RBI & Its Autonomy

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In 2016, Forum of Free Enterprise completed 60 years of its existence, while The A.D. Shroff Memorial Trust completed 50 years of its existence. The contents of the three articles in this booklet are based on talks delivered at a public meeting on "RBI & Its Autonomy" on 6th March 2017, in Mumbai, arranged by The A. D. Shroff Memorial Trust and Forum of Free Enterprise in association with Bombay Chartered Accountants' Society, R. A. Podar College of Commerce and Economics & Sydenham Institute of Management Studies, Research and Entrepreneurship Education (SIMSREE).

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RBI & Its Autonomy

I

Usha Thorat*

I thank the Forum of Free Enterprise for inviting me here today. Founded by Mr. A. D. Shroff in 1956, led by legends like Nani Palkhivala for several decades and supported by stalwarts such as M. R. Pai and Minoo Shroff, the Forum seeks to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital issues as befit a democratic society. The Forum you will all agree has been actively serving its purpose for over 60 years. This is a remarkable tribute for the founding fathers and the stream of people who came after them.

Demonetisation and Autonomy

One day after the United Forum of Reserve Bank Officers & Employees wrote to the RBI Governor voicing their anguish about what they perceived was an infringement of the central bank's autonomy when the Finance Ministry reportedly decided to send a

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* *The author is Former Deputy Governor, Reserve Bank of India.*

joint secretary to coordinate the RBI's currency chest operations, the Ministry of Finance issued a press release *"There has been a report in sections of the press that some unions have alleged infringement of the autonomy of the Reserve Bank of India. It is categorically stated that the Government fully respects the independence and autonomy of the Reserve Bank of India. Consultations between the Government and RBI mandated by law or as evolved by practice should not be taken as infringement of autonomy of RBI."*

The discussion in the media on RBI autonomy has been in the context of the demonetization move. When we take out a currency note from our pocket - we see that the paper has value only because the RBI's promise to pay is guaranteed by the Central Government. Fiduciary money, that has no backing of gold or any asset that has any intrinsic value, has fuelled the economy of the world for only a little less than the last hundred years, on account of the legitimacy given to it by the sovereign backing. Hence the sovereign has every right to withdraw the legitimacy.

If this is the case, then why this hoo-ha and why this discussion?

The answer is that never before has there been any economic measure that has affected every single person in this country except maybe a remote tribal engaged in barter. The task of physically replacing 15 billion pieces of paper is something that is of unimaginable magnitude. Three years' annual supply had to be replaced in two months and it is not surprising that the remonetisation is still going on. Naturally questions have been raised about RBI's competence to undertake this task, about whether the RBI knowing fully well the difficulties of achieving this task in two months, raised any issues with Government and whether its Board pointed out the risks to its reputation that could arise on account of the short time for preparation? How long were the consultations going on? Were RBI views ignored? Has RBI lost its voice, its autonomy?

As stated earlier, in an economy of fiduciary currency, the sovereign has the full right to withdraw the guarantee and its status as legal tender. For example, if there was a fear of large scale counterfeiting, both the Government and RBI would have a common interest in taking this kind of a step and this cannot be considered an infringement of the central bank autonomy. To the extent the grounds for demonetisation were other than counterfeiting, RBI had legitimate grounds to demur - in fact it did in 1978 when objective was to tackle black money.

This time around too, the objective was not just eliminating fake currency – it was also to deal with black money. Various options were and are available with the Government to deal with black money. Resorting to demonetization needs to be justified vis a vis other options and outcomes of this measure. Being in charge of currency management, RBI was in the front line for implementing a decision that was not integral to its functions such as price stability or financial stability. Its reputation took a hit on two grounds - one the common perception that RBI was a privy to the decision with its Board making an instigated recommendation in favour of the measure (unlike in 1978 when the Government resorted to an ordinance) and second for the implementation including the frenzy of circulars, the ignominy of inking the thumb of those who withdrew cash, the 19th December circular that clearly went against earlier assurances given and had to be rescinded immediately etc.

While the debate on autonomy has been triggered by demonetization, the debate is extremely important in the context of the RBI's role in maintaining price stability and financial stability. It is also important in the context of a perception that cumulatively over the recent period there is a move to diminish RBI's authority and independence.

I would like to start this discussion on RBI's autonomy by looking at the global and historical position.

Historical context

Historically central banks were created out of banks whose promise to pay was widely accepted. As sovereigns realised the value of these promises and they needed money to fight wars, they started borrowing from these banks, which began to enjoy special status. Sovereigns also recognized sometimes to their cost that unbridled borrowing could lead to inflation. Thus, Napoleon Bonaparte is reported to have commented in 1806, on Bank of France; "I want the bank to be in the hands of the Government, but not too much". The need for creation of a separate entity outside of the government was to ensure that the money creating entity was separate from the main money borrowing entity, normally the government.

