Government and RBI
No Real Stand-off over Macro Policy

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The so-called stand-off between the Reserve Bank of India and the Ministry of Finance is not as significant as the media is making it out to be. There is little disagreement between the two on fundamental issues. The stand-off is a reflection of the government's effort to regain some influence over macroeconomic management, which is reasonable as the government is accountable to the people whereas the RBI is not.

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The Indian media are agog with speculation of an ostensible stand-off between the Ministry of Finance and the Reserve Bank of India (RBI) on matters relating to macroeconomic management. "Leading" statements from the Governor of the RBI, Raghuram Rajan, and the Union Finance Minister, Arun Jaitley, a much-publicised set of meetings between the two and the signing of a Monetary Policy Framework Agreement (MPFA) in February 2015, have only fuelled such speculation.

The substance of the speculation is that efforts are on in the finance ministry to clip the RBI's powers in a host of areas, which is being resisted by the latter. The finance ministry's push is seen as illustrated by a number of recent initiatives or developments. First, there is ostensibly an effort by the government to check the RBI's growing inclination to make inflation targeting its primary goal to be pursued "independently," by entering into a formal MPFA between the RBI and finance ministry, the first of which was signed on 20 February 2015. The agreement ensures that inflation targets are set by the RBI in consultation with the finance ministry and requires the RBI to make public the operational procedures to be adopted to attain those targets, as well as the evidence of their effectiveness and the explanation for shortfalls if any.

Second, there is speculation that the finance ministry is attempting to increase its role in the Monetary Policy Committee of the RBI, which advises/decides on important monetary policy adjustments, by changing the composition of the committee and shifting the power to influence appointments to the committee in favour of the government.

Third, the management of public debt, which was hitherto being undertaken by the RBI, is now to be moved to a separate Public Debt Management Agency (PDMA) that would be "independent" of both the central bank and the Ministry of Finance. But in practice, since the selection of personnel manning the PDMA is likely to be influenced by the ministry, this too appears to rebalance power in favour of the government.

Finance Bill Provisions

Finally, in a move that seemed to be surreptitious, the Finance Bill, 2015 proposed to amend the RBI Act to do away with the central bank's power to regulate the market for government securities. In a provision that was left unmentioned in the finance minister's budget speech, the Finance Bill proposes to amend Sections 45U and 45W of the RBI Act to remove the central bank's powers to regulate transactions in and those dealing with government securities.

These actual or potential developments need not be signals of the finance ministry's disagreement with the policy framework favoured by the RBI. Rather they seem to be driven by concern about the manner in which that framework is being implemented. The MPFA, to which the finance ministry is a party, accepts that "the objective of monetary policy is to primarily maintain price stability," though it expects this to be pursued "while keeping in mind the objective of growth." That is, while there seems to be recognition that there is need for a "dual mandate" involving inflation and growth, there is agreement that the prime target of monetary policy should be inflation. Once that is accepted, the potential areas of disagreement shrink.

However, this "hierarchical mandate," typical of the inflation targeting approach, that privileges inflation control over the level of economic activity as an objective of monetary policy, is by no means god's truth. The grounds on which the approach has been challenged include: (i) empirical evidence to suggest that in many contexts monetary policy (in the form of interest rate

adjustments) has an impact on investment more than inflation; (ii) the validity of the assumption that inflation is largely demand-driven and not cost-driven; and (iii) the weak conceptual basis of the presumption that the real and nominal sides of the economy can be separated, with supply-side policies being used to address problems with the former (that keep the system away from its "long-run equilibrium growth path") and monetary policy being deployed to battle inflation.

