AUTONOMY OF CENTRAL BANKS@

C.Rangarajan *

It gives me great pleasure to be in your midst this evening and deliver this lecture instituted to commemorate the memory of Shri M. Govindan Kutty. My association with Govindan Kutty goes back to the days when we were together in college. Govindan Kutty was not only a brilliant administrator who held important positions in the West Bengal Government but also a thinker, who against the background of his rich administrative experience, reflected on many issues connected with finance and resource management. I am quite certain, that if he were amongst us today, Govindan Kutty would have contributed significantly to public policy issues particularly in the areas relating to better economic and financial management and institutional strengthening.

2. It is, in fact, the issue relating to strengthening of public institutions which has prompted me to speak on a theme connected with the institutional arrangements for the conduct of effective monetary policy or, what is better known in the literature as autonomy or independence of the central bank. In this lecture, I shall attempt first to draw the implications of autonomy or independence of central bank as has evolved in the industrialised countries and then, examine the implications of this concept in the Indian context.

CONCEPTUAL IMPLICATIONS

3. Autonomy of the central bank has been a recurring theme in the literature on monetary policy and central banks.. The issue has assumed added importance in Europe in the context of the efforts to set up an independent central bank for all countries forming part of the European community. The legal status of central banks in terms of their relationship to Government varies from country to country. However, the exact relationship between a central bank and the Government in any country is also determined by the historical circumstances as well as the practices which have developed over time. At one end of the spectrum, there are central banks which are almost viewed as being subordinate to the Government, in the sense, that the stance of monetary policy is primarily determined by the Government even though the central banks may play an important role in advising the respective Governments. Examples of central banks which fall in this category are Bank of England, Bank of Japan and Bank of France. In relation to Bank of France, legislative changes have been introduced very recently to give the bank greater autonomy. At the other end of the spectrum are countries where central banks remain independent of the Government and take monetary policy decisions on their own. In this category fall the Federal Reserve System in the United States and the Bundesbank in Germany. There are other countries in which central banks also make independent decisions but are subject to some form of Government over-ride. While in some countries this over-ride is exercised publicly, in others, there is no such explicit requirement. The Government simply retains the power to issue directives.

4. The concept of autonomy of central banks has essentially been discussed in terms of the independence a central bank enjoys in taking monetary policy decisions. The issue of independence obviously arises only in a system where the central bank has the 'discretion' in the determination and conduct of monetary policy. The institutional independence of a central bank may not really mean much, under a system where the monetary authority is compelled to follow a prescribed rule, such as a fixed rate of growth in money supply or as the ones under gold standard.

@ Tenth M.G. Kutty Memorial Lecture delivered by Dr.C. Rangarajan, Governor at Calcutta on September 17, 1993.

* The author is grateful to S.S. Tarapore, J.M. Chona, N.D. Jadhav and U.S. Das of Reserve Bank of India for their help in the writing of this paper. The first part of this paper draws heavily on the IMF working paper: Swinburne, Mark and Castello - Branco, Marta "Central Bank Independence : Issues and Experience".

5. The argument in favour of independent central banks rests on the premise that monetary stability, which is essential for the efficient functioning of the modern economic system, can be best achieved only if the task is entrusted to professional central bankers who can take a long term view of the monetary policy stance. Too much concern with the short term can result in 'stop-go' policies. Implicit in this kind of reasoning is the assumption that political leadership normally tends to take too short term a view and such an approach is not conducive to ensuring stability. Historically speaking, the concept of independence of central banks is associated with the concern that in the absence of such independence, Government would finance itself without limit, through money creation. While this concern is still a potent factor in several countries, more attention is now being paid to the broader issue of the impact of political influence on the pursuit of monetary policy. More than any other objective of economic policy, monetary stability requires the pursuit of a consistent policy over a long time. Prices respond with a lag to changes in money. Monetary expansion may initially lower unemployment or stimulate growth but subsequently, inflationary consequences emerge and measures to reverse inflation are initiated only when inflation crosses some threshold level. This sequence gives an upward bias to the price level. If this is to be avoided, the pursuit of a consistent policy over time becomes necessary.

