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Becoming and Being Governor of the RBI

Autonomy and Accountability of Central Banks

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In a democracy, should a central bank be autonomous or accountable? A middle ground and a balance has to be struck, The mix will depend on the legal system, traditions, and macro-economic context. In India, in recent years, there has been a greater emphasis on accountability than on independence.

When I was governor of the Reserve Bank of India (RBI), I gave a convocation address to students at the National Institute of Bank Management, Pune. At the conclusion of the talk when questions were invited, I was asked "Sir, how do you become governor, RBI?" I responded by asking gold medallists in the audience to identify themselves. A few put up their hands. I said, "None of you stand a chance because I became RBI governor and I have never been a gold medallist!"

The process of appointment of a governor of the Reserve Bank of India, the qualifications required, and the terms and conditions of the position are in some ways mysterious for a democracy in that they are not spelt out in law. On the appointment of the governor, the RBI Act of 1934 only states that the governor will be appointed by the government, will "devote their whole time to the affairs of the Bank" and that the governor shall hold office for a term "not exceeding five years" and "shall be eligible for re-appointment". The RBI Act also gives the central government the power "to remove from office the Governor". The reasons for a possible removal are not listed. The central government also has the power to replace the governor "if by infirmity or otherwise [the Governor] is rendered incapable of executing his duties or is absent on leave".

The RBI is a full service central bank. Yet, in the 2016 amendment of the RBI Act through the Finance Act of the same year for constitution of the Monetary Policy Committee, the institutional relationship between the RBI Board and the MPC was not spelt out and has been kept deliberately vague. Further, according to the amendment, the selection committee that appoints the members of the MPC will be headed by the cabinet secretary of the Government of India, with the RBI governor only a member of this selection committee. This indirectly reduces the position of the governor by making him or her subordinate to the government.

Importance of the RBI

Globally and in India, there has been an intense discussion of late about the independence and autonomy of the RBI. This is understandable because of current critical global geopolitical conditions.

The important functions of the RBI include issue of currency, monetary management, banker to banks and the government, management of public debt, and management of foreign exchange reserves. Over a period, it has subsumed and assumed powers to regulate money, securities and foreign exchange markets, regulation of banks and non-banks and payment and settlement systems. In serving the public good, the RBI has traversed a long distance and faced many challenges. In the process, it has evolved into a full-service institution encompassing regulatory and developmental roles in the financial system, besides partnering with union and state Governments as their fiscal advisor in domestic and external sector policies.

The RBI is special because: (a) it is a full-service bank; (b) its board represents broader society; (c) the Banking Regulation Act and Foreign Exchange Management Act give authority to RBI to undertake non-traditional banking functions. It also functions as the debt manager to the union government as per statute and as banker to state governments under agreements with each state government.

Why autonomy? Why independence?

In academic and policy literature, three reasons are given in favour of independence to the central banks. The first is what is called time inconsistency. Essentially, it means that the time horizon of democratically elected government is short-term and hence they may favour growth over price stability. However, on matters relating to money, actions have to be taken keeping a long-term view. The central bank is expected to take a longer-term view.

> If war is too important to be left to generals, money is too important to be left to monetary authorities, or economists.

There is a second reason: that there are political cycles and there are business cycles, which do not coincide. For instance, elections will encourage politicians to have expansionary policies at that time. The business cycle may already be booming, requiring contraction.

The third reason is that governments have a tendency to spend more money than appropriate and some limits have to be put on the spending. These can be put in the Constitution. This can also be enforced by independent central banks.

Equally, there are arguments against autonomy and in favour of accountability. There is no democratic legitimacy for a technocratic body to decide on the important matter of money. If war is too important to be left to generals, money is too important to be left to monetary authorities or economists.

> A middle ground has to be struck. There must be some autonomy and there must be accountability.

Second, the independence of central bank may result in friction between fiscal and monetary authorities.

Third, a central bank may 'impose' its outlook and preferences on the people, contrary to democratic preferences.

