclosures could have a salutary effect of strengthening the overall system by putting such information in the public domain.

5.19 While there are fears that disclosure of adverse action can have a systemic fall-out, the Advisory Group is of the view that so long as adverse action is taken at the incipient stage of infringement, and is seen to be objective and non-discriminatory the adverse action would be mild and would not have systemic dangers. The Advisory Group recommends that when penalties are imposed, however small, they should be publicised; minimal but timely adverse action would alert all stakeholders viz. owners, depositors and employees and there would be early convergence to least cost remedial action.

5.20 The regulator/supervisor has to ensure that a period of good macro economic performance does not create a euphoria which results in a dropping of the supervisory guard to ignore the requirements of prudential management. It is necessary to recall the old adage that *bad loans are made in good times.* The Advisory Group emphasises that a cardinal principle of sound regulation/supervision should be that it should never be varied over the business cycle. It is entirely a monetary policy function to deal appropriately with the business cycle. *Per contra,* monetary policy should not be diluted to make it less costly for financial intermediaries to comply with prudential norms.

Transparency in the Interaction of Exchange Rate and Monetary Policies

5.21 Monetary policy and exchange rate policy are closely inter-related and as already indicated these two segments of overall economic policy are mutually driven. In terms of transparency, the setting out of the principal objective of monetary policy would, in a sense, also provide the broad contours for exchange rate policy. The Advisory Group appreciates the sensitivities associated with exchange rate policy and it is recognised that the RBI does put out a significant amount of information on exchange rates and the management of the foreign exchange reserves. The RBI makes available daily information on exchange rates, turnover in the forex markets, including forward transactions, and also releases weekly data on movements in the foreign exchange reserves. Information is also released in the *RBI Monthly Bulletin* on the Nominal Effective Exchange Rate (NEER) and the Real Effective Exchange Rate (REER). Moreover, as indicated above, the RBI has for many years been publishing monthly information on the gross intervention (purchases and sales) and the position regarding net forward liabilities; in fact on this latter aspect the RBI has to its credit a long history of transparency of forex operations, far beyond that in a number of developed countries. This is an instance where Indian practices are ahead of international "best practices". The Advisory Group is of the view that the Indian disclosure standards compare favourably when considered against the *disclosure template* set out in the BIS Report on *Enhancing Transparency Regarding the Authorities Foreign Currency Liquidity Position* (September 1998). The Advisory Group recommends that the RBI should continue to be in the *avant garde* on disclosure of forward liabilities. Revealing the maturity pattern of forward liabilities would help stabilise market reaction to variations in the reserves resulting from maturing forward purchases/sales.

5.22 While recognising these commendable efforts the Advisory Group recommends that the efficiency of the forex market would be greatly enhanced if, without in any way

compromising the freedom of action on exchange rate policy, the RBI were to reveal on a regular basis, separately, its direct and indirect intervention operations.

Integration of Financial Markets and Transparency of Monetary Policy

5.23 *The Committee on Banking Sector Reforms* (April 1998) had stressed the need for integration of the money, securities and forex markets and that to enable the various segments to function well they should be seamless and changes in one segment should have an impact on other segments. Over the years, particularly after the submission in 1987 of the *Report of the Working Group on the Money Market,* a series of measures have been taken to bring about a progressive integration of financial markets. The Advisory Group is of the view that for an effective transmission of monetary policy the changes in the various segments of the financial markets should be allowed to traverse freely through different segments of the financial markets.

CHAPTER 6

SUMMARY AND RECOMMENDATIONS

The Advisory Group has set out a inter-lined package of recommendations to enable India to move towards attaining internationally accepted best practices on transparency in monetary and financial policies. These recommendations would need to be properly sequenced and implemented over time.

Overall Concept and Context of Transparency

1. For purposes of this Report, transparency refers to an environment in which the objectives of policy, its legal, institutional and economic framework, policy decisions and their rationale, data and information relating to monetary and financial policies and the specifics of accountability of different agencies are provided to the public in an unequivocal and understandable manner and accessible on a timely basis. Transparency should not be viewed as an end in itself but a necessary prerequisite of good governance as policy actions pass through the test of public scrutiny (Paragraph 2.3).
2. The government, while setting out the framework of objectives, should, in the first instance, set out these objectives before the legislature and after approval by the legislature entrust to the central bank the task of attaining these objectives (Paragraph 2.4).
3. The Advisory Group is of the view that greater transparency would compel the authorities to bring about a greater degree of rigour in the formulation of strategies and choice of instruments and there are distinct advantages in a well-informed public debate on the objectives and instruments (Paragraph 2.5).
4. The Advisory Group recognises that there may be good reason for central banks not to disclose certain internal deliberations and documentation and near-term monetary and exchange rate policy implementation strategies. The authorities have to display considerable finesse while drawing the line on disclosures (Paragraph 2.7).
5. Monetary policy is only an aspect of overall economic policy and, therefore, there is need for convergence in policies as also transparency in other aspects of economic policy (Paragraph 2.9).

Critical Evaluation of India's Compliance With International Codes

6. The RBI's policies and operations largely conform to the IMF Code, but there are clearly a number of areas where improvements need to be made before India can be said to be fully compliant with the IMF Code. In the area of dissemination of information and the rationale of policies the RBI could be considered as being in accord with international best practices though there could be scope for further improvement, especially in providing precision to the monetary policy mandate and revealing of the process of monetary policy formulation. The Advisory Group recommends that the process of communicating the policy process, albeit on a post facto basis, needs to be institutionalised (Paragraphs 3.1 and 3.2).
7. The Advisory Group hopes that the National Commission to Review the Working of the Constitution would address the relevant constitutional issues as they apply to the RBI (Paragraph 3.3).
8. The Advisory Group is of the view that there is need for a transparent setting of objectives of monetary policy by the government and if the government finds these objectives as having certain adverse effects it can always alter the objectives, but it should be done in a transparent manner and made public and placed on the Table of the House and the government should seek Parliamentary deliberation of the objectives. This would then reduce the possibility of counterproductive conflict between the government and the RBI (Paragraph 3.6).
9. The Advisory Group emphasises that the present RBI Act is anachronistic and there

should be an early move to amend the RBI Act to give sharper focus to the objectives of monetary policy. Transparency in monetary policy and greater responsibility and accountability for the RBI will be meaningful only if there is legislative amendment of the RBI Act to provide the necessary autonomy to the RBI to fulfil its responsibilities. The objectives of monetary policy should be set out by the government, as part of its overall economic policy package, and the government should seek Parliamentary approval for these objectives as also any changes in these objectives thereafter, which should be in the public domain (Paragraph 3.7).