6. In the discussion on policy effectiveness, a point that is often made is that effectiveness of policy depends upon how the public perceives policy maker's commitment and behaviour. Based on this premise, it is argued, that an independent central bank would tend to impart greater credibility to monetary policy and therefore improve its effectiveness.

7. Vesting in a central bank the sole authority to determine monetary policy has, however, not found universal acceptance. Two arguments are advanced against this idea. The first argument is, that in a democratic set up, all policy decisions should be subject to scrutiny by the elected legislature and therefore the concept of an autonomous central bank is 'undemocratic'. A typical expression of this opinion is found in a statement made by the Democratic floor leader in the American Senate while introducing the Balanced Monetary Policy Act of 1982.

"It is time for Congress to wrest control of monetary policy from the hands of a tiny band of monetary ideologues in the White House, the Administration and the Federal Reserve. It is time for basic economic policy once more to be set by elected officials who must bear the final responsibility. It is time to restore common sense, balance and stability to monetary policy."

8. The bill to strip the Federal Reserve System of its independence was, however, not pressed and passed into legislation. All the same, it needs to be noted that no central bank is totally autonomous, in the sense, that it is not answerable to any one. Even the most independent central banks have to report in one form or the other to the legislature, which in any case has the ultimate power to change the law relating to the central bank. All the same, there is a difference between a situation in which policy decisions are under continuous scrutiny, and an arrangement where the central bank periodically reports to the legislature.

9. The second argument against the autonomy of central banks is more substantial. It is argued that as monetary policy is an integral part of overall economic policy, there can be no meaningful separation between fiscal policy and monetary policy. If such a separation is attempted and if the two policies run at cross purposes, then either fiscal policy or monetary policy will have to give way. In the process, conflict of policies may inflict considerable damage to the economy. That such a situation is not unlikely was demonstrated in the US in the early 80s, when fiscal policy was lax and expansionary, while monetary policy was extremely tight. There is, therefore, substance in the argument that an integrated package of policies has a better chance of success than a set of conflicting ones. While admitting this, it can nevertheless be argued, that such conflicts are inevitable as long as central banks are charged with the primary responsibility of controlling inflation.

10. An interesting question which arises in this context is whether independent central banks have a better achievement record in the conduct of monetary policy. But then, what constitutes a better record? Almost all empirical studies carried out to find the relationship between independence and performance have judged performance in terms of inflation control. Among the researchers there are considerable differences on the manner of classifying central banks in terms of autonomy. Several characteristics have been taken into account, ranging from the legal provisions setting up central banks to the procedures relating to appointment, term of office and dismissal of the Governor of the central bank. The empirical evidence however is inconclusive. A number of studies have found an inverse link between the two. That is to say, that the average rate of inflation is lower in countries which have highly independent central banks. There are, however, some studies which do not establish such an inverse relationship. Even where an inverse relationship is found, it is subject to a number of interpretations. It is quite possible that the factor of independence as well as inflation control may stem from a common cause, such as the congruence of monetary and fiscal policies, in terms of objectives or a deep seated national sentiment against inflation, as in Germany.

11. Another point of view that arises in the context of the independence of central banks is that the success of a central bank in controlling inflation may arise not so much from its independence from the Government as from the nature of objectives it is expected to fulfill. Economic policies have multiple objectives to achieve. In most countries they include high growth rate, low unemployment and price stability. In the developing countries an additional objective of economic policy is redistributive justice. It has been argued that central banks which have had a high degree of success in controlling inflation are those which have been charged specifically to maintain stability in the value of the currency, even though there can be possible conflicts between maintaining the stability of the external and the domestic value of the currency.

12. The argument here is that since monetary policy is essentially a single instrument it cannot be called upon to achieve more than one objective. It is further argued that among the multiplicity of objectives of economic policy, perhaps price stability is the objective which can best be achieved through monetary policy. In fact, if the central bank also has multiple objectives, the net result in terms of the achievement of a single objective, such as price stability, may not be that striking. The central bank will also be compelled to think in terms of trade-off between one objective and another as in the case of overall economic policy. The conclusion that is drawn from such an analysis is that the success of those central banks which have achieved a high degree of price stability is attributable not so much to their independence as much to the fact, that they have statutory objectives with a narrower focus. Central banks which may not enjoy independence from Government can nevertheless succeed in ensuring price stability if they are asked to pursue that single objective.