Theories underlying autonomy

The theory underlying central bank autonomy arises from time inconsistency, political and business cycle and the theory of public choice. I draw from Dr. Y. V. Reddy's 2001 Indore speech in this section. The time inconsistency problem arises because there are incentives for a politically motivated policymaker to try to exploit the short-run trade-off between employment and inflation. To deal with this, the 'conservative central banker approach' postulates the appointment of a conservative central banker whose aversion to inflation is well known which would result in low inflation because of the economic agents' belief in the reputation of the central banker. The 'optimal contract approach' postulates the existence of an optimal contract between the central banker and the Government. The central banker's tenure in office is conditional upon his performance of achieving low inflation, failure of which would lead to the repudiation of the contract of tenure. An example of this is New Zealand. The political business cycles theory highlights the tendencies of incumbent governments to generate pre-election booms through expansionary fiscal policies. Once the incumbents get re-elected, the policy priorities could change towards inflation control rather than employment generation. The public choice theory postulates that unless there are constitutional or institutional constraints to the contrary, a democracy contains a bias towards deficit finance; thus they operate within the premise that politicians do not necessarily pursue public interest but are more concerned with their personal or political agenda. Thus the view that fiscal responsibility rules and limits of central bank funding of the government deficits, written into the law, helps autonomy of central banks.

Arguments against autonomy

First, detractors of autonomy argue that an independent central bank lacks democratic legitimacy. Secondly, independence may lead to frictions between the fiscal and the monetary authorities and the resulting costs of these frictions between monetary and fiscal policy may be somewhat costly for society, thus inhibiting the development process. Thirdly, there may be significant divergence in the preference pattern of independent central banks and the society at large. A strong central bank may impose its outlook on society resulting in a sub-optimal state in terms of economic welfare. At a pragmatic level, the basic issue is one of reconciling adequate independence with appropriate accountability to ensure that central banks are responsive to societal concerns.

Types of independence

In the literature on the independence of central banking in the context of modern market economics, a distinction is made between political or personnel independence, financial independence and operational independence. Political or personnel independence refers to the extent to which the Government distances itself from appointment, term of office and dismissal procedures of top central bank officials and the governing board. It also includes the extent and nature of representation of the Government in the governing body of the central bank. Goal independence viz. whether it is the sovereign who sets the inflation target or other goals before the central bank or whether it is set by the central bank itself is also put by some under political independence. Financial independence covers policy on transfer of central bank profits to the Government. Operational independence is defined as the ability of the central bank to select and use monetary tools with autonomy. These encompass the ability of the central bank to use the instruments of monetary policy such as the interest rate, and limit central bank financing of the government deficits, as this is considered to protect the central bank from any influence or obligation to fund the government at the expense of the ability to control inflation.

Pre-crisis and post-crisis view on central bank autonomy

Prior to the financial crisis, a consensus had developed around the model of an ideal central bank: independent from government, with a focus on price stability through an inflation target with primary responsibility for moderating macroeconomic fluctuations. This consensus was supported by theoretical and empirical evidence demonstrating that central bank independence was important in reducing inflation without a negative impact on growth or employment. Central banks in advanced and emerging economies converged upon this model of central bank independence.

In the wake of the global financial crisis, however, this model of a central bank is being challenged. In the US, Congress only narrowly rejected Senator Rand Paul's "Audit the Fed" plan to curtail the Federal Reserve's independence. The opposition Labour Party in the UK launched a review of the Bank of England and its leader, Jeremy Corbyn, previously called for a "People's QE" to force it to fund public projects. Even mainstream academic voices have begun calling for long-held taboos such as monetary financing of governments ("helicopter money"), scrapping inflation targeting, and questioning the value of independence.

This backlash reflects important shortcomings in the traditional model of a central bank. The crisis demonstrated that a focus on price stability alone is too narrow: effective macroeconomic policy cannot ignore the financial sector, and requires coordination between monetary and fiscal policy when at the zero lower bound. New trade-offs have been revealed between stable inflation, full employment and financial stability. For some, central bank independence itself – designed to prevent inflation from becoming too high – may no longer be useful when monetary policy is constrained and the central challenge is inflation being too low.

A group of researchers from Harvard in a recent paper on central bank autonomy have concluded that despite the backlash, the pre-crisis arguments in favour of central bank independence in monetary policy remain strong: if inflationary pressures return, politically-engineered business cycles and time inconsistency are no less likely to be problems than the past, and delegation of authority to an independent expert body remains important for credibility. Indeed, many of these arguments apply to some of the new central bank functions, including macro-prudential policy and bank supervision. They however feel that looking at the need for monetary-fiscal coordination and monetary-debt coordination, systemic oversight etc some sacrifice of political independence is called for and this can happen without compromising the objectives of price stability and financial stability as long as there is operational autonomy.