In brief, at a pragmatic level, a middle ground has to be struck. There must be some autonomy and there must be accountability. The mix will depend on the legal system, traditions, and macro-economic context.

There are three areas of independence: personnel, financial, and conduct of policy.

Personnel independence refers to appointments, the term of office, and dismissal procedures of the board and top central bank officials. Financial independence is the extent to which the government commands financing by the central bank without reference to the discretion of the central bank. This also involves the terms and conditions under which capital is made available by the government to the central bank to conduct its operations. Policy independence is related to the flexibility given to the central bank in the formulation and execution of monetary policy.

In sum, all these three aspects are part of arriving at a balance between autonomy and accountability.

Changing balance

The balance between autonomy and accountability keeps changing.

New Zealand was the first country to legislate on the single objective of price stability for the central bank to pursue. Recently, New Zealand seems to have abandoned this approach by law. In the interim there have been several phases in the nuance of defining price stability, financial stability, and growth.

For example, after 1970 - and particularly after 1995 - there was a general belief that central bank should ideally be independent and be accountable for maintaining price stability. This was partly because of the emergence of the financial sector and financial markets as critical to the global economy, especially advanced economies. This shift from dependent central banks to independent central banks was most evident during times of war and in the case of centrally planned economies. It was less glaring for other developing countries.

In a way the extent of independence depends on the mix of state and market, especially financial markets in the country.

Central bankers felt they were heroes because price stability was maintained historically for a long time. But the global financial crisis (North Atlantic) of 2008 changed the situation. Too much focus on price stability was the problem since rising asset prices and the role of globalisation in lowering prices was not appreciated. Central bankers were too technical to appreciate the emerging inequalities. The social unrest crisis happened with almost all central banks not anticipating it. Central banks had to pump in money to bail out banks and the financial system.

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The heroes failed but they had to be rescuers also. They had to fight the crisis they created. The 2008 financial crisis was too much for central banks to handle without backing of governments. The sovereign is always the ultimate risk bearer and central banks had to depend on government support and coordination amongst governments.

At this stage, though central banks became more active than before due to the crisis, they also lost their freedom. They had to depend on their respective governments. At the same time, there was a preference for returning to the old system of full-service central banks as in the case of the United Kingdom. Central banks became more central for coordination and less independent from governments to fight the 2008 financial crisis and its aftermath.

Aspects of central bank independence

Recent literature has stressed the difference between goal independence and instrument independence. Goal independence refers to a situation where the central bank itself can choose the policy priorities of stabilising output or prices at any given point of time, thus setting the goal of monetary policy. Instrument independence implies that the central bank is only free to choose the means to achieve the objective set by the government.

Some of the other factors considered in assessing central bank independence or autonomy are as follows.

The legal framework should clearly define the objectives, powers, and responsibilities of the central bank, while also providing safeguards against political interference. The central bank's statutes or laws should outline its independence and establish the conditions for the appointment and removal of its officials.

> It is crucial to have mechanisms in place to prevent political interference in the central bank's decision-making process.

The autonomy of monetary policy is feasible when the central bank has the authority to set and implement monetary policy independently, including taking decisions related to interest rates, money supply, and exchange rates. It should have the freedom to pursue its objectives without political interference.

The process for appointing central bank officials, such as the governor or board members, should be transparent and insulated from political pressure. Their tenure should be sufficiently long and protected against arbitrary removal to enhance their independence.

While independence is important, central banks should also be accountable for their actions. They should provide regular reports on their policy decisions and the economic outlook and be subject to external audits. Transparency helps build credibility and public trust in the central bank's actions.

It is crucial to have mechanisms in place to prevent political interference in the central bank's decision-making process. These mechanisms can include legal provisions, separation of powers, and checks and balances.

Central bank independence in practice

As we have seen, there are some pointers used traditionally to assess the independence of a central bank. In practice, what exactly is meant by independence will depend on the state of the economy, the relationship between the head of the central bank and the government, and so on.