10. The Advisory Group is of the view that it would be necessary to provide, through legislative amendments, reasonable security of tenure to the Top Management of RBI. This is essential if the RBI is to be clearly assigned specific responsibilities in the conduct of monetary policy and be accountable for the same to the wider public (Paragraph 3.9).

11. The Finance Minister Shri Yashwant Sinha in his Budget Speech for 2000-01 has said :

> "In the fast changing world of modern finance it has become necessary to accord greater operational flexibility to the RBI for conduct of monetary policy and regulation of the financial system. Accordingly, I intend to bring to Parliament proposals for amending the relevant legislation."

The Advisory Group is gratified to note this commitment and urges that early action should be taken on the intention set out in the Budget Speech to amend the relevant legislation to accord greater operational flexibility to the RBI for conduct of monetary policy and regulation of the financial system (Paragraph 3.10).

Process of Monetary Policy Formulation

12. The Advisory Group recommends that the determination of interest rates should be exclusively a monetary policy function. There should be well calibrated legislative measures to separate debt management and monetary policy functions. The government should set up its own independent Debt Management Office to take over, in a phased manner, the present debt management functions discharged by the RBI. The Advisory Group recognises that separation of debt management and monetary policy is a necessary but not a sufficient condition for an effective monetary policy which would also require a reasonable degree of fiscal responsibility (Paragraphs 4.2, 4.4 and 4.5).

13. The Advisory Group is of the view that what the RBI needs, by way of autonomy is headroom to operate monetary policy and this it would have once debt management is separated from monetary policy and the fisc is in reasonable balance. Over a phased period, as debt management is gradually distanced from monetary policy, the government and RBI should progressively work towards greater clarity in publicly setting out the objectives of monetary policy. The RBI should evolve a move to greater transparency is setting out the process of monetary policy formulation so that accountability of the RBI can be properly assessed (Paragraphs 4.6 and 4.7).

14. The Advisory Group recommends that with a view to moving towards a more transparent system it would be best to veer towards prescribing to the RBI a single objective while the government could have for itself a clearly set out hierarchy of objectives for which it could use its other instruments of policy. There is much merit in the authorities clarifying issues in monetary and financial policies in simple language intelligible to the general public (Paragraph 4.8).

15. Illustratively, the government can unequivocally set out to the RBI a medium-term inflation objective, say over a prospective three year period, and while fixing this objective the government can take cognisance of other objectives and the government can retain the right, with Parliamentary endorsement, to reset the single objective in the light of evolving developments. The initial statement and consequent resetting of the objective should be done transparently and the rationale of the change should be fully

explained. For purposes of credibility, frequent resetting of the objective, for a particular period, should be the exception rather than the rule (Paragraph 4.9).

Transparency in Policy Formulation

16. The Advisory Group recommends that the RBI should set up a seven member *Monetary Policy Committee* (MPC) as a Committee of the RBI Central Board. MPC consisting of the Governor, the three Deputy Governors and three other members drawn from the RBI Central Board. The members of the MPC should be knowledgeable in the areas of macro economics, monetary analysis, central banking policy and operations and banking and finance. More importantly, to ensure against any conflict of interest, the three Board members on the MPC should be independent professionals. The Advisory Group recommends that the MPC be set up early so as to give the MPC some time to work out its modalities and to undertake a few trial runs before the formal procedures are put in place starting from say the next financial year (Paragraph 5.2).

17. The Government of India should consider setting out to the RBI a single objective for monetary policy viz. the inflation rate. Once the single objective is set out the remit of the MPC would be clear and the RBI should be given unfettered *instrument* freedom and held fully accountable for attaining this objective. There is some merit in having an overriding provision under which the government can give a directive on monetary policy to the RBI but this should be in writing and in specific terms and applicable for a specific period; this should require Parliamentary endorsement after being placed on the Table of the House (Paragraphs 5.3, 5.4 and 5.6)

18. The Advisory Group recommends that there should be a monthly meeting of the MPC on a predetermined date, such as the last Wednesday of the month. A convention should develop wherein the RBI should time its measures immediately after the MPC meeting. A short statement should be issued immediately after the meeting of the MPC even when no measures are envisaged. The minutes of the meetings of the MPC should be made public with progressively increased details over time. The RBI should develop a healthy tradition of accepting the recommendations of the MPC save in very exceptional circumstances and in such cases the RBI should publicly justify its actions (Paragraph 5.7, 5.8, 5.9 and 5.11).

Transpararency in Other Financial Policies

19. Banks and other financial institutions owe it to their depositors to provide relevant information on performance in simple language easily understood by depositors. While stressing the need for greater disclosure the Advisory Group recognises the need for legitimate protection of proprietorial information (Paragraph 5.14).

20. The Advisory Group stresses that where there is regulatory forbearance it should be undertaken transparently. The regulatory regime should be rule based with minimum of discretion. Such a regime would obviously reinforce transparency (Paragraph 5.15).

21. The Advisory Group commends the recent RBI initiative to release a *Discussion Paper on Prompt Corrective Action* (PCA) and it is hopeld that after receiving appropriate feedback the RBI would put in place a PCA regime as part of a commitment to adopt the international best practices and comply fully with the *Core Principles of Supervision* (Paragraph 5.17).

