Undermining autonomy of RBI is the opposite of Modi's promise of good governance

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Governor of the Reserve Bank of India Urjit Patel | Dhiraj Singh/Bloomberg

Text Size: A- A+

The Modi-RBI tussle flies in the face of minimum government and maximum governance slogan.

The emergence of a public, unprecedented conflict between Reserve Bank of India Governor Urjit Patel and the government has opened up a yawning gap between the ministry of finance and the central bank.

The statement of the Reserve Bank of India (RBI) Deputy Governor Viral Acharya and reporting on the relationship between the RBI and the finance ministry indicate that the tensions have arisen because the interests of the government in the run-up to the elections conflict with the central bank's understanding of its institutional responsibilities to pursue objectives such as stability of prices and of the banking system, alongside growth and employment. For example, the perception that a government can demand at will transfers ('dividends') from the central bank can ultimately severely undermine the ability of the latter to contain the inflationary expectations of the private sector, and thus lead to accelerated inflation.

For the last 30 years, the fad of calling for formal independence of central banks and for assigning narrow inflation-targeting objectives to them has swept the world. These two ideas have usually been taken as going together. Most recently, in creating an inflation-focused Monetary Policy Committee with the consent and support of the government, the RBI has also adopted a modified version of inflation-targeting. It is thus especially puzzling to learn that the government does not view the RBI as possessing day-to-day independence. Within the globally understood framework of inflation-targeting, even of the 'flexible' kind adopted in India, this is simply incoherent. But even those who do not share this prescription generally agree that a prudent approach to fiscal and monetary affairs requires a degree of insulation of monetary policy from narrowly political and short-term demands. The open tension is therefore, from any point of view, very damaging to the ability of the RBI to pursue its proper objectives.

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Although there is reason to object to the increasingly narrow focus of the RBI on inflation, the issue raised by the recent controversies is more fundamental.

Undermining the ability of the RBI to pursue its goals in the interest of short-term political advantage (essentially, through the relaxation of scrutiny of bad loans, the provision of cheap and easy credit, and the relaxation of the financial constraints faced by the government) threatens to weaken the RBI as an institution.
It is therefore the opposite of Prime Minister Narendra Modi's promise of good governance. It is notable that in each case, his government has favoured looser standards.

The resulting controversy cannot be in the interest of the general public, nor play well with foreign investors. The country is increasingly dependent on the latter and the government's prioritisation of its political goals over maintaining, and being seen to maintain, a sound institutional framework is nothing less than reckless. (It is remarkable that the IMF has already stated that it is 'monitoring' the situation, adding that "International best practice is that there should be no government or industry interference that compromises the independence of the central bank and financial supervisor").

The demands of the government – to substitute fiscal discipline by seizing money derived from RBI activities such as printing money; to release favoured sectors from being subject to supervision of their bad loan books; and to lend more freely prior to the election – can only fuel worry about a slippery slope. That the same government has had frictions with a previous RBI Governor too (Raghuram Rajan) gives reason for concern that there is an underlying tendency to demand fealty from the RBI and to politicise unduly issues related to monetary policy and banking supervision.

While there can be reasons to break the 'orthodox' rules as part of a national development strategy, doing so because votes are needed around the corner is alarmingly sectarian. And worse, it is unlikely to deliver the goods that can ultimately justify such rule-breaking.

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The choice, then, is not between the pursuit by the RBI of an inappropriately narrow end that might be criticised and broader ones. The choice is, rather, between the pursuit of principled objectives and opportunistic ones. In a word, this is also the choice between bad governance and good. So much for the slogan of minimum government and maximum governance. It looks rather like the inverse.

What is the alternative? Developing a sound institutional framework – one that is not bent out of shape according to the ruling party's short-term preferences, or any other parochial interest – is a necessity for providing a credible long-term framework for growth and development in a democratic context. The historical objectives of the RBI, set out in the Reserve Bank of India Act 1934, identify a range of goals: "to regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage; to have a modern monetary policy framework to meet the challenge of an increasingly complex economy, to maintain price stability while keeping in mind the objective of growth."

These diverse and open-ended goals necessarily must both be given greater definition according to the requirements of the time and be appropriately balanced among themselves.

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Moreover, Section 7 of the Act, which may have now been invoked for the first time by the government, states that "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". The key here is the idea of the "public interest". Even in the unprecedented event that formal instructions are offered to the Reserve Bank of India by the government, this must be done in the interest of the people of India, and not for an election victory. It is the burden of the government that takes such a step to make this case.

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