



A Digital Daily from New Delhi

RBI Independence: The Dangerous Line Between Autonomy and Accountability

By [T.K. Jayaraman](#) on [10/06/2017](#) • [Leave a comment](#)

The latest refusal to cut rates, and the MPC's decision to decline meeting with finance ministry officials before its deliberations on monetary policy, will be hailed by those who are interested in good governance.



The exit of former RBI chief Raghuram Rajan (left) has not left behind a pliable central bank.
Credit: Reuters

It was an unusual press conference. After the central bank announced its monetary policy decision, the media were surprised to learn firsthand from the Reserve Bank of India (RBI) governor that the members of the monetary policy committee (MPC) did not accept an invitation to meet with Finance Ministry officials ahead of the monetary policy review.

Before June 7th's MPC meet, media reports had pointed out that finance ministry officials (including chief economic adviser Arvind Subramanian) would have separate meetings with the MPC's RBI representatives and also meet separately with the independent members of the committee.

Governor Urjit Patel's public statement, however, ups the ante. The seemingly simple words that they had an invitation, but rejected it, have much to convey. There are growing attempts to interfere with the autonomy of RBI. The central bank's mandated primary goal is maintaining price stability. The stated objective is to achieve the medium-term target for consumer price index (CPI) inflation of 4% within a band of +/- 2 %, while supporting growth.

Trying to influence RBI decision

The RBI wants the nation to know that government tried to influence the most important policy tool of RBI. A policy tool that affects the borrowing costs of investors and households and, of course, the governments' own borrowings which are used to bridge fiscal deficits at the Centre and state level.

The decision by the MPC to stick to the same old rate of 6.25%, which also remained unchanged at the last April meeting, is based on its own perceptions and future price expectations.

One of the two major differences between now and April is that RBI has changed its stance to a more proactive one. Or at the very least, the central bank appears to be more open to an accommodative monetary policy stance in that it has not ruled out a cut at its next August sitting.

Presently, however, the RBI is not certain. Why? For a number of reasons:

- (i) Although retail inflation based on consumer price index (CPI) dropped to 2.99% in April this year compared to 5.47% in April 2016, the whole price index is 3.85%.
- (ii) Although prices of food and manufactured products have cooled, the immediate future is still risky. The drop in inflation is purely due to transitory factors and on the other hand the horizon is not clear as there are signs which could reverse the currently rosy picture.
- (iii) The risks to inflation stem from the spurt in farm-loan waivers by states, disbursement of allowances under the 7th Central Pay panel's award to government employees and the July GST roll-out.
- (iv) Global political and financial risks materialising into imported inflation.

Although the RBI decided to keep the policy rate unchanged at 6.25%, it made borrowing attractive for home buyers by reducing the risk weightage for this category. Interest on loans between Rs 30 lakh and Rs 75 lakh will now be less. The central bank also made it easier for banks to lend more by cutting the Statutory Liquidity Ratio (SLR) by 50 basis points to 20% of total deposits from June 24, which would enable more cash resources for banks to lend.

In sum, RBI prefers to wait for some more time. At least two months until August, when signs are expected to be clear and more assuring, as we would have had a good monsoon in keeping with expectations and a clearer picture of the effect of GST on prices.

Myopic view

The government, however, is in a hurry. Its view, though myopic, is understandable. Its concern is with elections. The 8% economic growth rate of 2015-16 is unlikely to be repeated in the near future. Growth fell to 7.1% in 2016-17. The government's statistics have also, implicitly, [been questioned](#) by central bank deputy governor Viral Acharya.

His remark, "there was some lack of clarity in the narrative", will likely emerge as one of the classic economic understatements of the year.

"We have a combination of a big surprise in the inflation number as well as the CSO revisions. We are just trying to get a finer grip on what is exactly happening in the economy over the next few months," Acharya said.

Unhappy finance ministry

India's chief economic adviser Arvind Subramanian is unhappy. He [is frustrated](#) with RBI's cautious policy stance. He blames it for the slowest economic growth in two years and lowest credit growth in 25 years. However, he is also aware that the latter is more due to the mounting pile of non-performing assets in public sector banks over the last few years.

It is noteworthy that one of the six members of MPC did not agree with the decision of effecting no change. Thus, the decision of MPC is not unanimous, which is the other difference between past meetings and the June 7 meeting. Whether this member (IIM-A professor Ravindra H Dholakia) was in favour of a cut or whether he preferred an increase in the policy rate will be known only when the minutes of the MPC meeting are available later this month.

But one thing is clear: all the six members of MPC unanimously decided not to accept any advice from finance ministry officials.

Mythic reality

Central bank independence is a myth. In theory, central banks would like to impress upon the nation that it is free from any control by government while the government of the day will strive to assure global investors that it has no political influence over the central bank's policy. In practice, there is subtle and sometimes not-so-subtle persuasion on the part of the government.

In [an article](#) on April 27, 2017, the *Economist* celebrated the 20 year-anniversary of a decision taken by Gordon Brown, Britain's chancellor of the exchequer. On that day in 1997, hailed today as a historic day, Brown gave the Bank of England (BOE), mother of all central banks, the responsibility for setting interest rates as well as being in charge of meeting an inflation target.

Once BOE got the freedom to set and decide policy interest rates, long-term borrowing costs fell sharply, leading to a rise in the value of the British pound. Imported inflation fell and there was joy all around. Though BOE governor Eddie George was delighted, the chancellor of the exchequer was not happy. Fear gripped him. Afraid of BOE becoming more powerful, within weeks, he stripped BOE of all of its responsibilities for bank regulation and public-debt management.

The Economist refers to these tussles as the “wars of independence”. In the US too, President Lyndon Johnson (who was a democrat) and President Richard Nixon (who was a republican) were “not averse to bullying Fed chairmen into keeping interest rates low”.

And so it goes. Either keep the genie in the bottle, or, once out, persuade it to get back into the bottle. Arvind Subramanian's gentle invitation to MPC members is yet another chapter in [Keynes' “essays in persuasion”](#).

If gentle measures do not succeed, it could be that they are followed by more drastic steps of the kind BOE Governor Eddie George had to contend with. Any drastic step, however, is not only unlikely but would backfire.

This is not the first time that Urjit Patel has asserted the central bank's autonomy. He refused to fulfill the expectation of finance ministry in December 2016, when [he did not cut the policy rate](#) in a cash-starved economy following demonetisation late last year. By so doing, he lived up to the high traditions set up by former governor Raghuram Rajan.

The latest monetary policy decision and MPC's decision to decline meeting with finance ministry officials before its deliberations on monetary policy will be hailed by those who are interested in good governance.

Is the MPC wrong in its refusal to cut rates? That remains to be seen. What is clear is that the central bank officials often find themselves between a rock and a hard place. Patel should take comfort in the words of a former first lady of the US, Eleanor Roosevelt:

“Do what you feel in your heart to be right, for you will be criticized in any way. You will be damned, if you do and damned if you don't”.

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