The case of India

In the case of India, it has to be remembered that RBI is a full service central bank. Apart from being a monetary authority, it is a bank regulator, it manages public debt, it manages the forex markets and controls capital flows, it regulates the payments system and the government securities markets, and it has a developmental role. Hence we need to look at India from the angle of political, financial and operational independence in respect of each of its functions.

Taking the angle of the political or personnel independence first, there is no official on the RBI Board, the nominee of the Government cannot vote, the Government can issue directions only after consultation with the Governor. Vacancies on the Board, however, if not filled, do not allow the earlier incumbent to continue with the result that you can have vacancies for a long time and these do not augur well. The process of appointment of the Governor and DGs has somewhat changed in the recent period with bureaucrats now being involved in selection of the Governor and DGs. The tenor of the Governor/DGs is not specified anywhere and the Government have generally been giving tenor of three years. There is a case for making the tenor for five years going beyond the political cycle.

In regard to goal independence, the Act says that the Central Government shall, in consultation with the Bank, determine the inflation target in terms of the Consumer Price Index, once in every five years. Let us discuss this in a little more detail. Inflation targeting was not formally adopted for several reasons as Dr. Reddy spelt out in a lecture in Hyderabad in August 2015. First, there are supply shocks, which make it difficult to deliver on the inflation target within a meaningful range, especially when food and fuel formed a large part of consumption basket. The other reasons are the weak transmission mechanism, no proven evidence that inflation targeting by itself rendered a better inflation record, and the complexity of the inflation/growth trade-off in a country undergoing structural transformation like India. Following the global financial crisis, there is more awareness of the limitations of monetary policy in managing inflation – and the tilt is towards flexible inflation targeting and an emphasis on reforms in the real sector to revive the economy. In other words, the jury is still out on inflation targeting. The Urjit Patel committee also recognises the difficulties involved. Having said this, the actual range of 2-6% for CPI inflation set in the March 2015 agreement is quite wide and allows for flexibility. The main advantage with having an explicit target is that it sets inflationary expectations, which itself is a factor affecting inflation. As for the credibility of the RBI being eroded in the event of failure to achieve the target, ultimately the government of the day is always held responsible when inflation becomes intolerable, and the distinction between it and the RBI is too fine for the common person!

From the point of financial independence, the Fiscal Responsibility Act that prohibits RBI participation in the primary market is critical in ensuring that there is no fiscal dominance. In the case of the public debt management, there can be no independence and there has always been close coordination between the RBI and the Ministry of Finance MOF. Such coordination was required to ensure that the large government borrowing was carried out in an orderly manner without too much upward pressure on interest rates and without compromising the price stability objective. The logic for removing debt management from RBI is that it could conflict with its role as monetary authority. But as the post crisis wisdom reveals, when there is huge government debt there is need for close coordination with the central bank in managing such debt. In the move to transfer the debt management function to a separate agency, care should be taken that the interests of the government as debt manager do not override its interest in the government owned and controlled banks that are the biggest subscribers to the government debt. In any case there would need to be huge coordination between the public debt management agency and RBI

Another aspect of financial independence is in terms of the transfer of profits to the Government each year. For several years RBI built up internal reserves to ensure that these are commensurate with the growth in the balance sheet. In the recent period, all surplus profits have been transferred on grounds that the capital is adequate, based on a risk management model adopted by the RBI. This has led to a reduction in the ratio of the contingency reserve to the total assets of RBI. This is the cushion available to RBI in its balance sheet to ensure flexibility in policy making.

From point of view of operational autonomy, the Monetary Policy Committee (MPC) has full freedom to set the interest rates and the Governor has a casting vote. The selection of the MPC is by a committee headed by the Cabinet Secretary. Governor is a member and apart from the three external experts there is one more bureaucrat as member. The tenure is for four years and no reappointment is allowed. Accountability is enshrined in the Act, as there will need to be a report in the case of not adhering to the target. Ultimately, the proof of whether the independence has increased will be reflected by the actual experience of decision making by the MPC over a reasonable period.

RBI's mandate

RBI has perhaps more roles than most central banks. The Financial Sector Legislative Reforms Commission set off a debate on whether the regulatory roles of RBI need to be curbed so that it focuses mainly on monetary policy. A number of suggestions have been made some of which are in the process of implementation. These include removing certain roles from the RBI like debt management, consumer protection, bank resolution etc. Many of the roles performed by RBI are intrinsic to or synergic with its role in maintaining financial stability. Some examples are its role as systemic and bank regulator and supervisor, its role in capital account management, its role in regulation of payments systems, money and government securities markets. Merely removing a role on grounds that there are too many functions being performed by RBI is not a good enough rationale and it has to be shown how these roles conflict with others or are not performed adequately by the RBI to justify the sifting of such roles. Any such change must be brought about only after extensive debate and discussion. As Dr. Subbarao stated *"It is also important that the mandate of the Reserve Bank is written into the statute, so that it is protected from the political dynamics of changing governments".*

Accountability

The flip side of autonomy is accountability. There is already a system whereby the Governor and Deputy Governors interact regularly with various parliamentary committees; now there is a regular six-monthly interaction with the Parliamentary Standing Committee on Finance, where the Governor reports on the activities of the Bank, and the Committee offers its views and concerns. This needs institutionalisation as it not only secures the accountability structures but also the mandate.