But the differences between the finance ministry and the RBI have little to do with such differences over the inflation targeting approach itself. In fact, besides accepting inflation targeting as the key objective of the central bank, the MPFA also endorses the inflation target of 4% with a band of +/– 2%, which was recommended by the RBI's Urjit Patel Committee. This target is to become effective by January 2016, by which time the inflation rate is expected to be brought down to a consistent "below 6%" (or 4% plus 2%) level. The agreement institutionalises this target by making it the norm that cannot be altered by the RBI on its own, while holding the central bank rather than the government responsible for realising this target. Thus, the "independence" of the central bank is limited to its freedom to use the instruments it has at hand to pursue this objective and target recommended by the neo-liberal orthodoxy, on which there is no difference of opinion between the finance minister and the RBI governor.

Differences on Relative Role

The differences, if any, between the two seem to be on the relative role of the ministry and the RBI in deciding where the interest rate must be set and how much it must be raised in the battle against inflation in any particular growth environment. As a representative of the epistemic community that wants freedom for financial markets from interference by elected government representatives (or "politics," as it is labelled), Rajan would clearly want full freedom to pursue the inflation targeting agenda. As a neo-liberal minister of finance, who has given up control of the fiscal lever by committing to a light-touch tax environment and stringent fiscal deficit targets, Jaitley cannot be faulted for wanting some influence over the only remaining real lever for macroeconomic management, which is monetary policy, and some role in deciding on the relative emphasis on the objectives of fighting inflation and driving growth.

This is the substance of the perceived stand-off. The government does see the RBI as being overly cautious when targeting inflation and keeping interest rates so high that it hurts growth. Since raising gross domestic product (GDP) growth has become the lead indicator of policy success in a neo-liberal environment, this does bother a government that needs to win voter support, unlike the RBI governor who does not.

Not surprisingly, the finance minister wants to make clear that he, as representative of the government, is the one who calls the shots. That, for example, is evident from this statement in the budget speech for 2015–16 (para 13):

> To ensure that our victory over inflation is institutionalised and hence continues, we have concluded a Monetary Policy Framework Agreement with the RBI, as I had promised in my Budget Speech for 2014–15. This Framework clearly states the objective of keeping inflation below 6%. We will move to amend the RBI Act this year, to provide for a Monetary Policy Committee.

That much for the so-called independence of the central bank, whose governors, in any case, the government chooses.

'Independence'

This tendency to reiterate the institutional subordination of the RBI to the government is also reflected in the push to bring the public debt management office under the influence of the finance ministry, once it is shifted out of the RBI. This, together with the move to transfer the regulation of the government securities market out of the RBI to the Securities and Exchange Board of India (SEBI), suggests that the government wants some degree of "independence" from the central bank as well. If instituted, these changes in the market for government debt would probably give the government greater flexibility in deciding the structure of its borrowing and some influence on the cost of borrowing through appropriate design of instruments.

Read in these terms, the so-called stand-off between the government and the RBI on aspects of macroeconomic management is far less significant than the media makes it out to be. There is little disagreement on fundamental issues. In the first stage of neo-liberal reform the effort was to make monetary rather than fiscal policy the principal lever of macroeconomic management, and to give the central bank a degree of independence in the conduct of monetary policy with inflation targeting as the primary objective. The current stand-off is a reflection of the government's effort to regain some influence over macroeconomic management and a degree of manoeuvrability in its conduct. That seems reasonable. This government may not be one that serves the best interests of the people or even one the people would want once they experience the effects of its policies. But at least it was voted to power in the first instance and can be voted out in future. That is more credible than a central bank leadership chosen from an epistemic community that seeks to impose its ideology without restraint on nations and peoples, on the specious grounds that it possesses the knowledge and expertise to implement the only correct macroeconomic policy solution available.

EPW Index

An author-title index for EPW has been prepared for the years from 1968 to 2012. The PDFs of the Index have been uploaded, year-wise, on the EPW website. Visitors can download the Index for all the years from the site. (The Index for a few years is yet to be prepared and will be uploaded when ready.)

EPW would like to acknowledge the help of the staff of the library of the Indira Gandhi Institute of Development Research, Mumbai, in preparing the index under a project supported by the RD Tata Trust.