22. The regulatory/supervisory authorities in India should give early consideration to introducing, in a phased manner, a practice of disclosure of adverse supervisory action. The Advisory Group recommends that when penalties are imposed, however small, they should be publicised; minimal but timely adverse action would alert all stakeholders viz. owners, depositors and employees and there would be early convergence to least cost remedial action. A cardinal principle of sound regulation/ supervision should be that it should never be varied over the business cycle. It is entirely a monetary policy function to deal appropriately with the business cycle. *Per contra,* monetary policy should not be diluted to make it less costly for financial intermediaries to comply with prudential

norms (Paragraphs 5.18, 5.19 and 5.20).

23. In terms of transparency, the setting out of the principal objective of monetary policy would also provide the broad contours for exchange rate policy. The Advisory Group is of the view that the Indian disclosure standards compare favourably when considered against the *disclosure template* set out in the BIS Report on *Enhancing Transparency Regarding the Authorities Foreign Currency Liquidity Position* (September 1998). The Advisory Group recommends that the RBI should continue to be in the *avant garde* on disclosure of forward liabilities. This is an instance where Indian practices are ahead of international "best practices". Revealing the maturity pattern of forward liabilities would help stabilise market reaction to variations in the reserves resulting from maturing forward purchases/sales (Paragraph 5.21).

24. The Advisory Group recommends that the efficiency of the forex market would be greatly enhanced if, without in any way compromising the freedom of action on exchange rate policy, the RBI were to reveal, on a regular basis, separately, its direct and indirect intervention operations (Paragraph 5.22).

25. The Advisory Group is of the view that for an effective transmission of monetary policy the changes in the various segments of the financial markets should be allowed to traverse freely through different segments of the financial markets (Paragraph 5.23).

Annexure 1

RESERVE BANK OF INDIA
CENTRAL OFFICE,
SHAHID BHAGAT SINGH ROAD,
MUMBAI – 400 001, INDIA

DEPUTY GOVERNOR

MEMORANDUM

Constitution of Advisory Group on "Transparency of Monetary and Financial Policies"

A Standing Committee on International Financial Standards and Codes has been set up by Governor, Reserve Bank of India on December 8, 1999 with the objectives of identifying and monitoring developments in global standards and codes pertaining to various segments of the financial system, considering all aspects of applicability of such standards and codes to the Indian financial system, chalking out the desirable road map for aligning India's standards and practices in the light of evolving international practices, periodically reviewing the status and progress in regard to codes and practices, and making available its reports to all concerned organizations in public or private sector (copy of Governor's Memorandum in Annexure).

2. The Standing Committee in its first meeting held at New Delhi on January 13, 2000 decided to constitute non official Advisory Groups in ten major subject areas encompassing 43 different standards/codes. In this regard, one of the subject area identified is "Transparency of Monetary and Financial Policies". Accordingly, an Advisory Group on "Transparency of Monetary and Financial Policies" under the Chairmanship of Shri M. Narasimham(Chairman, Administrative Staff College of India, Hyderabad), with Shri S.S. Tarapore, as Member is constituted with effect from February 8, *2000*.

Shri K. Kanagasabapathy, Adviser-in-Charge, Monetary Policy Department, Reserve Bank of India/Dr. R. Kannan, Adviser, Department of Economic Analysis and Policy will be convenors to the Advisory Group.

The terms of reference of the Advisory Group are as follows:

(i) to study present status of applicability and relevance and compliance of relevant standards and codes,
(ii) to review the feasibility of compliance and the time frame over which this could be achieved given the prevailing legal and institutional practices,

(iii) to compare the levels of adherence in India, vis-à-vis in industrialized and also emerging economies particularly to understand India's position and prioritize actions on some of the more important codes and standards,

(iv) to advise a course of action for achieving the best practices appropriate to us; and

(v) to help sensitise the public opinion on the above matters through its reports.

The Chairman may co-opt other non-officials as members and officials as special invitees and decide to have meetings on schedules and at places of his convenience.

Secretarial assistance to the Advisory Group will be provided by the Reserve Bank of India. The Reserve Bank will also provide the following facilities to the Chairman and Members and special invitees to the Advisory Group :

a) reimbursement of return air fare by executive class to attend the Advisory Group meetings.

b) provision of local transport and local hospitality.

c) reimbursement of a sum of Rs.500/- per diem to outside members to meet incidental expenses.

d) necessary arrangements for conducting the meetings preferably in the RBI premises.

The Advisory Group is expected to submit its Reports as and when they are ready and a final report in any case within a time frame of one year from the date of the first meeting.

Sd/-
(Y.V Reddy)

May 25,2000

Annexure 2

Institutional Aspects of Monetary Policy Formulation in Select Countries *

UK

Following the persistence of high inflation rates during the seventies and eighties and exit from the exchange rate mechanism(ERM) due to the inability to maintain the target exchange rate, the UK decided, in 1992, to adopt a monetary policy framework of inflation targeting. The then Chancellor of the Exchequer, Mr. Norman Lamont, described the new strategy as providing sufficient scope for reducing interest rates without jeopardizing the goal of achieving permanently low inflation and, at the same time, giving greater weight to securing an early resumption of growth and employment. The move was also considered to be in line with the trend in other countries which had proceeded to emphasize greater degree of transparency and accountability in their monetary policy implementation.

As the new monetary policy framework of inflation targeting was required to first achieve an explicit inflation target, initially a range of 1–4 per cent and subsequently 2.5 per cent *or less*, it was expected to provide a clear anchor for inflation expectations and make it easier for the public to monitor how successful the central bank was in achieving the target. The announcement of the new framework had an immediate and favorable effect on inflation expectations and long-term interest rates in the UK economy. Ever since the inflation targeting framework was adopted in October 1992, inflation in the UK averaged around 2.8 per cent and has remained highly stable.

In a bid to further improve transparency in the conduct of monetary policy, the Chancellor also asked the Bank to produce regular independent quarterly Inflation Reports in order to "make the formation of policy more transparent …". The first Inflation Report appeared in February 1993. The original objective of the Inflation Report was to act as a disciplining device on the Government. The Bank Report was expected to set out its views of the likely implications for inflation of decisions taken(or not taken) by the Chancellor. Since February 1996, the Bank has been regularly publishing a probability distribution of future inflation in the Inflation Report in the form of a fan chart.