Conclusion

Everyone is familiar with Dr. Subbarao's lament on his last day in office, when he said *'I do hope the Finance Minister will one day say, 'I am often frustrated by the Reserve Bank, so frustrated that I want to go for a walk, even if I have to walk alone. But thank God, the Reserve Bank exists.'* Dr Raghuram Rajan on his last day said he would go a little further. *"The Reserve Bank cannot just exist, its ability to say 'No!' has to be protected. At the same time, the central bank cannot become free of all constraints, it has to work under a framework set by the Government in terms of its mandate and accountability."*

RBI & Its Autonomy

II

Rajendra Chitale*

Possible Triggers for renewed debate on RBI Autonomy

Demonetisation seems to be the most immediate trigger for a renewed debate on the subject of RBI autonomy. The earlier trigger was perhaps the recommendations of Financial Sector Legislative Reforms Commission (FSLRC) on the reshaping of some of the functions and powers of RBI.

Future of Central Bank independence - Global Debate

In the context of the subject of autonomy of RBI, it may be helpful to take note that globally, debate on central bank independence centres around conduct of Monetary Policy independently from interference by fiscal and political authorities. And here, central bank independence has been largely uncontroversial for a long period particularly the past 2 decades. Yet, it is

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remarkable that a substantial fraction of the experts polled in survey by the Centre for Macroeconomics and CEPR in January 2017, now think that there could be serious changes in central bank independence. Inspite of the evenly distributed final responses in this Survey, the comments made by the experts provide a more united view. Many of them acknowledge that there will be pressures challenging central bank independence. The disagreement mainly lies in whether the pressure will be strong enough and whether it will last long enough to make a difference.

Incidentally, compared to central banks globally where all have Monetary Policy responsibility and some also have responsibility for banking supervision and key components of the payment system, RBI is a full service central bank with responsibilities that extend far beyond those entrusted to central banks globally.

Demonetisation - Legal Overview

Before commenting upon whether the decision to demonetise and the lead involvement of the central government in implementation matters should be construed as having compromised RBI's autonomy, a brief overview of the legal provisions on the subject of demonetisation would be helpful and interesting.

Section 26(2) of RBI Act empowers the Central Government (CG) on recommendation of RBI (Central Board) to demonetise any series of bank notes through notification, and upon notification such bank notes cease to be legal tender except to the extent specified in the notification. Further, CG guarantee u/s.26(1) of RBI Act which backs over every bank note is also specifically subject to the CG power u/s.26(2) to demonetise bank notes. Therefore, arguably, CG power to demonetise through notification on recommendation of RBI Central

Board, is enshrined in sec.26 of RBI Act. And, indeed an Ordinance is not strictly necessary to confirm such demonetisation.

Nevertheless, the Specified Bank Notes (Cessation of Liabilities) Bill, 2017 was introduced in Lok Sabha on 31 January, 2017 as a Financial Bill under Article 117(1)(/(3) of Constitution for India (with President's recommendation). The Bill seeks to provide, inter alia, the following:

(i) it withdraws the government guarantee u/s.26(1) of RBI Act on the demonetied bank notes through an overriding provision in sec.3 of the Bill, which applies notwithstanding anything contained in the RBI Act, and

(ii) it provides that the demonetised note shall cease to be liabilities of RBI u/s.34 of the RBI Act.

Sec.34 of RBI Act reads as follows: *"**34. Liabilities of the Issue Department –** (1) The liabilities of the Issue Department shall be an amount equal to the total of the amount of the currency notes of the Government of India and bank notes for the time being in circulation."*

Arguably, once notes are demonetised pursuant to section 26(2) of RBI Act, they automatically cease to be *bank notes in circulation* and consequently cease to be liabilities of the Issue Department u/s 34 of RBI Act without any requirement to specifically cancel them through an Ordinance or Act.

I would submit that the above Bill which seeks to repeal the Specified Bank Notes (Cessation of Liabilities) Ordinance, 2016 has been proposed to sidestep legal ambiguity and pre-empt legal challenge to demonetisation.

Interestingly, the past demonetisation in January 1998 of Rs.1000 notes was also implemented by Ordinance promulgated by the President, and not by way of notification under the RBI Act. However, Supreme Court observations on 1978 demonetisation Ordinance in case of Jayantilal Ratanchand Shah v/s. RBI & Ors vide its judgment dated 9 August, 1996, support the view that RBI has obligation to exchange notes except to the extent it is relieved of that obligation by the Central Government is patently clear from the provision of sec.26 of RBI Act. Thus, I would submit that, as confirmed by the Supreme Court, section 26 of RBI Act empowers the Central Government sufficiently to demonetise a series of bank notes through a notification upon recommendation of the RBI Central Board, and a legislative actions through an Ordinance followed by an Act of Parliament is not necessary, and the latter is only by way of abundant caution to avoid any subsequent legal or judicial surprises particularly given the monumental consequences of any such surprise.

