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The RBI, the RBI board and the government must understand the limits to which they can push each other

The saying, 'all's well that ends well', appears to be most appropriate in the case of the recent spat between the Reserve Bank of India (RBI) and the government. However, the agreement arrived at could as well have been settled before things went public. Even though the agreement itself has raised certain fresh questions, by and large it is a satisfactory one. Without going into the merits of the issues raised, two important questions have arisen, which relate to the relationship between the RBI and the government and between the RBI management and its board. Even if one cannot come to definitive conclusions, it is important to note the ramifications of the issues raised.

Earlier episodes

Section 7 of the RBI Act, in a sense, sets out the relationship between the government and the RBI. This section gives the government the right to issue directions to the RBI in public interest. Strangely, the framers of the Act seemed to have had in mind frequent use of the section as it says: "The central government may from time to time give such directions…." Leaving that aside, it is a fact that the government had not issued such directions. But it does not mean that the government did not have its way. When Benegal Rama Rau resigned as RBI Governor in 1957 on an issue on which he differed from the government, Jawaharlal Nehru wrote to him: "You have laid stress on the autonomy of the Reserve Bank. Certainly it is autonomous, but is also subject to the Central Government's directions… Monetary policies must necessarily depend upon the larger policies which a government pursues. It is in the ambit of those larger policies that the Reserve Bank can advise."

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The tone of the letter was harsh. Similarly, some years later when another Governor, H.V.R. Iengar, raised the issue of ad hoc Treasury Bills, Finance Minister T.T. Krishnamachari said: "What to my mind is necessary is to ensure that Government policy is formulated in this respect after very full discussion with the Reserve Bank and that the latter is kept informed from time to time of any changes that Government feel called upon to make before they are made."

These episodes effectively set the tone and nature of the relationship between the government and the RBI. In one more instance, the RBI, in 1985, decided to allow banks the freedom to fix the interest rate on term deposits up to maturity of one year. The government was consulted before the circular was issued. Later, the government changed its mind. Of course, there was some uneasiness among public sector banks and the freedom given was not properly managed. The government wanted the RBI to withdraw the circular, which was done. Governor R.N. Malhotra and I, at the time, Deputy Governor of the RBI, agonised over the issue for several hours before writing the new circular withdrawing the earlier one. After issuing the new circular, I wrote to the Finance Ministry reiterating again why we had taken the earlier decision. Monetary policy measures were never announced without the concurrence of the Finance Minister.

The recent change in the monetary policy framework setting up the Monetary Policy Committee and giving it full freedom to determine the policy rate is a giant step forward in terms of giving the RBI autonomy. Literally, the Finance Minister gets to know the decision along with others.

A distinction

But it must be noted that the first step in this direction was taken by Manmohan Singh when he was the Finance Minister. When I approached him to do away with the system of the issue of ad hoc Treasury Bills which had the effect of monetising fiscal deficit, he readily agreed to this. It was this act of statesmanship by Dr. Singh which put the RBI on the road to autonomy. There is, however, a distinction between autonomy as a monetary authority and autonomy as a regulator.

In the first case, autonomy has to be full once the mandate is given. In the second case, autonomy is somewhat blurred because the mandate is broad and vague. However, coming to the issues that were thrown up in the current spat, these are mostly operational and it would have been unwise for government to use Section 7 to issue instructions. It would have sent out the wrong signals both at home and abroad. It is good that the government has desisted from using Section 7. Nevertheless, one must say that Section 7 hangs like the sword of Damocles. It is important to have continuous and sustained dialogue, and an atmosphere of give and take is much needed.

RBI and board

The second issue is about the relationship between the RBI management headed by the Governor and the board. The debate arose because of the contentious issues between the government and the RBI being referred to the board. The question that has been raised is whether the board as it is constituted today can discuss such issues and compel the Governor to act according to the majority view.

In order to understand the relationship between the government and board, we have to go back to Clause 2 of Section 7, which says: "The affairs and business of the Bank shall be entrusted to a Central Board of Directors which may exercise all powers and do all acts and things which may be exercised or done by the Bank."

However, Clause 3 says: "Save as otherwise provided in regulations made by the Central Board, the Governor… shall also have powers of general superintendence and direction of the affairs and business of the Bank and may exercise all powers and do all acts and things which may be exercised or done by the Bank."

Some argue that Clause 3 abridges the powers of the board. To me, the right way of interpretation is that both the board and the Governor have concurrent powers in almost all matters. The board has members nominated by the Central government from various walks of life, including industry. It does create a problem. This can result in a conflict of interest because the actions taken by the RBI could directly affect their interest. Therefore, the tradition that had evolved is that the board has largely functioned as an adviser.

Two things need to be clarified in this context. First, it is not as if the board has not passed resolutions on matters which are operational and policy oriented. The change in the Bank rate in the past had the prior approval of the board. In fact, in the weekly meetings of the RBI Board, the first resolution used to be on the Bank rate. But with the Governor's concurrent powers, in the past, on occasions, the Bank rate had been changed without going to the board. Second, strictly speaking, the board has the powers to discuss and even pass resolutions, which have been done. But given the nature of the board and the interests of the members, it becomes difficult to let the board to take binding decisions.

Endnote

It is, however, true that in the case of the Federal Reserve System in the U.S., the board does take decisions with voting if necessary. But then the nature of the board is very different. Section 7 is a mix of things. First, it gives powers to the board, and second, it gives powers to the Governor as well. The way the relationship between the board and the Governor has evolved over time in India is a good one. The board by and large has played an advisory role.

Against this background, while the Governor can act on his own, he must listen to what the members feel and the sense of the board must be fully reflected in his actions. The crux of the problem is that the RBI, the board and the government must understand the limits to which they can push. A spirit of accommodation must prevail.

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