Amendment of the Bank of England Act, 1998

Despite significant progress being achieved in improving the framework and transparency of monetary policy, the very the lack of the willingness to divest operational decision making on interest rates from the Exchequer continued to cast doubts regarding the UK's commitment to monetary stability. It was still believed that the timing and magnitude of interest rate changes could sometimes tend to reflect political considerations. In order to establish a durable policy commitment for price stability, Chancellor Mr. Gordon Brown, in 1997, announced far reaching changes in the Bank of England Act including the setting up of a Monetary Policy Committee(MPC) and handing over of the operational responsibility for setting interest rates to the Bank of England barring "in extreme circumstances" wherein instructions on interest rates may be given by the Treasury for a limited period only under subordinate legislation approved by Parliament. The Chancellor hoped that this move would help in securing long-term economic stability which was a precondition for lasting prosperity. The amendment to the Bank of England Act came into force on June 1, 1998.

Institutional Arrangements

A note by the Chancellor dated 13 June 1997 provides a conceptual background to the goal of inflation targeting and the remit for the MPC sent to the Governor of the Bank of England.

In the new framework, there is a clear distinction between the roles of the Government and the Bank of England. As per the note, the Government has the responsibility for setting the objectives of economic policy and, therefore, reserved the prerogative of setting the inflation target. The Bank would support the Government's economic policy, including its objectives for growth and employment. The Bank was expected to achieve 2.5 per cent inflation *or less* as per the standard official measure of inflation in the UK. Although the Government sets the inflation target, it is left to the Bank to decide what intermediate targets are relevant to meet the inflation target. The ultimate purpose of the new arrangement was to provide the right rules and incentives to ensure that the Bank's actions were consistent with the Government's objectives.

The Government would recognize that there could be legitimate reasons why inflation might temporarily diverge from the target. But as the commitment to the inflation target was crucial, the level of the thresholds was chosen such that they were not expected to be triggered too often. If inflation is more than one percentage point higher or lower than the target, the Bank is required to publish an 'open letter' explaining why inflation had deviated from the target and what actions it intended to take to get it back on target. Whether and how the Chancellor responds to any letters would depend on the merits of the case and the prevailing economic condition at the time.

The target would be confirmed in each Budget. The target could be lowered if the Government judged that an improvement in the underlying performance of the economy or international trends justified such a move.

In the new framework, the Government would be responsible for determining the exchange rate regime. The Bank would have its own separate pool of foreign exchange reserves which it may use at its discretion to intervene in support of its monetary policy objective. If the Government so instructed, the Bank, acting as its agent, would intervene in the foreign exchange markets by buying or selling the Government's foreign exchange reserves. All such intervention would be automatically sterilised. *The Bank's role as the Government's agent for debt management, the sale of gilts, oversight of the gilts market and cash management, however, would be transferred to the Treasury.*

The Monetary Policy Making Body

Besides imparting operational independence, the creation of a new MPC with its clearly defined remit with recognized monetary experts, has served to strengthen the Bank's ability to deliver its objectives and depersonalised the monetary policy process.

Comprising of nine individuals with expertise in monetary policy – five executive members of the Bank (the Governor, two Deputy Governors and two other senior officials of the Bank appointed by the Governor) and four non-executives (appointed by the Chancellor), the decisions at the MPC are made by a vote of the Committee, each member having one vote. If there is no majority, the Governor has the casting vote. The Treasury has the right to be represented in each meeting in a non-voting capacity. Each member of the MPC has a three year term.

The MPC meets on a regular monthly basis. Any decision on interest rates is made by a vote of the Committee and announced immediately, after the Chancellor is notified of the decisions and proceedings of the Committee.

Transparency

At the time of formation of the MPC, it was decided that the minutes of the meetings of the MPC, *including a record of any vote*, would be released no later than six weeks after the meeting. They are, however, currently published along with the details of the recorded votes on the second Wednesday after the meeting takes place. The minutes also appear in the Bank of England's Quarterly Inflation Report.

During its meeting the MPC takes up a comprehensive review of the economy including the discussions on the Budget; money and asset prices; demand and output; the

labor market; prices and costs; the world economy; and other considerations relevant to its decision. The members of the MPC also review the Reports prepared by the Bank's regional agents and information available from market surveys and polls on expectations about interest rates. At the conclusion of the meeting, and for purposes of immediate policy decisions such as an changes in interest rates, the Governor calls upon the members of the Committee to vote for the given proposition.

The new framework has made the process of monetary policy making in the UK one of the most open and accountable in the world. Notably, the recent Experimental Report on Transparency Practices for the UK prepared by the International Monetary Fund(IMF) has commended the new monetary policy framework for its high degree of transparency with respect all the four principles underlying the draft code.

The new framework has also made monetary policy-makers accountable to Ministers, Parliament and the public at large. It has also helped to build credibility by making the basis of monetary policy decisions clear. As a consequence, policy and its effects have been made more predictable, reducing the degree of risk and uncertainty in the economy.

As per the new framework, the Bank has been made accountable to the House of Commons through regular reports and evidence to the Treasury Select Committee (TSC). The Bank is statutorily required to publish a quarterly Inflation Report in which it accounts for its monetary policy actions, sets out and justifies its analysis of the economy, and explains how it intends to meet the Government's inflation target and support the Government's economic policy.

Finally, through the publication of the minutes and votes of the Monetary Policy Committee meetings and the *Inflation Report*, the Bank is also clearly accountable to the public at large. It is pertinent to note that the names of members of the MPC for or against a specific cause of action are clearly set out in the minutes.

The United States

Institutional Arrangements

The Federal Open Market Committee (FOMC) was established by the Banking Act of 1935 on March 1, 1936. The FOMC is responsible for the formulation and conduct of monetary policy for the Federal Reserve System in the United States. At its meetings, the FOMC develops its policy priorities and specifications to guide open market operations carried out by the Federal Reserve Bank of New York.