13. Central bank independence raises certain issues with respect to the performance evaluation of an independent central bank. Easily observable yardsticks will have to be established in order to ensure monetary policy accountability. Perhaps, the most striking example in this context is the arrangement that has been introduced in New Zealand where the central bank is required to achieve a specific inflation target. This raises a further question as to the extent to which monetary policy by itself can achieve price stability. There are also issues connected with the transmission mechanism of monetary policy actions. Central banks in the industrialised economies have experimented with various intermediate targets in order to influence the economy in general and prices in particular. In the context of money demand instability, central banks in these countries have responded by placing less emphasis on a single monetary aggregate. A range of monetary variables is taken into account for guiding the course of monetary policy.

14. An aspect of independence of the central bank on which a high degree of consensus is developing is on the funding of the Government by the central bank. Many countries have placed legal constraints on central banks' lending to Government. There are countries in which central banks are totally prohibited from purchasing Government paper from the primary market. In countries such as Germany, Switzerland and Netherlands, legislative limits have been set on direct central bank credit to Government. There are, however, countries in which there are no legal limits but central banks do not normally provide direct credit to the Government. It is clearly recognised that since central banks can acquire Government securities as part of their open market operations, there cannot be a ban on central banks acquiring Government debt. While statutory limits on credit to Government can also be got around, quite clearly, direct funding of Government, without limits by the central bank, will come in the way of the efficient conduct of monetary policy.

15. Institutional arrangements to make the central banks independent have centered around the appointment, tenure and the dismissal of the Governor as well as the role and the constitution of the board of central banks. The appointment of Governors for a reasonably long tenure coupled with very stringent conditions under which they can be dismissed are said to favour independent actions on the part of the central banks.

16. Many central banks perform functions which go beyond the core central bank functions. Central banks in a number of countries perform supervisory functions in relation to the banking system. There are several countries in which the supervisory function is either shared between central bank and other authorities or totally left outside the ambit of the central bank. Since monetary stability cannot be divorced from financial stability, several have argued for the supervisory function to be an integral part of a central bank. However, there are some who perceive a conflict of interest between supervisory and monetary policy concerns. There can be occasions when a tight monetary policy can force difficulties on the banking system, which, if the central bank as a supervisor tries to moderate, could lead to a situation involving a conflict of interest. However, most of the difficulties associated with financial stability arise out of factors not directly connected with monetary policy, such as poor asset quality, inadequate capital, etc.

17. Certain broad conclusions, thus emerge from the foregoing analysis. Monetary policy being part of an overall economic policy, cannot be divorced totally from fiscal policy or other policy perceptions. Economic policy makers have always to contend with multiple objectives. While in the long run there may be a congruence of the various objectives, in the short run there can be a trade-off which the policy makers may find difficult to resist. It is also accepted that a policy package as a whole is most effective when there is no conflict among the different policy instruments. Hence, the need for coordination among policies. Monetary policy, as an instrument of policy, is more efficient to deal with price stability than with other objectives, and this objective can be best achieved if the central bank enjoys a high degree of independence. While it is recognised that political leadership represented through Government should have the final say on all policy matters, there is considerable merit in a system where there is greater transparency in the resolution of conflicts between the government and the central bank. The freedom of the central bank to pursue monetary policy according to its judgement requires that direct funding by the Central Government is restricted and the limits are made explicit.

THE INDIAN SETTING

18. The Reserve Bank of India is an institution that was set up in the pre-independence period. The legislation to set up the Reserve Bank was first introduced in January 1927. However, it was only seven years later, in March 1934, that the enactment was made. There is no specific provision in the Act laying down the objectives of the Bank. However, the Preamble of the Act says that the Bank has been constituted "to regulate the issue of bank notes and keeping of

reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage". At the time of the enactment the Indian public opinion was strongly in favour of an institution which was not dominated by the British Government. For differing reasons, both the Government and Indian legislators at that time wanted a central bank that was independent. After much debate, the Bank was set up as a private shareholders' Bank with some subscription from the Government to enable those nominated by the Government to be directors. The Finance Member while introducing the Bill said:

"...It has generally been agreed in all the constitutional discussions, and the experience of all other countries bears this out, that when the direction of public finance is in the hands of a ministry responsible to a popularly elected Legislature, a ministry which would for that reason be liable to frequent change with the changing political situation, it is desirable that the control of currency and credit in the country should be in the hands of an independent authority which can act with continuity. Further, the experience of all countries is again united in leading to the conclusion that the best and indeed the only practical device for securing this independence and continuity is to set up a Central Bank, independent of political influence."