Let us take the classic conundrum of growth and inflation. Governments, particularly in the year leading up to elections, focus on growth. The central bank might be concerned about containing inflation. There are two approaches to this problem.

> It is extremely difficult, if not impossible, to quantify the independence of a central bank and reduce it to a formula.

A 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. An 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 in achieving low inflation, failure of which would lead to the repudiation of the

contract of tenure.

Historically, there are successful examples of both types of models of central bank independence. The US is often seen as an example of a conservative central bank and New Zealand is characterised as a follower of optimal contract approach.

In other words, it is extremely difficult if not impossible to quantify the independence of a central bank and reduce it to a formula.

The TAC and MPC of the RBI

The RBI established the Technical Advisory Committee (TAC) on Monetary Policy in 2005. The TAC was formed to provide inputs and advice to the RBI on monetary policy decisions, including the stance of monetary policy, interest rates, and liquidity management. Its purpose was to enhance the quality and effectiveness of the monetary policy formulation process. The committee consisted of the central bank's top brass including the deputy governor and the governor and external advisors. It gave its opinion and suggestions on what the RBI should do. But the governor's word was final on the rates and the advice of the technical advisors was not binding on the RBI.

> In recent years, the government of India has emphasised more of accountability and less of autonomy.

The Monetary Policy Committee (MPC) was constituted through a legal change in 2016 so that decisions in regard to monetary policy were not taken by the governor alone. In the membership of the MPC, all members are virtually appointed by the government, either directly or through the RBI.

The MPC has six members. Three each are appointed by the government and the RBI and each member has one vote. While the majority voice of the committee is final in deciding the interest rates and the RBI has to accept the verdict, the governor gets a casting vote in case of a tie.

Inflation targeting has now been adopted through legal changes. A Monetary Policy Committee has been constituted. The Governor has been made accountable; but he is only a chairman.

In brief, in recent years, the government of India has emphasised more of accountability and less of autonomy.

Conclusions

"I don't want independence," I had once said as governor of the RBI.

When capital flows are in excess of the normal demand, the exchange rate may appreciate beyond what is desirable and there is a cost involved in managing the impact of such increases. This is the cost of sterilisation and it is not fully compensated by the returns on the investments made from foreign exchange reserves. Normally the RBI would have to bear the costs. But I suggested that the magnitude of flows could be too large for RBI to incur the cost and prepared a proposal which could increase the fiscal burden of the union government. (*Advice and Dissent:* 350-51)

I went to the then finance minister, Jaswant Singh, who agreed to support my proposal. I suggested that he obtain the informal assent of the prime minister. Singh called after due consultations on my proposal. As suggested, I met the chief economic adviser, Ashok Lahiri, who said my proposal implied an erosion of the independence of the central bank. At this I said, 'On this important matter I do not want central bank independence anymore.'

I then explained to the finance minister that we in India did not need to go by the textbook idea of central bank independence. The finance minister approved the proposal.

Later at a meeting of central bank governors at the Bank of International Settlements (BIS), some expressed surprise that the government had agreed to my proposal. Any government's natural tendency is to avoid the fiscal burden when it can be borne by the central bank. Yet Finance Minister Jaswant Singh and Prime Minister Atal Bihari Vajpayee took on the burden despite bureaucratic and economic advice they most likely would have received.The approval of the Market Stabilisation Scheme scheme was an act of statesmanship by both of them. The other governors in the BIS meeting were right to be surprised.

This, I believe, illustrates the essence of central bank independence. Central bank independence is not self-serving. It is in the larger interests of the nation.

I will end by recounting an occasion when I was asked about the independence of the RBI, I replied: "I am very independent. The RBI has full autonomy. I have the permission of the finance minister to say so."

(The author acknowledges with gratitude the professional support of S. Subbaiah and Ravi Menon.)

Y.V. Reddy was the governor of the Reserve Bank of India between 2003 and 2008. He is currently patron of the Forum for State Studies. *This is the second of an occasional series of articles on money, banking and finance. The first was "The Rupee as an International Currency".*