Institutional Arrangements

The FOMC formulates monetary policy by setting a target for the federal funds rate (the interest rate that banks charge one another for short-term loans) on the basis of its assessment of economic activity, inflation, financial market conditions and the monetary and credit aggregates. In addition to formulating monetary policy, the FOMC, together with the Treasury Department also decides on the timing of forex interventions.

The FOMC must meet at least four times a year. In recent years, the FOMC has had eight scheduled meetings during an year. The February and July meetings also focus on the decisions to be covered in the Chairman's semiannual testimony before the House and Senate Banking Committee as required by the Humphrey- Hawkins Act and, by law, must choose annual growth rates for specified monetary and credit aggregates.

The meetings, held in Washington, D.C., are attended by the seven members of the Fed's Board of Governors (BOG), the presidents of the 12 Federal Reserve Banks, and some senior Federal Reserve staff members. There are 12 *voting* members of the FOMC: the

seven members of the BOG and the presidents of five of the 12 Federal Reserve Banks. The President of the Federal Reserve Bank of New York is a permanent voting member of the Committee, and the Presidents of the other Reserve Banks serve one-year terms as voting members on a rotation basis set by law. Nine of the Reserve Bank presidents vote one year out of every three, while the presidents of the Federal Reserve Banks of Chicago and Cleveland vote in alternate years.

By tradition, the Chairman of the Board of Governors serves as FOMC chairman and the president of the New York Fed as FOMC vice chairman. If a voting Federal Reserve Bank president misses an FOMC meeting, another Bank president votes in his/her place; however, if the president of the Federal Reserve Bank of New York is absent, the first vice president of the New York Fed votes instead. The status afforded the New York Fed is in recognition of the unique role that the Bank plays in the Federal Reserve System through its open market operations that influence money and credit conditions in the economy.

The appointment procedures for both the members of the BOG and the Reserve Bank presidents are designed to minimize political influence on the FOMC. Governors are appointed (by the President of the United States, with the approval of the U.S. Senate) for 14-year terms, much longer than the terms of elected office holders. Moreover, the 14-year terms are staggered -- one expires on January 31 in every even-numbered year, limiting the ability of a U.S. President to name a majority of the Board in a four-year presidential term. Once appointed, the governor can only be removed for cause.

Each Reserve Bank President is appointed for a five-year term by his/her Bank's board of directors, with the approval of the BOG. Six of the nine directors, in turn, are chosen by the banks that belong to the Federal Reserve System, and remaining three by the BOG.

Prior to the meeting, members of the Committee are briefed on economic conditions by members of their staffs and receive the *Green, Blue and Beige Books.* The Green book prepared by the staff members at the Board of Governor's has two parts. Whereas the first part summarises recent events and presents a series of forecasts, the second part offers detailed sector-by-sector description of recent economic developments. The Blue book provides the Board staff's view of recent and prospective developments related to the behavior of interest rates, bank reserves, and money. The Beige book presents reports on regional economic conditions in each of the twelve Federal Reserve Districts and contains a summary of the conditions described by each Reserve Bank. Only the Beige Book is available to the public, and it is released approximately two weeks before each FOMC meeting.

The confirmation of the minutes of the previous meeting is followed by the Report of the Manager of the Federal Reserve Bank New York which discusses domestic operations with an accent on the implementation of monetary policy through open market operations and outlook concerning economic activity, interest rates and prices followed by a review of current and prospective economic and financial developments by the senior staff of the BOG. Thereafter, individual Governors and Reserve Bank presidents (including those not currently voting) present their views of the economic outlook. Following the conclusion of the presentations, the Director of Monetary Affairs Division follows up with a discussion of relevant monetary policy options drawing upon the material presented in the Blue Book. Then, usually beginning with the Chairman, the BOG members and Reserve Bank presidents, again including those not voting, discuss their policy preferences. The committee then votes.

In recent years, FOMC decisions generally have been unanimous or nearly unanimous; there have not been more than two dissents on any FOMC monetary policy vote since 1992. It is notable that such unanimity was achieved without the FOMC itself having the authority to change the discount rate and which typifies the consultative approach taken in the FOMC. To do so, the Board of Directors of the twelve Reserve Banks must initiate requests for a change in the discount rate, and the change must be approved by a majority of the members of the Board of Governors.

Transparency and Independence

After each FOMC meeting, the Secretariat of the FOMC prepares extensive minutes that report the substance of the meeting's discussion. The minutes including the voting record of members are published approximately six weeks later, a few days after the following meeting, and appear in the BOG's monthly Federal Reserve Bulletin. The members who voted against the directive are also included with the minutes with an account of his or her reasons for dissenting.

In recent years, the FOMC has given added emphasis to transparency with which the policy decisions are made and implemented. In 1994, the FOMC began formally announcing, immediately after any meeting in which a policy action had taken place, the change in the targeted federal funds rate and a brief rationale for the decision. Until that time, changes were "signaled" through open market operations. It sometimes took several days before market participants and the broader public were certain that a new policy setting was in effect. In the earlier regime, the public rarely received a prompt explanation for the change.

In 1999, the FOMC went a step further and began a policy of communicating major shifts in its views about future policy even when the current policy setting has not changed. The idea is that providing more information about the Committee's views of the economic outlook may allow financial market prices to reflect more accurately the likely future stance of monetary policy. The Committee made its first such announcement after the May, 1999 meeting.

As far as accountability is concerned, the Federal Reserve is accountable to Congress which has delegated to it specific powers Congress is granted by the Constitution. Congress thus retains the authority to oversee and instruct the Federal Reserve as it sees fit. The Federal Reserve accounts to the Government in numerous formal and informal ways. There are continuous contacts between officials in the Federal Reserve and the Government. The Chairman of the BOG reports semi annually to the Congress on its monetary policy targets and its senior officers routinely appear before Congressional committees and sub-committees.

Over the years, Congress and the Administration have periodically sought to alter certain elements of the Federal Reserve. These efforts have contributed to changes in the Federal Reserve's procedures and authority, in many cases allowing the Federal Reserve to evolve and keep pace with the needs of the changing times. At the same time at no point of time has the fundamental independence of the Federal Reserve been put in jeopardy.

