

# A deeper reform

The question of the age is how to set up a regulatory apparatus that powers high growth. Draft Indian Financial Code offers an answer



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THE CENTRAL problem that India faces is one of creating greater state capacity so that the government can effectively deliver what the political leadership desires. This requires a full re-engineering of government, with an emphasis on clarity of objectives, rule of law and accountability. These concepts should be defined by law. In the field of finance, the revised Indian Financial Code (IFC) shows the way to create greater state capacity.

We, in India, transitioned from colonialism to socialism. Now we are trying to build a market economy, and are beset with malfunctioning government organisations. Too often, government organisations meddle unreasonably in the economy, fail to competently do the things that need to be done, and engage in excesses of corruption, sloth and arbitrary power.

The question of this age is how to set up the regulatory apparatus that will power high growth. If we set up a regulator as a controller of a sector, there are no limits on the actions of the regulator and misbehaviour is likely. Each regulator must have a clarity of objectives, limited powers and ample accountability mechanisms.

Regulators are given the power to write law in the form of "regulations". A well-structured process is required, with checks and balances, to avoid the abuses associated with unelected officials writing law. Regulators also perform the executive function of enforcing the law. Here too, formal procedures must be in place to avoid the abuse of power. Regulators further perform a quasi-judicial function in writing orders. This requires adversarial hearings. Once an order is passed, it should be subject to judicial review.

The law defines the DNA of the regulator on all these fronts. In order to ensure the better functioning of regulators, we need to rewrite the law. In the field of finance, a comprehensive rewriting of the law has been

done in the form of the draft IFC. The Srikrishna Committee worked from 2011 to 2013. A large volume of public comments was received. The finance ministry has come out with a revised draft, with many technical improvements. In parallel, the finance ministry has begun constructing the financial regulatory institutions required to enforce the law. Once this is enacted and enforced, India will have a modern financial system.

Public discussions about the IFC have focused on the organisation of monetary policy. India is now in the early stages of establishing a monetary policy committee (MPC).

The key intuition is similar to the idea behind a bench of judges. A bench of five or seven judges obtains a better answer than any single judge. No matter how skilled, an individual judge can be wrong. A good bench offers a better outcome by bringing multiple perspectives. When there is one judge, there are pressures on him, and all kinds of considerations as well as deal-making can come into play. It is much harder to pressure an entire committee and it ensures greater independence. Also, no one person should control the committee, else we will face the same problems associated with the single judge.

External members are particularly important because of the need for a diversity of perspectives. Colleagues within a central bank are likely to have shared assumptions, a shared worldview, and they will be reticent in breaking ranks. External members bring a fresh perspective and independence of thought, thereby improving the outcome.

Recent experience provides an example. The RBI has a Technical Advisory Committee (TAC) composed of external members. In 2014, the TAC was the first to understand the collapse of demand in the economy, and it favoured rate cuts. The governor thought differently at the time. But the TAC was proved right when the governor chose to make two unexpected rate cuts in January and March 2015. If the external members of the TAC had the formal power of voting in the MPC, then rate cuts would have come in January and September 2014. We stand to make such gains by shifting the power of rate-setting from an individual to a committee.

External members would come from all walks of life. Some could have connections to the world of business. They would have

better appreciated the problems of demand in India in 2014 and 2015, and possibly voted in favour of much bigger rate cuts. Such diversity of perspective helps obtain the best outcomes for the country.

How big should rate changes be? The RBI has followed the style of central banks worldwide, raising or cutting at 25 basis points at a time. However, monetary policy transmission in India works differently. Given the malfunctioning financial system, a 25 bps rate change makes a negligible difference to the cost of funds for households and firms. External members, more grounded in the realities, could possibly argue in favour of much bigger moves, given the differences between the Indian financial system and the conventions of other central banks.

There is a lot of talk about the independence of the RBI. Under the present law, the RBI does not have independence. The government has the power to give directions to the central bank about anything, without needing to offer a rationale and without transparency. Whether it is exchange rate policy or rate-setting, the government has the power to give directions. Under the proposed law, the RBI will have greater independence. But the independent authority to set interest rates will vest with the MPC and not with the governor. This will result in greater institutional stability and predictability.

Too much of the discussion has focused on who appoints the MPC members. We must remember that the governor, deputy governors and all RBI board members are appointed by the government. The same appointment procedure should be used for the MPC members.

There is a clamour for deeper economic reforms. The revised IFC is the deeper reform that will create state capacity, reset the role of government in the economy, and reduce the cost of doing business. As with all reforms, this will face resistance from incumbents in government agencies. However, there are no political barriers to this reform in the form of voters' opposition. In order to obtain the full benefits in the shortest possible time, we must also emphasise the early implementation of the non-legislative recommendations and the creation of the requisite institutional architecture.

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