# Government and RBI: Moving forward – Basic autonomy of RBI does need to be protected

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The basic autonomy of RBI does need to be protected. The most serious, and unprecedented violation of this, not to speak of being a bad policy, was demonetisation

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In my last column (goo.gl/RTbeCh), I suggested that tensions between different parts of government are natural, because they have different objectives and motives. Good institutional design allocates authority in ways that balance different goals to maximise national welfare. There are still difficult questions of how to balance the welfare of different groups within the country, or balancing welfare over different time horizons. There is never an attainable ideal, but one can keep analysing institutional structures and looking for improvements in their design. The ongoing conflict between the central government and the Reserve Bank of India (RBI) is a case in point.

RBI is a particularly important regulator of the economy, with responsibilities that matter for the fundamentals of the health of the economy, in a manner that specialized regulators such as the Securities and Exchange Board of India (Sebi), Telecom Regulatory Authority of India (Trai), and others do not match. But neither are these others insignificant, and the perspective that there are general principles of regulation is important to keep in mind. Autonomous regulatory institutions benefit from insulation from short term political compulsions and distortions that favour politically powerful interest groups. They also can accumulate expertise over time—specialised regulation requires technical expertise and domain knowledge.

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Past common practice in India was to keep regulatory power and control within bodies controlled directly by the central government, in ministries, or if a separate organization existed, to exert control or influence by appointing bureaucrats or former bureaucrats to head it. The RBI was often headed by senior officers of the Indian Administrative Service (IAS), the bureaucratic elite of India. Newer "independent" regulators created after economic reforms were also often led by

IAS officers. This model suffers from two problems: susceptibility to influence through prior social and professional networks, and lack of sufficiently deep domain expertise.

Even in such cases, institutions often developed enough independence to stand up to government pressure. RBI Governors who were ex-IAS officers would disagree with central government ministers, and these disagreements would sometimes lead to confrontations, though typically less public than what has happened in the current RBI-government conflict. It should also be recognised that academic economists do not always agree—in the current situation, there were academic economists in the finance ministry and in RBI—on each side of the disagreement about what to do with RBI reserves. The difference, perhaps, is that academics are more vocal when they have opinions.

While it looks like the current disagreements are being papered over for now, it is important to lay out what needs to be done in the future to improve the outcomes of decisions relating to managing the nation's money supply, interest rates, banks, and other aspects of the financial sector. While there will always be disagreements, making sure they are not frequent and not unduly contentious is important. Most important is improving the quality of decision-making. What follows is a set of recommendations for moving forward.

First, the basic autonomy of RBI does need to be protected. The most serious, and unprecedented violation of this, not to speak of being a bad policy, was demonetisation. To my mind, this policy was completely out of line with the general direction of Indian economic reform and institution building. Something like this should never happen again.

Second, the scope of RBI's authority needs to be re-examined. There have been proposals on the table for moving government debt management to a different authority. These have stalled, but need to be resurrected and taken forward. Basically, RBI does too many things, not all of which make sense from the perspective of its role as a central bank.

Third, the government needs to reduce its direct involvement in the banking sector, by reducing its ownership of public sector banks. Public sector banks lack sufficient autonomy and organizational competence to do a good job of lending money wisely and effectively.

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Fourth, RBI and government need to work together to improve bank regulation. Clearly, just privatising banks will not protect against fraud and incompetence. High quality regulation has to be an essential part of financial sector management. Other regulators need to be involved in this process as well.

Fifth, financial sector competition needs to be strengthened. This can include new bank licenses, digital platforms for other kinds of financial intermediation, and so on. Of course, this goes hand-in-hand with better quality regulation. It also requires making sure that there is adequate transparency and disclosure of financial information. Lack of these is a major problem for India's corporate overall.

Sixth, RBI needs to improve the functioning of its own core responsibility of conducting monetary policy. Currently, it is open to criticism for how it takes decisions. The relatively new Monetary Policy Committee is a step forward from the past discretionary decision-making by RBI management and bureaucrats, but better explanation, justification and communication of decision-making is still needed. Underlying this, RBI needs better models and greater transparency as to how it uses its models and makes decisions.

Seventh, and last, the government needs to do more to improve its own economic statistics. Professor TN Srinivasan, a giant of the economics profession, recently passed away. He had been sounding the alarm for years about the declining quality of Indian economic statistics. It would be a fitting tribute, and a high rate of return effort, to address this problem. The RBI, finance ministry and numerous policy makers would benefit.

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