Australia
Institutional Arrangement

The Reserve Bank of Australia Board is responsible for the Bank's monetary and

banking policy. The Board has a maximum of nine members; three are ex-officio – the Governor of the Bank (who is also Chairman of the Board), the Deputy Governor (Deputy Chairman) and the Secretary to the Treasury. Of the remaining six members, at least five must be persons who are not officers of the Bank or of the Australian Public Service. A director, officer or employee of a corporation (other than the Reserve Bank itself) whose business is wholly or partly that of a bank is not eligible to be a member of the Reserve Bank Board. In recent years, members of the Board have come from the manufacturing, mining and retailing industries, the rural sector, the trade union movement and the universities.

The Governor and Deputy Governor are appointed by the Governor-General, on the recommendation of the Government of the day. Terms are for periods not exceeding seven years, and they are eligible for reappointment. Subject to the policy of the Reserve Bank Board, the Governor is responsible for the management of the Bank. In the event of a vacancy in the office of the Governor, the Deputy Governor performs the duties and has the powers and functions of the Governor.

Since the formulation of monetary policy is the responsibility of the Reserve Bank Board, detailed monitoring of the economy, forecasting and evaluation of alternative policies are carried out by the professional staff of the Bank. The Bank’s *Economic Group*, working directly with the Governor and Deputy Governor, is the principal source of advice on the formulation of monetary policy. This advice, accompanied by detailed supporting documentation, is presented to the Reserve Bank Board at its monthly meeting. The Board’s decision is communicated to the Treasurer before a change in policy is made. Changes in monetary policy settings are accompanied by a full public statement from the Bank explaining the change.

The centerpiece of the policy framework is an inflation target, under which the Reserve Bank sets policy to achieve an inflation rate of 2-3 per cent on average, a rate sufficiently low that it does not materially affect economic decisions in the community. The target provides discipline for monetary policy decision-making, and serves as an anchor for private sector inflation expectations. The target is agreed between the Bank and the Government, as spelt out in the *Statement on the Conduct of Monetary Policy, 1996.*

The target is defined as a medium-term average rather than as a hard-edged target band within which inflation is to be held at all times. This formulation allows for uncertainties that are involved in forecasting, and lags in the effects of monetary policy on the economy.

Transparency and Independence

In keeping with the inflation target objective and the desire to conduct the monetary policy in an open and forward looking way, in recent years the Reserve Bank has taken steps to make the conduct of policy more transparent. Changes in policy and related reasons are now clearly explained. In addition, the Bank has upgraded its public commentary on the economic outlook and issues bearing on monetary policy settings, through public addresses and its regular quarterly report on the economy. In furthering the arrangements already in place, the Governor supports the release by the Bank of specific statements on monetary policy and the role it is playing in achieving the Bank’s objectives at roughly six monthly intervals.

The Bank also endeavors to enhance the community’s understanding of its responsibilities and its monetary and banking policies through a broad communications

program. The primary vehicle is its monthly publication Reserve Bank of Australia Bulletin. Speeches and presentations are other avenues through which the Bank explains its views to the community.

The Reserve Bank Act 1959 requires that "the Governor and the Secretary to the Department of the Treasury shall establish a close liaison with each other and shall keep each other fully informed on all matters which jointly concern the Bank and the Department of the Treasury". The Bank is also a participant in the Joint Economic Forecasting Group which brings together regularly officers of the Treasury, the Department of Finance, the Department of the Prime Minister and Cabinet, the Australian Bureau of Statistics and the Bank to review economic prospects.

Consistent with its responsibilities for economic policy as a whole, the Government, however, reserves the right to comment on monetary policy from time to time, and in doing so desists from making parallel announcements of monetary policy adjustments, when the Reserve Bank changes the overnight cash rate. This has tended to enhance both the perception, as well as the reality, of the independence of Reserve Bank decision making.

The Reserve Bank also appears before parliamentary committees to account publicly for the conduct of Bank policy. It was the practice for senior representatives of the Bank to appear before the House of Representatives Standing Committee on Banking, Finance and Public Administration (now renamed the Standing Committee on Economics, Financial Institutions and Public Administration) to discuss matters raised in the Annual Report.

With the appointment of the new Governor of the Reserve Bank in August 1996, a *Statement on the Conduct of Monetary Policy* was issued jointly by the Governor and the Treasurer. The *Statement* reiterated and clarified the respective roles and responsibilities of the Bank and the Government in relation to monetary policy and provided formal Government endorsement of the Bank's inflation objective. It also outlined an arrangement whereby the Governor would have to appear before the House of Representatives Standing Committee on Economics, Financial Institutions and Public Administration twice a year, to report on the conduct of monetary policy. The first of these appearances took place in May 1997; documents which were issued in conjunction with this appearance were the *Semi-Annual Statement on Monetary Policy* explaining the conduct of monetary policy to the Standing Committee and the Governor's Opening Statement to the House of Representatives Committee.

Independence of the Reserve Bank also stems from the agreement between the Treasury and the Reserve Bank to keep an arms length between monetary policy and the debt management, with the Treasury directly responsible for the latter and the Reserve Bank responsible for the former. Although the Bank acts as agent for the Commonwealth Government, it has only limited involvement in decisions about the Government's debt management, and it subscribes to tenders only when necessary for its own portfolio management purposes.

Furthermore, the independence of the Bank is further reinforced by the provisions such as Section 11 of the Act which prescribes the procedures for dispute resolutions. While Section 11 allows the Government to determine policy in the event of a material difference the safeguards are politically demanding and their nature reinforces the Bank's independence. Safeguards like this have ensured that monetary policy is subject to the checks and balances inherent and necessary in a democratic system.

By virtue of the Act of 1959, the Bank had always enjoyed high degree of general independence to determine monetary policy despite the fact that it was unable to exercise this independence in monetary policy for much of the pre-World War II period because of the lack of instruments of monetary policy in its possession and in the post war period due to government controls on setting interest rates. It was not until deregulation was largely completed in the mid-1980s that the Reserve Bank was in a position to exercise the monetary policy powers contained in its Act through use of its open market operations.

