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RBI independence: The middle ground

In the principal-agent relationship of finance ministry and central bank, autonomy arguments are weak

SNAKES & LADDERS

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The demonetisation drama has brought debates about Reserve Bank of India's (RBI's) independence to the fore. There are two extreme views. Some argue that when the chips are down, the power of the Ministry of Finance must be unchallenged. Section 7 of the RBI Act reflects this view. Others argue in favour of extreme RBI independence. The truth lies in between: There is a case for regulatory independence in licensing and investigation, and monetary policy independence in the control of monetary policy instruments. In other areas, what is required is a sound board, where the Ministry of Finance should have a seat.

All financial agencies are created by an Act of Parliament. There is a principal-agent relationship, where the Ministry of Finance is the principal and the financial agency is the agent. The tug-of-war of every principal-agent relationship takes place: The agent favours laziness and corruption while the principal seeks to keep the agent on track.

The board is a key component of this process. The board exerts oversight over the management. The board must be dominated by independent directors, so that it can be tough on the management. It must control the budget, the organisation structure, and internal processes, including the reporting systems. The Ministry of Finance should have one representative on the board, through which it is part of this principal-agent relationship management.

Financial agencies like RBI or the Securities and Exchange Board of India (Sebi) have a legislative function — they write law. This is an unusual arrangement, as the power of making a law normally resides only in Parliament. In recognition of how special this situation is, the legislative function must be controlled by the board. There must be a formal regulation-making process, which is initiated by the board, and involves an institutionalised application of mind. The final decision on each regulation must be taken by the board. Delegation of law-making power to mere officials of a financial agency, as is done at present, is an inappropriate delegation of power. The Ministry of Finance would have a role in this process, by virtue of its membership on the RBI board.

The Ministry of Finance must, of course, appoint all the members of the RBI board, management and independent members. It must also appoint the independent members of the Monetary Policy Committee (MPC). The management should have no say in these appointments, so as to avoid capture of the independents by the management. This is a sound arrangement, even if it is not extreme RBI independence.

These arguments show that the phrase "RBI independence" is a confused concept, and one that is best avoided. Like other financial agencies, RBI is the agent, and the only reasonable arrangement is where the principal makes appointments, has a seat on the board, and is part of the board process which controls regulation-making, budget-making, organisation design, and holding the management accountable. Nobody can argue that the Ministry of Finance should not be in these things.

The case for independence is narrow and unambiguous, and it concerns three things: Licensing, investigations and monetary policy instruments.

When elections are nearing, the ruling party has an incentive to push for reduced interest rates. This gives a temporary boost to the economy, but it kicks off an inflation headache for the next government. These ups and downs are best avoided. Hence, it makes sense to insulate monetary policy instruments from the Ministry of Finance. This is done by handing control of all monetary policy instruments to the Monetary Policy Committee, where the Ministry of Finance does not have a membership.

The Minister of Finance wields immense power over the governor. There is the danger that the RBI governor will make deals with the Minister of Finance, and deliver the desired rate cuts in exchange for other favours. Hence, MPC should be so structured that the RBI governor is not able to deliver a desired outcome. As an example, it would make sense to have an MPC with four external members and the RBI governor, so that he has only one vote out of five. We should aspire for the RBI governor to be a technician and not a deal maker.

The ruling party may want to give a licence to its friends, or ask a regulator to go easy on an investigation into certain private firms. We need regulatory independence in order to avoid this. Hence, it makes sense to place the executive functions of licensing and investigation inside the regulator but below the board. The decision to give a licence should not come to the board. The steps in investigation and adjudication should be handled by the management without recourse to the board. The board should be involved in the process design of how investigation is done, but not in individual transactions.

RBI is unique in its monetary policy function. The monetary policy independence described above is thus an issue at RBI only. The rest of this article is generic to all regulators, including Sebi, Telecom Regulatory Authority of India etc. All regulators require such arrangements. Section 7 of the RBI Act, the power to give directions, interferes with this entire arrangement and hence it should be removed.

In order to obtain high performance organisations in government, we require exquisite design of this machinery. These elaborate checks and balances are the secret sauce through which we can obtain institutions which deliver sound performance across staffing changes. The present RBI Act is faulty in having none of this exquisite machinery. It is not surprising that it has failed when put to the test.

Some people have simplistic notions that the government is bad and RBI is good. Humans are the same everywhere, and all humans desire arbitrary power, laziness and corruption. Institutional design creates the incentives for humans to behave in certain ways. Our job is to build rules of the game through which the individuals in the Ministry of Finance and the financial agencies are pushed towards better behaviour. The consistent application of this philosophy is what has given the sound design of the Indian Financial Code.

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