Moot Question with regard to RBI Independence: Coming to the question of RBI autonomy in the context of demonetisation, it is rather obvious that any decision to demonetise high value notes of Rs 500 and Rs 1000 that constitute over 85% of currency in circulation is inevitably political and bound to be intensely contentious. And, it seems misplaced to make the issue of RBI Board recommendation as the basis for adjudicating upon RBI's independence. And, as for involvement of the Central Government in the implementation of the demonetisation decision, this was inevitable given the unprecedented and exceptional countrywide short term dislocation of economic and monetary activity and its effect on every day lives of millions of people. An unprecedented situation, arguably, demands an unprecedented response, and this underscores the inevitability of Central Government and RBI taking de facto joint responsibility for its implementation. Again, I submit that considering Central Government involvement in implementation of demonetisation as erosion of RBI autonomy a red herring.

RBI Independence – De jure v/s De facto

While debating autonomy and independence of RBI, it would be instructive to understand as to whether the independence under discussion is indeed *de jure*, that is, enshrined in the law, or it is *de facto*, and flows from past practice and convention. Significantly, the independence and autonomy of RBI that we speak of is entirely de facto and not de jure. Indeed, a brief overview of the relevant legislative provisions in the RBI Act is helpful.

Crucially, section 7(1) of RBI Act empowers the CG to: (i) issue directions after consultation with Governor, in public interest. Further, section 30(1) of RBI Act empowers the CG to supersede Central Board of RBI if in CG's opinion RBI fails to carry out its obligations under the Act. On supersession, CG shall entrust the superintendence and direction of RBI to such agency as CG determines. The CG has always had these powers ever since the enactment of the RBI Act. Indeed, similar powers are vested in CG under the provisions of SEBI Act and IRDA Act vis-à-vis power to issue directions to SEBI and IRDA and power to supersede the boards of SEBI and IRDA. In fact, the CG powers to issue instructions to SEBI and IRDA under those Acts is wider than the corresponding power under section 7(1) of RBI Act, as the requirement to consult with the head on the organisation (namely, Governor, RBI, in RBI's case) and that such directions can be issued only in public interest is missing in SEBI Act and IRDA Act. Similarly, the CG power to supersede Boards of SEBI and IRDA is wider than the corresponding power under section 30(1) of RBI Act. While the CG power under RBI Act can be exercised only if RBI fails to carry out its obligations under the RBI Act, the corresponding provisions of SEBI Act and IRDA Act empower CG to supersede Boards of SEBI and IRDA in several circumstances listed in those Acts, and not merely when they fail to discharge their obligations under those Acts.

Having said this, it is important to note that the above cited legislative powers conferred on the CG under the RBI Act to issue directions to RBI or to supersede the Board of RBI have never ever been used by the CG since their enactment over 8 decades back. To be sure, neither have the corresponding powers in SEBI Act and IRDA Act been used by the CG till date.

The conclusion thus is that RBI has no legislative autonomy or independence. RBI's independence flows wholly and solely entirely from past practice and convention.However, recent changes on Monetary Policy (Chapter III-F) introduced in RBI Act vide Act 28 of 2016 constituting the Monetary Policy Committee (MPC) marks a legislative milestone in *instrument independence* of RBI in operating Monetary Policy. Let's turn now to a brief overview of the new MPC framework in the context of RBI's independence.

Monetary Policy Committee – Legal Changes & Independence

Notably, whilst legislating the MPC framework into the RBI Act by Act 28 of 2016, the preamble to RBI Act itself was altered as follows:

> "AND WHEREAS it is essential to have a modern Monetary Policy framework to meet the challenge of an increasingly complex economy;

AND WHEREAS the primary objective of the Monetary Policy is to maintain price stability while keeping in mind the objective of growth;

AND WHEREAS the Monetary Policy framework in India shall be operated by the Reserve Bank of India."

The above alteration substituted the following unbelievably fossilised and inappropriate preamble of the 1934 era which seemed to hint that until 2016, the RBI itself was a temporary arrangement!:

"AND WHEREAS in the present disorganisation of the monetary systems of the world it is not possible to determine what will be suitable as a permanent basis for the Indian monetary system;

BUT WHEREAS it is expedient to make temporary provision on the basis of the existing monetary system, and to leave the question of the monetary standard best suited to India to be considered when the international monetary position has become sufficiently clear and stable to make it possible to frame permanent measures."

