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Protecting The Central Bank's Independence

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(The editorial is based on the article "Protecting the central bank's independence" which appeared in Livemint on 29 October 2018. It analyses the importance of the central bank's independence.)

The debate over the independence of RBI may have been rekindled only in the recent past, but the debate is as old as the central bank itself. Recently, deputy governor of Reserve Bank of India (RBI), Viral Acharya chose to deliver a strong message on the importance of the central bank's independence. It brought to light the tension between the central bank and the government on the current issues of setting up of an independent payments regulator outside RBI, blame game on Nirav Modi scam and government's choice of directors on the central bank board. This lecture, therefore, serves a cautionary note.

Global Scenario

- The issue of importance of the independence of central banks is being widely debated globally.
- US President Donald Trump has often criticized the Federal Reserve for raising interest rates.
- European Central Bank president recently raised the issue of the threat to central banks' independence from governments.
- The most recent example of what can happen when the government obstructs the central bank in Turkey. Turkey's example is relevant with the lira having depreciated over 80% against the dollar in the 12 months due to government interference.

Functions of Central Bank :

- It controls the money supply.
- Regulates credit by setting the rate of interest on borrowing and lending money.
- Manages and regulates the external sector including the exchange rate.
- Supervises and regulates the financial sector, notably banks.
- Banker to the commercial banks, to the Government of India, and also, to the state

governments.

- Therefore, it seeks to ensure financial stability, domestic as well as on the external front.

History

- The RBI always has had its disagreements with the government, mostly in private and rarely in public, when it comes to its autonomy in setting the monetary policy, regulating banks, managing the rupee value in the foreign exchange market, and even debt management function.
- In the late 50s, the fourth RBI Governor under Jawaharlal Nehru's prime ministership, Benegal Rama Rau exited abruptly when the then finance minister encroached into RBI's turf by levying some taxes. The 22nd Governor D Subbarao had a public spat with two finance ministers over the direction of interest rates. Raghuram Rajan, a predecessor of incumbent Governor Urjit Patel, always showed the mirror to the government, which was not appreciated by the current government.

Why is the central bank separate from the government?

The world over, the central bank is set up as an institution separate from the government; put another way, it is not a department of the executive arm of the government; its powers are enshrined as being separate through relevant legislation. Its tasks being somewhat complex and technical, central banks are ideally headed and manned by technocrats or field experts – typically economists, academics, commercial bankers, and occasionally private sector representatives, appointed by the government but not elected to the office. This architecture justifies that central banks should be allowed to exercise their powers independently.

How the independence of Central bank is undermined?

- By appointing government (or government-affiliated) officials rather than technocrats to key central bank positions, such as Governor, and more generally, senior management.
- By pursuing steady attrition and erosion of statutory powers of the central bank through piecemeal legislative amendments that directly or indirectly weakens the separation of the central bank from the government;
- Blocking or opposing rule-based central banking policies, and favoring instead discretionary or joint decision-making with direct government interventions; and
- Setting up parallel regulatory agencies with weaker statutory powers and encouraging the development of unregulated (or lightly regulated) entities that perform financial intermediation functions outside the purview of the central bank.
- However, the present government got the legislation passed to make RBI an inflation

targeting central bank through a monetary policy committee (MPC). This will make it more difficult to influence the decision of a committee with respect to changing the interest rates in the economy. This is a confidence booster for markets too.

Need for the independence of Central Banks

- The basic difference between the approach of a government and central bank is that the latter is not bound by short-term targets. Use of the bank's powers of money creation and setting the cost of money for short-term benefits can be disastrous for the economy. So it calls for independence of central banks.
- Governments driven by electoral calculations will favour lowering of interest rates just before elections to provide a short-term boost to growth even if it comes at the cost of long-term inflation. Thus, there is a risk that monetary policy would become volatile, and lose credibility and effectiveness. In such circumstances, it becomes imperative to ensure the autonomy of the central bank.
- The government will always want the economy to grow at a faster rate. But it's the job of the central bank to function as a check and balance so that the economy remains on a sustainable growth path.
- Therefore, it is important that central banks have the institutional capability to take independent decisions in order to be able to maintain price and financial stability.

Way Forward

- Independence of central banks is in the interest of the government as the central bank taking independent decisions sends the right signal - helping maintain macroeconomic stability.
 - Therefore, it is advisable for the government to avoid forcing decisions that could be seen as undermining the central bank.
 - At the same time, the central bank should also explain its position to the government and public at large so that issues can be debated more widely. There is also a need for better communication.
 - In addition, RBI needs to assert its autonomy when required. For example, the Monetary Policy Committee took the right call by refusing to meet finance ministry officials to discuss interest rate policy last year.
 - At the global level as well, central banks will have to work hard to maintain their independence.
 - However, given that their decisions have wider implications for the economy and in order to sustain their autonomy, central banks should be more accountable for their decisions.
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