

‘Independence factor’ of RBI

The demonetisation decision has led several observers to express concern about the autonomy and institutional integrity of the Reserve Bank of India (RBI). Many of those against demonetisation on a matter of principle (or practice) are blaming the RBI for ‘caving in’ to the government’s diktat and surrendering its independence.

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How well is the ‘independent factor’ of RBI?

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- The RBI is not a self-governing Republic.

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- A cursory reading of the RBI Act (Section 7 on Management) lays out things quite unambiguously. Part (1) of Section 7 states: “The Central Government may from time to time give such directions to the Bank as it may, after consultation with the Governor of the Bank, consider necessary in the public interest.” Parts (2) and (3) spell out the roles for the Central Board and Governor. There is a clear ‘seniority’ principle with (1) taking precedence over (2) which takes precedence over (3).

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Ensuring low and stable inflation

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- It is critical to understand what autonomy and institutional integrity mean for a central bank like the RBI.

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- The RBI, like most central banks, consists of technocrats and bureaucrats who are unelected and not directly accountable to the people.

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- In a democracy, the final responsibility of all policy decisions must lie with the elected representatives of the people, either the government or Parliament or both.

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- The notion of central bank independence first gained traction in the advanced economies when it was noticed that elected governments often chose to disregard price stability in favour of growth, especially in the run-up to elections.
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- This behaviour only raised and entrenched inflationary expectations to the medium-term detriment of the economy.
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- **The central goal of central bank independence was to ensure low and stable inflation via the autonomous conduct of monetary policy.**
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- It is important to note that it is not the central bank's discretion to decide what the targeted rate of inflation ought to be (or indeed what the optimum rate of growth should be); that remains the job of the elected government.
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- But once that target is laid down, the central bank must ensure that it meets those targets with complete operational autonomy.
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- The proper way to conduct monetary policy is via explicit goals laid out by the elected government which are then executed by a group of experts — a Monetary Policy Committee — rather than one individual, without any interference from the government.
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- Still, on the setting of interest rates, even before the creation of an explicit monetary policy framework, the RBI has had its autonomous way under successive governors and with different political dispensations in office.
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- This has led to tensions between the Finance Ministry and the RBI but rarely, if ever, any encroachment on the RBI's space.
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Debt management

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- Consider also RBI's roles beyond the conduct of monetary policy. The RBI is the government's debt manager, a function that has been proposed to be hived out to an independent debt management agency but resisted by the central bank.
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- The separation of debt management from the RBI is not an assault on the RBI's independence by the government.

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- Instead, it is to remove the conflict of interest that exists in the RBI's functions of setting interest rates, and management of the government's debt. The latter could influence the former when it ought not to.

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- The RBI's independence to carry out its primary mandate, the efficient conduct of monetary policy, will only be enhanced by hiving off the debt management function.

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RBI's role in banking system

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- Like any regulatory agency, RBI must be allowed to operate at an arm's length from the government while doing its work. Again, there is no evidence to suggest that the government has interfered in any way.

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- Remember that the government plays a separate role in the banking sector as the owner of public sector banks which control nearly 70 per cent of all lending.

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- The RBI is the regulator, not owner, of banks. Unsurprisingly, both the RBI and the government play critical and visible roles in banking but that does not mean that they are stepping on one another's turf.

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Way ahead

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- The government, when it exercises its right as sovereign, whether to set an inflation target or to demonetise high-value currency, should act well within the norms of the law and the spirit of democracy.

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- Any attempt by unelected officials to obstruct would only be abuse of their autonomy.

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