Incidentally, the Monetary Policy objective is now enshrined in the preamble to RBI Act with the primary objective being *"to maintain price stability"* and the secondary objective being *"keeping in mind the objective of growth"*. It is common for central banks to have dual objectives for Monetary Policy. Illustratively, the Monetary Policy objectives of US Fed (FOMC) are *maximum employment and stable prices*. Since price stability requires that the central bank not attempt to drive employment above its sustainable level, in practice, US Fed has interpreted its ultimate mandate to include maximum sustainable employment. Whereas, the Monetary Policy objectives of European Central Bank (ECB) are to *maintain price stability*, and without prejudice to objective of price stability, to support the general economic policies of the EU which include *full employment and balanced economic growth*.

Notably, Chapter III-F (sections 45-Z to 45-ZO) titled “Monetary Policy” introduced in RBI Act by Act 26 of 2016 specifically overrides other provisions of the RBI Act, and applies notwithstanding anything inconsistent contained in any other provision of RBI Act. Thus, power of the Central Government to issue directions u/s.7(1) of RBI Act does not apply to the matters provided in Chapter III-F. Thus, CG has no power to give direction to the MPC with respect to its mandate of determining “policy rates” u/s.45-ZB of RBI Act. Also, CG’s power u/s 30(1) to supersede the Central Board of RBI does not extend to superseding the MPC constituted under Chapter III-F of RBI Act. Significantly, the specific statutory power of RBI to determine interest rate policy was included in RBI Act u/s 45W only in year 2007 when Chapter III-D (sections 45-U to 45-X) was inserted by Act 26 of 2006 wef 9-1-2007. And Till then, RBI’s power to determine interest rates flowed from the business it is authorised to transact u/s 17 of RBI Act.

Construct of MPC: The MPC has a inflation target of 4% CPI *plus / minus* 2% applicable for 5 years until March 2021. If CPI is out of range for 3 successive quarters, it will constitute Monetary Policy failure, requiring RBI to send a report u/s. 45-ZN to the CG setting out: (i) reasons for failure to achieve inflation target; (ii) remedial actions proposed to be taken by RBI; and (iii) estimated time period within which inflation target shall be achieved pursuant to timely implementation of proposed remedial actions. The MPC comprises 6 members, of which 3 are independent outsiders appointed by search cum selection committee comprising Cabinet Secretary, Governor, RBI, Secretary of Department of Economic Affairs (DEA), 3 experts nominated by CG. MPC decides questions by majority present voting, and in the event of equality of votes, Governor, RBI to have a casting vote. I submit that the MPC construct now in place is superior to the earlier arrangement as it delivers collective wisdom with 3 out of 6 members being RBI officials including the RBI Governor, coupled with a casting vote of RBI Governor in case of equality of votes amongst the 6 member MPC.

It is true that the ability of Monetary Policy instruments to maintain price stability could be severely constrained without fiscal constraints or review mechanisms for the central government fiscal policies. The ability can be further constrained due to supply side bottlenecks particularly in an economy such as India where agricultural outputs contribute materially to the CPI basket. However, the fiscal constraints under the Fiscal Responsibility and Budget Management Act, 203 (FRBM Act) coupled with the wide tolerance range of CPI from 2% to 6% around a 5 year target of 4% provide adequate elbow room to address the limitations.

Central Bank Autonomy- Global Literature

Global literature about central bank autonomy seems to converge on a broad consensus that goals of Monetary Policy should be established by political authorities, but the conduct of Monetary Policy in pursuit of those goals should be free from political control (i.e. not *goal independence*, but only *instrument independence*). This conclusion is a consequence of time frame over which Monetary Policy has its effect. Because Monetary Policy works with lags that can be substantial, achieving set goals of Monetary Policy requires Monetary Policy makers to take a longer term perspective when taking their decisions. Political interference in conduct of Monetary Policy can generate undesirable boom and bust cycles that ultimately lead to both a less stable economy and higher inflation. Lack of independence of central bank can lead to higher inflation and inflation expectation in the longer run, with no offsetting benefits in terms of greater output or employment.

Globally, it is equally well established that central bank independence cannot be unconditional. Democratic principles demand that, as an agent of the Government, central bank must be accountable in the pursuit of its mandated goals responsive to its public and its elected representatives, and transparent in its policies. Transparency regarding Monetary Policy in particular not only helps central banks make more accountable, it also increases efficacy of the policy. Transparency measures include frequent testimonies before parliamentary/congressional Committees, annual/semi annual report, release of minutes of Monetary Policy committee, etc.

