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Hold RBI to account but not at the cost of autonomy

BY [ATMADIP RAY](#) & [MC GOVARDHANA RANGAN](#), ET BUREAU | NOV 07, 2018, 06.57 AM IST

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Diwali crackers may not be as noisy and plentiful this year as in the past due to judicial intervention, but the duel between the Reserve Bank of India (RBI) and the government is more than compensating for lack of usually loud fireworks on our streets.

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The central bank and the government, often at odds ever since the regulator was founded in 1935, are at it again. Since independence to the present day, there have been scores of issues over which the two differed majorly. But this time is different, calling for a whole new approach if the two have to discharge their duties as custodians of national interests.

For the first time in history, the government invoked the never used Section 7 of the Reserve Bank of India Act, which empowers it to consult the governor and instruct the central bank on certain issues such as [liquidity](#) to non-banking finance companies (NBFCs), relaxation of capital norms for banks, and transfer of surplus reserves to the government.

This, at one level, reflects the right of the government in a democracy to question an institution that is answerable to it, but at the same time raises the propriety of invoking the section to consult on issues such as liquidity.

“These are the two giant institutions. They should not write acrimonious letters to each other,” said DK Mittal, former bureaucrat in the finance ministry and a former member on the RBI board. “There are enough mechanisms available for effective communication. The government has nominees on the RBI board and the government can use that channel to let the RBI know its concerns. Then, there is the forum of FSDC. The finance minister and secretary could always communicate directly with the governor.”

While the debate about who was responsible for this breakdown could never be settled as the government blames the RBI for its intransigence, the [regulatory](#) position appears to be that the issues are vested interests in nature rather than of national interest.



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POLICY VS REGULATION

The recent invoking of Section 7 may have been the last-ditch attempt by the finance ministry to make the RBI toe its line, but the friction has been building up ever since February, when the RBI came up with a ruling that missing of payment by a day also amounts to default. This ruffled many feathers in the corporate world. Ironically, many cash-rich companies gaming the system by deploying money in markets to earn are hurt more than actual defaulters.

Furthermore, the government, which has pledged itself to fiscal prudence, has been eyeing the unused reserves at the RBI to fund its infrastructure — something akin to the [Manmohan Singh](#) government that tried to tap the foreign exchange reserves to build roads and ports.

Come August, yet another lobby group found its way to the North Block seeking relief after credit markets tightened, following the default of Infrastructure Leasing & Financial Services (IL&FS). Nonbanking finance companies (NBFCs) and housing finance companies (HFCs), most of which have built their edifices with shortterm funding, suddenly trembled in an earthquake brought about by a liquidity crunch.

“The government can direct the RBI on policy issues as per law, if required,” says a former governor who did not want to be identified. “Many of the issues the government is trying to address are not even policy issues, but regulatory issues. I wonder how much the finance ministry people understand about the issue of liquidity.”

HISTORY OF CONFLICTS

Although this may be the first time that a vital part of the legislation is being used to conduct the RBI government business, the relationship between the two has been dotted with many conflicts, including those involving [Raghuram Rajan](#), D Subbarao and YV Reddy with former finance minister P Chidambaram during the UPA rule.

Issues have ranged from lowering of interest rates to boosting economic growth, and opening up of markets for global institutions such as portfolio investors and global banks.

Manmohan Singh, who became the longest-serving prime minister after Jawaharlal Nehru, was among the RBI governors who once decided to quit in protest against interference by the then Indira Gandhi government, where Pranab Mukherjee was the finance minister.

When the government directed, though not under section 7, to grant a branch licence to the Bank of Credit and Commerce International (BCCI), owned by a Pakistani, Singh flew down to Delhi with a resignation letter, writes TCA Srinivasa Raghavan in Dialogue of the Deaf. Ultimately, a licence was granted and the bank went bust too.

Although some government relationships were smooth like those between Manmohan Singh and C Rangarajan and Yashwant Sinha and [Bimal Jalan](#), there have been differences all along.

YV Reddy, who is seen as a legend for not falling for financial innovation glib-talk and saving the Indian financial system from the Lehman contagion, has had many run-ins with the government — ranging from licensing of foreign bank branches to letting the government have a say on the use of foreign exchange reserves.

Financial markets have seen many of these come their way.

“Despite the pain, the regulators are likely to display tough love in the regulatory space to strengthen the financial system,” says Radhika Rao, economist at [DBS Bank](#). “Markets have taken these developments in their stride, as there is an inherent belief that the central bank is independent and will continue with its rules-based mandate, while the government focuses on reforms and looks to buoy growth, drawn also by the approaching elections.”

AUTONOMY VS ACCOUNTABILITY

Most things are not in ‘black and white’ when it comes to government-central bank relationships. While the RBI needs autonomy, when it comes to regulation which the government cannot handle due to various interests influencing at different points of time, policy matters have to be guided by the government.

“The government has full right to demand RBI’s surplus,” says Mittal. “But if the government seeks the transfer of reserves, then it is

sheer madness. The government has the right to question the parameters in deciding the reserves but it can't demand transfer of it because this is a risk buffer.”

While deputy governor Viral Acharya ignited the fire with his speech for autonomy of the central bank, failing which a government would be punished by the markets, there is a need for accountability of the institutions as well.

“Autonomy can be given where there are measurable outcomes against which performance can be measured, so that there is accountability,” says TT Ram Mohan, professor at the Indian Institute of Management, Ahmedabad. “In other matters, we do not have clear outcomes to which the RBI has committed itself — indeed, such outcomes are rather hard to define. It follows that decisions cannot be left entirely to the RBI. These must happen through consultations between the RBI and the government. Autonomy must go hand in hand with accountability.”

A democratically-elected government has the right to demand accountability of any institution created under the statute, but can it cross the Lakshman Rekha to achieve the desired results?

The jury is out on that.

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