19. It is also worth quoting another passage from the speech of the Finance Member which went into the question of funding of Government budgets by the Central Bank.

"....in modern life and in modern economic organisations, there are two important functions: they are the functions of those who have to raise and use money and there are the functions of those who are responsible for producing the actual tokens of money, the money in circulation. The basis of the whole proposal for setting up an independent Central Bank is to keep those two functions separate. The largest user of money in a country is the Government, and the whole principle of the proposal is that the Government, when it wants money to spend, should have to raise that money by fair and honest means in just the same way as every private individual has to raise money which he requires to spend for his own maintenance. If the Government is in control of the authority which is responsible for exercising the other function, then all sorts of abuses can intervene".

20. The Reserve Bank of India was nationalised in 1948. The issue regarding fiscal and monetary policy inter-linkages in India can be understood by undertaking a brief review of the borrowing programme of the Government of India through Treasury Bills. Until 1955, the total outstanding treasury bills had never exceeded Rs.472 crore. Subsequently it rose to Rs.2518 crore by end-March 1971 and soared further to Rs.12,851 crore by end-March 1981. With the sharp deterioration of the fiscal deficit during 1980s, the outstanding treasury bills rose to Rs.19,266 crore by March 1993. Indeed, if allowance is made for the funding of treasury bills of Rs.71,000 crore in aggregate during 1982, 1987, 1988, 1991 and 1992 the actual outstanding treasury bills at the end-March 1993 would be a formidable level of Rs.90,266 crore. An overwhelmingly large proportion of these treasury bills was held by the Reserve Bank of India, thereby monetising the budget deficit of the Government. In fact, in addition to treasury bills, the Reserve Bank also held dated Government Securities not picked up by the captive market. As a consequence, the outstanding reserve money (i.e. money created by the Reserve Bank) as of March 1993 amounted to Rs.1,10,943 crore, of which the net Reserve Bank credit to the Central Government accounted for as much as Rs.96,523 crore or 87 per cent. This growing budget deficit and its monetisation by the Reserve Bank of India indeed raises important issues on the relative roles of fiscal policy and monetary policy. Monetary Policy particularly in the Eighties had to address itself to the task of neutralising the inflationary impact of growing deficits by continually mopping up the large increases in reserve money. Given the then fully administered interest rate structure, the much needed absorption of excess liquidity in the system was undertaken mainly by increasing the Cash Reserve Ratio (CRR). Furthermore, given the below-market rates on Government securities, the Statutory Liquidity Ratio (SLR) had to be

progressively raised so as to meet the large financing requirements of the Government. This process inevitably culminated into the CRR reaching its statutory maximum limit which had to be raised by amending the Act. The SLR reached the phenomenally high level of 38.5 per cent.

21. The genesis of the practice of automatic monetisation will be a significant revelation when the definitive history of the Reserve Bank for the period 1951-67, the writing of which is underway, is published. The Reserve Bank under the Act is authorised to grant to the Government advances repayable not later than three months from the date of making the advance. These provisions are *enabling* and not *mandatory* and the provisions of the Act do not require the Reserve Bank to finance unlimited deficits of the Government. What the historical documents reveal is that as a matter of operational convenience, an official of the RBI and an official of the Ministry of Finance agreed in early 1955, that whenever the cash balances of the Government fell below Rs.50 crore, *ad hoc* treasury bills would be created to restore the Central Government's cash balances to Rs.50 crore. Thus, a seemingly innocuous operational arrangement opened up the floodgates of automatic monetisation which changed the entire course of monetary history for the next forty years. It is to the credit of the then Governor Shri H.V.R. Iengar who on taking charge as Governor expressed great anxiety regarding the automatic creation of *ad hoc* to finance the Government deficit. The then Finance Minister Shri T.T. Krishnamachari was appreciative of the concerns expressed by the then Governor and he assuaged the anxieties of the Reserve Bank by assuring the Governor that it would be the duty of the Finance Ministry to formulate its proposals for borrowing and deficit financing in consultation with the Reserve Bank. The rest is history !

