

# RBI vs GoI dispute: Historically, autonomy is not a privilege but a matter of right

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The whole relationship between the government and RBI needs to evolve out of its historical settings where its autonomy is not seen as a privilege but a matter of right



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In the ongoing controversy between [RBI](#) and the government, both sides (quite undesirably) have sought to wash their dirty linens in public, the need or justifiability of which is a moot question in itself. Be that as it may, the episode has once again brought the underlying question of RBI's independence into sharp focus. During the ongoing spat, questions have also been raised about the relative importance of independence of RBI to the macroeconomy and its impact on financial markets. It must be admitted that there is not enough empirical evidence to suggest that independence of a central bank is either necessary or a sufficient condition for a thriving economy as the case of China and some other countries demonstrate. However, it may also not be denied that independence of the central bank may not be either necessary or sufficient but it is highly desirable for any economy and more so for a democratic polity like India. In finance, few things are as important as uncertainties. Whole business of finance revolves around assessing risks which are complicated by uncertainties. Policy predictability helps in reducing these uncertainties in a major way. While governments are equally important, in a democracy, the executive is subject to the vagaries of electoral politics and therefore cannot itself always guarantee policy continuity. Institutions are valued by financial markets because they fill this vacuum by offering some continuity and predictability in policy making. It is this role that institutions in general, and the central bank in particular, plays in ensuring a predictable policy environment that makes them critical for the larger economy in democracies like

India while they may not be so critical in China where this predictability is offered by a single party polity.

Given this political economy of importance of a central bank, it is intriguing why RBI and successive governments have often found themselves on a collision course. While the impression being created is that this is the first such instance, a reading of the history suggests otherwise. Understanding this history is also important to appreciating the deep-seated causes for an uneasy conflict between the government and RBI and to devise long term policy solutions for the same. Several metaphors have been thrown around during the recent controversy with Viral Acharya giving a cricketing analogy while [Raghuram Rajan](#) compared it to a relationship between a driver and seat belt. So, it might be appropriate to dig a bit into history and throw in yet another metaphor to highlight the nature of the relationship and need for change.

Legendary governor of Bank of England, Montague Norman, had, on the eve of setting of RBI, characterised the relationship between the then government and RBI as a “Hindu marriage” with the government being the dominant spouse and RBI being the wife. There was considerable opposition from the nationalist leaders of the time to the structure and constitution of RBI and in particular to the power of the executive to appoint directors to the board. They sought a greater say of the provincial and central legislature in the matter. It is therefore ironic that the structure was adopted almost as it is after independence that ended up giving control of the board and the Governor to the executive. Things were not much different in practice as evidenced by incessant attacks by finance minister Krishnamachari—with a formal backing of none other than PM Nehru—against Governor Rama Rau which led to his eventual resignation. There were several

other instances of bank rates being changed by finance ministers rather than the Governor under the leadership of both Nehru and Indira Gandhi, thereby conforming to the analogy of a “Hindu marriage”. Several dominant economic thinkers have also explicitly rejected the concept of independence of central bank. Milton Friedman had explicitly rejected the notion of independence of central bank. Closer home, Manmohan Singh also echoed the views of Milton Friedman when he said:

“Autonomy of the bank is a state of mind which depends on the vision, knowledge and experience of the Governor and while the bank must have as much autonomy as possible in the sense that it must be free to give advice to the government but one cannot legislate the autonomy of the Reserve Bank”.

Essentially, he also envisaged a limited advisory role for RBI. However, just as the institution of Hindu marriage is evolving with greater assertion of independence by wives, RBI must evolve and secure greater independence for itself. This need is accentuated by the increasing financialisation of the Indian economy which increases the relative importance of the central bank. Thus, the whole relationship between the government and RBI needs to evolve out of its historical settings where its autonomy is not seen as a privilege but a matter of right. This is not to suggest that we blindly import any foreign model but that there should be an informed debate on the extent and nature of independence which is then codified through a legislation so that it is not susceptible to the whims of the government of the day. In many ways, there is a need to revisit the nationalist position articulated at the time of establishment of RBI and give a greater role to legislature in the constitution of RBI. Some of the reforms which could be contemplated include appointment of the board of directors by a select committee of the Parliament and a

longer term of 5 to 7 years for the Governor with removal powers being vested in the Parliament. These moves could ensure real independence of the central bank going forward and provide for a better policy continuity irrespective of the electoral cycles.

Relationship between RBI and the government is too important to be left to personality and wisdom of individual governors and formal institutionalisation of this relationship must remain on the long-term agenda. However, one hopes that in the ongoing controversy, both sides will demonstrate the level of maturity expected of people in such critical offices and resolve the issues behind the doors.

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