From the Editor's Desk

The Future of Central Banking : The Political Dimension

- *Howard Davies*

The paper discusses the changing institutional structure and governance of Central Banks within the political background in which it operates. Four significant trends, viz. movement towards inflation targeting; reorganization of financial supervision and regulation; development of new definitions for the financial stability objective of central banks; and the emergence of public expectations regarding their accountability and transparency have been observed in the recent times in the evolution of Central Banks. The paper argues that Central Banks should not seek responsibilities like financial supervision, which carry reputational risks and require different forms of accountability and political dependence, so that they could maintain monetary policy independence.

The Future of Central Banking

- *C A E Goodhart*

A Central Bank (CB) will normally be primarily concerned with three main, and interconnected, aspects of stability. These are: (a) domestic price stability, (b) external stability of the value of the currency, and (c) overall systemic stability in the financial system. With only one main instrument, the short-term interest rate, a CB can focus primarily on either (a) or (b), but not on both simultaneously. We ask whether there may be secondary instruments to help achieve (b) and (c). We conclude that there is now a consensus on how to maintain domestic price stability. But there is less understanding of the determinants of exchange rate volatility, which remains undesirably high. Several of the historical operations of the CB in managing the financial system remain firmly maintained and well-functioning, but there are continuing organizational problems in arranging and coordinating responsibilities for financial supervision and crisis management.

Evolution of Central Banking in India

- *Rakesh Mohan*

It is a great pleasure in mentioning that the theme of the Report on Currency and Finance – 2004-05, prepared by the staff of the Reserve Bank of India (RBI), is also that of evolution of Central Banking in India (RBI, 2005a). In going through the process of compilation of the Report, it has been found that the evolutionary process of central banking all over the world and also in India to be very interesting and informative. The most striking feature of central bank functioning both across time and over countries in a contemporaneous manner, is not how similar their functions are or have been, but how heterogeneous they are and how their functions have constantly evolved over the changing times.

Monetary Policy : Role of Central Banks and Government

- *S S Tarapore*

It has been proposed to provide a brief historical backdrop of the evolution in India of the legislative framework governing central bank-government relations and how it impinges on present day monetary policy formulation. The inbuilt difficulties in the formulation and conduct of monetary policy have then been dealt and some issues on the directional changes necessary to work towards a more effective monetary policy have been raised. Lastly, the 1994-96 episode has been recalled so that one learns the right lessons for RBI-government relations in regard to monetary policy.

Some Reflections on Financial Stability

- *C A E Goodhart*

The Organizational Structure of Banking Supervision

- *C A E Goodhart*

In this paper the question has been asked whether, and why, it matters whether banking supervision is undertaken inhouse in the Central Bank or in a separate specialized supervisory institution. After all, the bank supervisors and those in the Central Bank concerned with systemic stability must continue to work closely together wherever the supervisors are physically located.

Nevertheless there has been some recent trend towards hiving-off bank supervision to a separate agency, as with the Financial Services Authority (FSA) in the UK. The main driving forces behind this tendency are the changing, more blurred, structure of the financial system, and continuing concerns with conflicts of interest. As the dividing lines between differing kinds of financial institutions become increasingly fuzzy (e.g. universal banks), continuing bank supervision by the Central Bank threatens both inefficient overlap between supervisory bodies and a potential creep of Central Bank safety net, and other, responsibilities into ever-widening areas. With the accompanying trend towards Central Bank's operational independence in monetary policy, continued Central Bank supervisory authority enhances concerns about potential conflicts of interest, and raises issues about the limits of delegated powers to a non-elected body.

On the other hand, separation of supervision from the Central Bank raises questions whether systemic stability might suffer. The ethos, culture and concerns of the separate supervisory body might come to focus more on conduct of business, consumer protection, issues. Potentially systemic financial crises would have to be handled by a committee, not by a unified Central Bank. How much, if at all, would the collection, transmission and interpretation of information relevant to a Central Bank's concerns, both on monetary and systemic stability policy issues, be lost as a consequence of separation.

These are, mostly, qualitative issues, and more developed countries, with differing historical, legal and institutional backgrounds, will, and have, come to differing conclusions. But in less developed countries, more weight needs to be placed on ensuring the quality of the supervisory staff, i.e. their professional skills, independence from external pressures, and adequate funding. These latter considerations tell strongly towards retaining banking supervision under the wing of the Central Bank in emerging countries.

Measuring Independence of Central Banks : Theory and Evidence

- *Jiji T Mathew*

Nowadays, it is widely believed that a high degree of Central Bank Independence (CBI) coupled with some explicit mandate for the Central Bank (CB) to restrain inflation is an important institutional device to assure price stability. This paper mainly tries to construct a new index for measuring CBI in twenty-five selected countries and examines the characteristics of the proposed linkage between CBI and inflation. Analysis shows the existence of a negative association between CBI and inflation, which is consistent with the theory. The new CBI index offers a strong model for optimal implementation and sequencing of CB reforms in emerging market economies, including India.