22. The Chakravarty Committee to review the working of the monetary system, of which I was a member, in 1985, recognised the dangerous trajectory that the monetary-fiscal policy was on and strongly recommended a fundamental restructuring of the monetary system. The Committee argued that price stability should be the dominant objective of monetary policy and inflation control was perceived as the joint responsibility of the Government and the Reserve Bank. It was in this context that the Chakravarty Committee laid stress on the net RBI credit to Government as an unambiguous and economically meaningful measure of the monetary impact of fiscal operations. Since 1987, the budget documents also indicate as a memorandum item net RBI credit to Central Government. The Chakravarty Committee strongly advocated a system of monetary targeting which will bind the Government and the Reserve Bank to a mutually agreed level of RBI credit to Government, consistent with the appropriate level of expansion of money supply. The Committee later went on to spell out how to arrive at the appropriate level of money supply growth and linked money supply growth to the expected increase in real output and an acceptable level of increase in prices. In my Presidential Address on 'Issues in Monetary Management' at the 71st Annual Conference of the Indian Economic Association at Calcutta in December 1988, I had stated —

".....The essence of co-ordination between fiscal policy and monetary policy lies in reaching an agreement on the extent of expansion in Reserve Bank credit to Government, year to year. This will set a limit on the extent of fiscal deficit and its monetisation and thereby provide greater maneuverability to the monetary authorities to regulate the volume of money. It is in this context the introduction of a system of monetary targeting mutually agreed upon between the Government and the central bank assumes significance."

23. In the last few years, there has been a conscious effort to contain fiscal deficit and budget deficit. This has facilitated the efforts of the Reserve Bank to moderate the growth in money supply. However, the system is far from perfect. So long as the practice of issue of ad hoc treasury bills continues, there is no immediate check on the expansion of RBI credit to Government. Even in the last few years, when year-end deficits have been moderated, deficits

during the year have been large. It is therefore necessary to move away from the system of issue of 'ad hoc' treasury bills and the consequent monetisation of the budget deficit. The latest Annual Report of the Reserve Bank has suggested that the proportion of auction bills in the total creation of 91-day Treasury Bills should be raised in a phased manner so that by 1996-97 the system of ad hoc treasury bills is totally discontinued. At that point, the Central Government can be provided with a Ways and Means advance limit from the Reserve Bank for meeting temporary requirements with the limit being liquidated by the end of the financial year. In effect, this will mean that the borrowing requirements of the Government will have to be met outside the Reserve Bank. This does not however imply that the Reserve Bank of India will not hold any Government paper. It may and will. As part of its open market operations, it will decide on the extent of Government paper it wants to hold. With the moving away from automatic monetisation of the deficit, monetary policy will come into its own. The regulation of money and credit will be determined by the overall perception of the monetary authority on what the appropriate level of expansion of money and credit should be, which in turn will depend on how the real factors in the economy are evolving.

24. As the system of automatic monetisation of deficit gets phased out and the preemption of funds of banks in the form of SLR comes down, Government will be obliged to place nearly all its borrowings in the market, at market determined rates. We are in fact gradually approaching this situation. Interest rate on Government securities are now in the realm of substitutability — the maximum rate on Government securities is 13.5 per cent while the weighted average lending rate of banks is around 15 per cent. Bank's choice of asset holdings will be increasingly determined, not by statutory prescriptions, but by the risk-reward perception on securities and bank lending. With market determined rates, an active secondary market will develop and acquire depth. It will then be possible for the Reserve Bank to undertake open market operations effectively at its discretion.