Central Bank functions (also Functions of RBI)

As I mentioned earlier, compared to Central Banks globally, RBI is a full service Central Bank with responsibilities that extend far beyond those entrusted to Central Banks globally. RBI has the responsibility for the following functions in line with other Central Banks globally:

- **Monetary Policy Conduct:** *Instrument Independence* (not *goal independence*);
- **Bank Note issuance:** This is a sub-set of Monetary Policy function;
- **Lender of last resort:** As a lender of last resort, the central bank should only support illiquid — but solvent — banks that are of systemic importance. It should only be authorized to do so against clearly defined collateral, which could include government guarantees. RBI's lender of last resort function conforms to this standard;

- **Payment systems:** The design of the payment systems is crucial for reducing systemic risk and, thus, the likelihood of the central bank having to function as a lender of last resort. Therefore, the Central Bank should have the authority to oversee key aspects of the payment system;
- **Banker of Government:** This is partly an extension of Monetary Policy function;
- **Banking supervision:** There could be a potential conflict between conducting Monetary Policy and banking supervision. A central bank could be tempted to relax Monetary Policy to address financial sector problems that might have arisen because of weaknesses in its supervision instead of addressing the underlying structural problems. This, combined with the growing integration of financial service providers, is viewed by some as a good reason to separate the responsibility for prudential supervision from the central bank and to entrust it to an autonomous specialized agency. On the other hand, a government agency in charge of banking supervision may be more prone to political pressures to license weak banks and not to enforce prudential regulation—particularly for state-owned banks. This may undermine Monetary Policy more than an autonomous central bank in charge of banking supervision. In some countries, the central bank may be the only institution with adequate resources and sufficient strength to withstand potential government interference on supervisory matters.

Additional Functions of RBI (beyond core Central Bank functions internationally)

As a full service central bank, RBI has the following additional responsibilities beyond those commonly discharged:

- Regulation and supervision of Non-Bank Financial Companies (NBFC). (FSLRC wanted it out of RBI);
- Forex Market regulation (this stems from capital controls and RBI responsibilities under FEMA)
- Government Debt Market: RBI regulates the government securities market pursuant to the *institutional regulation* model currently followed, instead of the alternative *product regulation* model. RBI locus standi in regulation of government debt market flows from banks being major participants in the government securities market. FSLRC favoured *product regulation* over *institutional regulation* model and wanted regulation of government securities market to be moved out of RBI onto the unified financial services regulator called Financial Services Agency;
- Public Debt Management Agent for Government. FSLRC favoured independent PDMA outside RBI

RBI/Central Bank Accountability

As I mentioned earlier, central bank independence cannot be unconditional. Democratic principles demand that, as an unelected official agent of the Government, central bank must be accountable in the pursuit of its mandated goals responsive to its public and its elected representatives, and transparent in its policies. Therefore, transparency and performance measurement of a central bank (or for that matter any regulator) is as important as its independence.

Issues in measuring performance: Monetary Policy target of inflation rate provides a quantitative benchmark against which to measure performance of the achievement. Accordingly, the new provisions of section 45-ZN of RBI Act on MPC provide for reporting and remedial framework for failure to maintain inflation in the notified band for 3 successive quarters. However, it is hard to fix quantifiable performance targets for RBI/ central bank's other functions such as banking regulation and supervision, efficient payment systems, reserve management, forex market regulation, etc.

Where quantifiable performance targets are hard to fix, adherence to appropriate procedures, transparency in rule making and enforcement (draft rules, public consultation, cost benefit analysis, final rules, regulatory comment on significant variations, turnaround time on permissions/approvals, rate of successful prosecution of regulatory violation, etc.), annual reporting to government/ legislature, costs imposed on regulated entities. On this count, I submit that all Indian regulators including the RBI have a long way to go, and the recommendations of FSLRC on transparency and accountability of regulators in India need closer attention and early implementation.

India Centric Thematic Issues in reducing RBI functions

Lastly, in the context of FSLRC recommendations on moving certain responsibilities from RBI to other regulator/authorities, I submit that it is crucial to be cognisant of the intense institutional capacity building constraints & challenges that prevail in the Indian context. It could take years for a new regulator or authority to build capacity in terms of competence, quality, consistency, maturity, financial independence, and there is no certainty of achieving the requisite capacity. Therefore, while hiving off of certain responsibilities currently discharged by RBI to another regulator is possible, much caution is warranted given the systemic constraints on capacity building.

RBI & Its Autonomy

III

A. K. Purwar*

Mrs. Thorat, who was the Deputy Governor, Reserve Bank of India, (RBI), represented the regulators. Since I was in State Bank of India, (SBI), I was a kind of regulatee. How does a regulatee organization look at the RBI and what kind of a role do we see it performing there? I would like to cover it from this perspective.

Well, it is a unique institution which has evolved over a period of the last 80 years or so; a very unique institution involved in monetary management and regulating financial markets i.e., the banking system. It discharges a lot of developmental functions. As Chairman of State Bank of India, I used to interact with lot of regulators globally; with the US, UK, Europe, the Middle East, so on and so forth. What is not known is that RBI is a revered institution, it is an institution which is on a completely different pedestal from the other regulators with which we have interacted throughout the world with the kind of market awareness that it has, not in terms of global awareness but domestic awareness.