Relationship with the Government

The Act lays down procedures which are to be followed if there is a difference of opinion between the Government and the Board of the Bank as to whether the monetary and banking policy of the Bank is "directed to the greatest advantage of the people of Australia". First, the Treasurer and the Board are to endeavour to reach an agreement. If they are unable to do so, the Board is required to provide the Treasurer with a statement on the matter. The Treasurer may then submit a recommendation to the Governor-General who, with the advice of the Federal Executive Council, may determine the policy to be adopted by the Bank. The Treasurer would then inform the Bank's Board of the policy so determined and the Board would be obliged to implement it; the Board would also be informed that the Government accepted responsibility for the adoption by the Bank of that policy. The Treasurer would lay before each House of Parliament a copy of the order determining the policy which was to be implemented by the Bank, together with the statement provided to the Treasurer by the Bank Board and a statement by the Government on the matter on which opinions had differed. To date this procedure has not been used.

New Zealand

Prior to 1984, New Zealand's inflation record had been amongst the poorest in the OECD – with inflation above 10 per cent per annum every year through most of the seventies and early eighties. During these years, the Reserve Bank was bound under legislation to consider all manner of real economy objectives and to implement the day-to-day monetary decisions of government. Over the three decades to the mid-eighties, the Bank was clearly among the 'least independent' of central banks.

The new Government which came to power in 1984 was determined to eliminate inflation and directed the Bank to achieve that end. It was also keen to put an end to the manipulation of monetary policy for political purposes at the cost of serious damage to the economy. Accordingly, the Bank and the Treasury were asked to prepare new legislation appropriate to a modern understanding of what monetary policy can actually deliver. It was with a unanimous vote, that the Reserve Bank of New Zealand Act was enacted in 1989.

Institutional Arrangement

This piece of legislation has no exact parallels anywhere else in the world which establishes unstinted commitment for policy objectives, operational independence and transparency with the following key features :

(i) Since monetary policy affects the inflation rate, it cannot be used to engineer a sustainably faster rate of economic growth or a sustainably higher

level of employment.

(ii) Under these circumstances, it was felt appropriate for monetary policy to target price stability. Hence Section 8 of the Act gives monetary policy the sole task of 'achieving and maintaining stability in the general level of prices'.

(iii) In a democracy, it is appropriate for the elected government, not bureaucrats, to define 'stability in the general level of prices', and indeed to override that objective if it so chooses. Hence, Section 9 requires a written Policy Targets Agreement(PTA) to be signed between the Minister of Finance and the Governor, which Section 12 allows Government to override by Order in Council if desired. The PTA ensures public confidence that monetary policy would be conducted in a stable and predictable manner over the longer term, and helps to anchor expectations of ongoing price stability. The current policy target was agreed in December 1997 at the time of the reappointment of the Governor to his current term of office, which commenced in September 1998. The Agreement covers his five-year term of office to 31 August, 2003. During the currency of the PTA , when inflation is, or is expected to be, outside the target range, the Bank is required to explain why this has happened and what actions are being taken to ensure that inflation comes back within the target range.

(iv) Having specified the objectives, it is incumbent upon Government to leave the Bank to *implement* monetary policy without interference from Government, Treasury, or anybody else.

(v) With operating independence should come accountability, in the form of a statutory obligation to report to Parliament at least six-monthly, and a provision for the Governor to be dismissed for 'inadequate performance' under the PTA.

(vi) Since such uncertainty involves costs, the objective of monetary policy, and the *modus operandi* of policy implementation, should be as open and transparent and policy intentions absolutely unambiguous to the public.

This framework has proved very successful. Inflation has been steadily reduced and price stability as defined in the current PTA has been maintained with scarcely a break for almost five years. Inflationary expectations have also been sharply reduced – as most vividly seen in long-term bond yields (which have been consistently lower than those in, for example, Australia for some years, and lower than those in the United Kingdom also for most of the last four or five years). Recent market research suggests that some 73 per cent of New Zealanders support low inflation being the Reserve Bank's objective, and 63 per cent believe, despite recent tight monetary policy, that the Bank has been doing a good job in delivering that objective.

The framework has also facilitated much improved fiscal performance – Government has understood that, for any given inflation target, an easing of fiscal policy involves some tightening of monetary policy. In the 1990 election campaign, the National Opposition promised the public lower interest rates if elected – not by interfering with the implementation of monetary policy but by giving monetary policy some mates, in the form of tighter fiscal policy and labour market deregulation. The desire to see an easing in monetary policy was undoubtedly one factor in the expenditure reductions subsequently approved by the new Government, while the Government repeatedly made it clear that one of the preconditions of tax cuts in 1996 and 1997 was that these cuts should not necessitate a significant tightening of monetary policy.

Monetary Policy Making

Monetary policy in New Zealand is mostly associated with the inflation targeting framework under which the Bank operates. The framework provides the Bank with its objectives and with the limits to its decision-making discretion. The focus of public and market attention is, thus, on the price stability objective and the Bank's progress in meeting that objective.

In matters concerning decisions on monetary policy, the Governor enjoys discretionary powers subject to the provisions of the Reserve Bank of New Zealand Act, 1989. These, *inter alia*, include the obligation under Section 8 to direct monetary policy towards maintaining price stability, the terms of the PTA entered into with the Treasurer and any ministerial directives that override Section 8 in accordance with the Act.

The Board of Directors comprising not fewer than 7 and not more than10 members comprises of non-executive directors appointed by the Treasurer ands the Governor and Deputy Governors as executive directors. When making appointments of non executive directors, the Treasurer is required to have regard to the person's skill and experience and to the likelihood of any conflicts of interest. The non executive members, Governor and Deputy Governors each have a term of five years.

The Board of Directors monitors the performance of the Governor on behalf of the Treasurer and could recommend the dismissal of the Governor if his performance is unsatisfactory. The Board, *inter alia*, also determines whether Monetary Policy Statements required to be made under the Act are consistent with the price stability objective specified in the Act, and in terms of the PTA and reviews the use of Bank's resources.