25. With the interest rate on Government securities becoming market determined, a stage may be set when we can move away from the administered structure of interest rates to a system in which the rates will be determined by the banks and other financial institutions based on supply and demand. Except for the prescription of one or two concessional rates which may be necessary from the point of view of societal concerns, the rest may be determined by participants in the financial system. Interest rate policy will then emerge as a flexible instrument and the Reserve Bank can influence the level of the rate using the normal instruments of credit control. A signal on interest rate from the Reserve Bank, which will depend on the central bank's perception of what is required, will be a vital aspect of the interest rate policy and the bank rate can evolve as the reference rate for the economy. A convention can develop whereby banks take cognisance of this reference rate and fix their deposit and lending rates at appropriate differentials below and above the reference rate. Such a system, once it becomes operative, will become the medium to transmit the impulses originating from the Reserve Bank throughout the organised segments of the economy.

26. Apart from the issues connected with the conduct of monetary policy, a feature unique to the Indian financial system and bearing upon the independence of the central bank, relates to the Government ownership of most of the commercial banks in India. This introduces another element in the relationship between Government and the Reserve Bank. While at a conceptual level the problem can be resolved, in practice the issue may not remain fully resolved. As the owner of the banks, Government must exercise proprietal control on all matters directly relating to ownership, whereas the Reserve Bank, as the supervisory authority should exercise the supervisory function in the same way as it would exercise on any bank, whether owned by the Government or not. Supervisory functions would include the prescription of prudential norms and their effective monitoring. Ownership functions, which are unambiguous, relate to the appointment, term

and emoluments of chief executives and the constitution of the board of directors. Government and central bank may confront a conflicting situation only if the Government issues directions which may have the effect of going against the prudential and other guidelines issued by the RBI. Deterioration in the quality of loan assets of the nationalised banks in recent years is partly attributable to the fact that explicit prudential norms relating to income recognition, provisioning or capital adequacy were not in place. In fact a firm set of prudential norms will itself act as restraint on the Government in its direction to the banks. The Government has also to redefine its relationship with banks. While exercising strict control over certain aspects, the nationalised banks must be allowed to enjoy a high degree of operational autonomy. A similar situation exists in countries like France, where the Government owns a fairly large number of banks. Since monetary stability and financial stability are all inter-woven with each other there has necessarily to be a continuous dialogue between the Government and the Reserve Bank and appropriate conventions need to be established. The ownership factor need not by itself affect the independence of the monetary authority so long as the prudential norms are explicit and are monitored closely.

27. The emergence of an autonomous central bank does not mean that the 'state of bliss' has arrived. It only enables the central bank to pursue a consistent monetary policy over a long time without being influenced by short term pressures to deviate from its path. Naturally, there are other problems to contend with. Monetary economics, no more than any other branch of economics, is not a settled science. Controversies rage over several issues. There are many theories to explain how changes in money and credit affect the real economy. And, there is as yet no unanimity on the transmission mechanism. Opinions differ on which should be the appropriate variables to monitor, in order to determine the stance of monetary policy as well as the progress of monetary policy action. While some central banks tend to place emphasis on monetary aggregates, such as broad, narrow or base money, there are others which attach greater importance to movements in interest rate. No wonder, opinions differ among experts on when to stimulate an economy or to restrain it. Nevertheless, an autonomous central bank is in a distinctly better position to take monetary policy actions. Autonomy in any case is not unrestrained. In a democratic set up it can always be subject to policy directives either from the Government or the legislature. In the Indian context, perhaps the first step should be to move away from a system in which the deficits that are incurred by the central government automatically get financed by the Reserve Bank through the issue of ad-hoc treasury bills. This is distinct from the question of setting limits on Government's borrowing. In the context of increasing interest payments, as a proportion of revenue and the consequent preemption of resources for non-development expenditure, there exists a compelling need to see that the Government, either on its own or statutorily limits its borrowing. However, when the borrowing gets monetised, there is the additional impact on money supply growth with all the attendant consequences. Thus, the situation towards which we should move, if not today but at least within a three year time frame is, where the central government should borrow whatever amount it wants from the market and not rely on any direct credit from the Reserve Bank which is what the issue of ad-hoc treasury bills does. Then, the onus of responsibility for the conduct of monetary policy will be squarely on the shoulders of the Reserve Bank, where it should logically rest.