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Let me explain this. Dr. Bimal Jalan was Governor, Reserve Bank of India, when I was Chairman, State Bank of India. Regularly, once in 6 weeks, I would dutifully take an appointment to meet him. If, for some reason, either because I was unwell or touring, I did not visit him, I would get an enquiry from his office asking where I was; which meant that I should go and meet him. During our talks, he would ask several questions about the movement of the currency markets, about the security markets, interest movements and my views and opinions on all this. He used to be very casual and formal but it was a close interaction between one of the topmost regulators and one of the top regulatees in the Indian market.

RBI's policies used to be continuously evolving which would be dynamic, getting fine-tuned with the continuous feedback that Dr. Jalan was getting. There was constant supervision over all functions. This reminds me of an incident. Once, SBI made a lot of profits in certain security transactions. They were unusual profits but within the law. After one meeting which Dr. Jalan, the regulator, attended, he requested me to see him for two minutes once the programme got over. He said he had information that we had made huge profits in the transaction and asked what was the amount.

I told him politely that it was in four figures. He further asked what the profits were used for. I replied that we had utilized them for cleaning the books of the bank. And the matter was over. This was the scrutiny exercised by one of the strongest, most revered and wonderful institutions in the world.

Let me narrate another incident. A regulation was issued to all the banks in the system. It was issued to SBI too. We promptly wrote back to RBI that we felt that it wasn't right. RBI replied saying that we had to implement it. I refused giving them reasons for my refusal. But, when they did not pay heed to my reasons, I got upset and telephoned to fix an appointment with the Governor, Dr.Jalan.

He enquired whether I was agitated and the reason for my agitation. Unlike, his usual habit, when he would take us to a corner to speak to us during a meeting, this time, he requested me to sit before him and narrate what was on my mind. He heard me out for 15 minutes and after that he called the concerned Deputy Governor and Chief General Manager. He told me to repeat to them what I had told him. I did so during which time he did not allow the Deputy Governor or the Chief General Manager to speak. At the end of this discussion he instructed me to return to the bank and write back to RBI regarding our objections. It is unbelievable today that this was the kind of system that prevailed with RBI in those days; to monitor, fine tune and reverse a decision if necessary, depending upon a genuine, honest feedback.

Now questions are asked whether such an institution should be autonomous. Yes, it should be, but there are two issues that bother me. One of them is demonetization. Why did the policy have to be amended more than 100 times over a period of two and a half months? I am sure that a lot of thinking has gone into it, but since RBI is seen as the implementing organization there were many questions asked and there were many doubts and issues. One of them was the purpose of demonetisation; which was to monitor, fine tune and reverse it if necessary, depending upon a genuine, honest feedback. But, another objective, perhaps the main one, was to unearth black money. We will have to wait and see what will happen but a lot of people had doubts whether it was the same RBI which they had known for 80 years or a different one. We will have to leave it to time to decide about this.

Another point is that when demonetisation was taking place there were concerns about double counting of notes. This comment hurt as it reflected on the professionalism of RBI; whether it is the same RBI or has it lost its credibility. These are the two issues that bothered, perhaps, all those sitting in this room, or we were waiting for the right forum to express our doubts.

As you all know, I have distanced myself from the system since 10 years. So, although I am a part of it, I am also not a part of it. So I can voice things that I think are important to us. Having said that, we must remember that the RBI is an excellent institution, which has evolved over a long period of time. We must ensure that the fear of politicisation of its policy-making should be addressed. We have one great institution. As you know, it takes time to build up an institution, it takes decades. Therefore, the test of a great institution is during difficult times.

Today we are recording a growth of 8-10%, which is fine. But, but thanks to RBI, when a lot of issues happened on the global economic front, our institutions, our economy and our society did not feel the brunt of it simply because the RBI took pro-active steps to ensure that our institutions and our economy were somewhat insulated. In my view, the autonomy of the RBI needs to be respected, should be respected, should be jealously guarded, needs to be carefully ensured and if I am allowed to say so, it should be treated as sacrosanct. I agree that in our democratic setups, elected institutions, elected people have their own way; but, they are responsible to the public, they are responsible to the general society. Having said that, it is exactly such an institution that is extremely important in difficult times and you never know when those difficult times are going to hit you. So, these institutions need to be carefully preserved, carefully protected, carefully safeguarded and they should be kept as autonomous as possible.

Today, you know, we are entering a different world, a different economy. Today, if you ask me to look, as a banker, 20 years back, and the position of the Indian economy, vis-à-vis today. Today, we are seeing a very sophisticated economy, a different kind of economy. That is because we are recording a growth of 8% easily, maybe 8% plus in times to come. A lot of reforms are taking place in terms of GST, in terms of bankruptcy law and so and so forth. So, an ideal balance between the inflation–targeted, financial-stability and development role has to be attempted and this is what we are faced with, for the institutions and for the country. I think that is the challenge which is there before the RBI and the Government of India.

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