The Act ensures operational independence of the Bank in meeting its statutory objective of price stability. Section 12 of the Act, however, allows the Treasurer to override the Act's price stability objective and instruct the Bank to pursue a different objective. Such an override must be by Order-in-Council, must be published in the Gazette and tabled in Parliament, and can not stand for more than 12 months without being renewed. While this mechanism was incorporated in the legislation to enable the Government-of-the-day to pursue a monetary policy objective other than price stability, the Act requires full transparency about that choice (hence the Order-in-Council procedure, and the requirement that the override be tabled in Parliament).

Transparency and accountability

A key feature of the Act is the requirement that the Reserve Bank formulate and implement monetary policy transparently. *Monetary Policy Statements* are required to be published at least six-monthly. Each *statement* is required, by Section 15 of the Act, to address:

- the policies and means by which the Bank proposes to achieve the policy targets;
- the reasons for adopting those policies and means;
- how the Bank proposes to formulate and implement monetary policy during the next five years; and
- the implementation of monetary policy since the last *statement.*

In practice, the Bank publishes a *Statement* approximately every three months. They are an important mechanism by which the Bank gives account to the public and the financial

markets.

The Bank is also accountable in other ways for its performance in meeting its objective. The formal mechanisms are:

(i) The Board of Directors.
(ii) Monetary Policy Statements and the Bank's Annual Report stand referred to Parliament and any parliamentary committee responsible for public sector financial management.
(iii) The practice has been for *Monetary Policy Statements* to be reviewed by the Finance and Expenditure Select Committee and for the Governor to appear before the Committee. The Committee has not, however, felt it necessary to review and call the Governor to give evidence on every *Statement.*
(iv) Under the Act (s.167), the Treasurer can appoint an external party to assess the Bank's performance of its functions. A report arising from such an assessment stands referred to Parliament and any parliamentary committee responsible for public sector financial management.

South Africa

The South African Reserve Bank was established in 1921. At that time central banks existed mainly in the United Kingdom and Europe, and the South African Reserve Bank was only the fourth central bank established outside this area (there were already central banks in the USA, Japan and Java). The Reserve Bank's stock is privately held. After provision has been made for bad and doubtful debts, depreciation of assets, transfer to reserves, gratuities or other pension benefits, and items for which provision is usually made by bankers, one-tenth of the Bank's surplus is paid into a reserve fund and nine-tenths paid to the government.

Institutional Arrangement

The monetary policy of the Bank is formulated by a Monetary Policy Committee(MPC) and implemented by the Monetary Policy Implementation Committee.

Monetary Policy Making

The MPC was constituted in August 1999. The Monetary Policy Implementation Committee is assigned the task of implementation of the decisions of the MPC, but may also bring issues to the attention of either the Governor or the MPC. Presently, the MPC consists of the Governor and the deputy governors as voting members and senior officials of the Bank as non-voting members, although the final decision-making power on monetary policy matters vests with the Governor and deputy governors, in accordance with the current legal framework. In addition, it is envisaged that specialists from outside the Bank might in due course be co-opted to serve on the MPC, but this would require an amendment to the South African Reserve Bank Act.

Transparency and Independence

Following the explicit announcement of the numerical inflation target to the public to indicate clearly what the Reserve Bank should be held accountable for, an endeavour is made to make the framework of monetary policy as transparent as possible. The announcement of the target makes the intentions of monetary policy explicit. If targets

are not met, the central bank has to explain the divergence. Regular reporting of the stance of monetary policy are made to Parliament. The Reserve Bank is required to publish, twice a year, a Monetary Policy Review to increase transparency in the application of monetary policy. This Monetary Policy Review attempts to describe in more detail the decisions taken by the central bank and analyses developments in South Africa and the rest of the world that could affect inflation. The monetary policy stance is communicated regularly to the public and the Bank endeavours to explain the monetary policy framework and operational procedures it follows in the application of monetary policy. This is done by means of a monetary policy statement after the completion of every meeting of the MPC.

A Monetary Policy Forum opens an avenue for on-going discussions on monetary policy and general economic developments and to ensure that the views of interested parties are taken into account in the determination of monetary policy. The Monetary Policy Forum meets twice a year in the major centres of South Africa to allow as many stakeholders as possible to participate in these discussions.

In terms of section 32 of the Reserve Bank Act, the Bank must publish a monthly statement of its assets and liabilities and submit an annual report to Parliament. The Governor of the Reserve Bank holds regular discussions with the Minister of Finance and appears before the Parliamentary Standing Committee on Finance from time to time.

The Constitution of the Republic of South Africa also formally recognises the independence of the Reserve Bank. The Constitution states in Section 196 that: ”The South African Reserve Bank shall, in the pursuit of its primary objective ……… exercise its powers and perform its functions independently, subject only to an Act of Parliament… provided that there shall be regular consultation between the South African Reserve Bank and the Minister responsible for national financial matters”.

The Reserve Bank has been given an important degree of autonomy for the execution of its duties. In terms of the **Constitution (Act No.108, 1996)**: “*The South African Reserve Bank, in pursuit of its primary object, must perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters*”.

The institutional framework in South Africa in the form of the South African Reserve Bank Act, Act No.90 of 1989, provides the Reserve Bank with a great degree of independence in its operations. The Reserve Bank’s functional independence on monetary and related policies is clearly stated in Sections 10 and 35 of the South African Reserve Bank Act. Section 35 empowers the Board of the Bank to make rules “*for the good government of the Bank and the conduct of its business*”.

The Act provides for independence for the Reserve Bank in the use of instruments of policy. The Reserve Bank is precluded in Section 13(f) from making excessive direct purchases of government stock. The Bank may not “hold in stocks of the Government of the Republic which have been acquired directly from the Treasury by subscription to new issues, the conversion of existing issues or otherwise, a sum exceeding its paid-up capital and reserve fund plus one-third of its liabilities to the public in the Republic”. This section therefore restricts the direct financing of government deficits.

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