

Accountability with autonomy



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Discussions have shifted from objectives of monetary policy to the appropriate mechanism for formulating monetary policy. In February 2015, the Reserve Bank of India and the Government of India entered into an agreement on a new monetary policy framework. Under this framework, the inflation target is set at 4 per cent with a band of +/- 2 per cent beginning 2016-17. The Reserve Bank of India under the agreement shall be seen to have failed to meet the target if inflation is more than 6 per cent for three consecutive quarters for the financial year 2015-16 and all subsequent years and less than 2 per cent for three consecutive quarters in 2016-17 and all subsequent years. If the Reserve Bank fails to meet the target, it will have to send a report to the central government giving the reasons for its failure to achieve the target and the remedial measures that would be taken by the Reserve Bank.

Thus control of inflation has emerged as the dominant objective of monetary policy. This is a welcome step. The clarity with respect to the objective establishes the accountability of the central bank. This also implies that the government will not interfere with any action that Reserve Bank of India may take to keep inflation within the limits.

Current Process

What is the process of policy making currently in the Reserve Bank of India? The Reserve Bank of India is not an insular institution. It keeps its ears open. Before any major policy decision is taken, it holds extensive consultations with banks, industry associations, economists and various market participants. It discusses the various alternatives with the Government. The Board of the Reserve Bank of India is not involved in the specific policy decisions. However, the broad contours of monetary policy are discussed at the meetings of the Central Board.

Since 2005, a technical advisory committee comprising of experts, has been set up to advise the Reserve Bank of India on policy matters, particularly with respect to changes

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in the policy rate. The Committee remains advisory in character and the majority view is not binding. Ultimately, the responsibility for the decision rests with the Governor. The question that arises is whether, in the context of the new policy framework, a change is called for in the process of policy formulation.

Even among central banks across nations that have adopted inflation targeting, there is no uniform organisational structure regarding policy making. While many central banks have set up monetary policy committees, there are important exceptions. New Zealand, a pioneer in the adoption of inflation targeting, which became the model for others to follow, has no committee with external members. In fact, the tenure of the

mended the setting up of a Monetary Policy Committee. The Urjit Patel Committee endorsed the idea but had a different view on its composition. If we were to set up a Monetary Policy Committee in India, what should be its composition? The key issue is the proportion of external members to Reserve Bank of India representatives in the Committee. There are three possible alternatives.

Composition of committee

First, the Committee could have a majority of members nominated by the Reserve Bank of India. This will help to fix the responsibility squarely on the shoulders of the Reserve Bank of India for keeping inflation within the agreed limits. The second alternative is to have parity between the members

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Governor is at stake if the inflation target is violated.

On the composition and strength of monetary policy committees also, there are differences among countries that have taken the route of instituting such a committee. These committees do have external members i.e. chosen from outside central banks. The U.S. has not formally announced an inflation target, even though the Federal Open Markets Committee plays a critical role. It is however, an old institution and its membership reflects the federal character of the central banking system. The membership comprises of either representatives of the Fed Board or the heads of the regional Feds.

The Financial Sector Legislative Reforms Commission in its report in 2013 recom-

nominated RBI and the external members. If there is a tie, the Chairperson who is the Governor, can have a casting vote. Even in this set up, the accountability of Reserve Bank of India holds good. The third alternative is one in which the majority of the committee comprises of external members. In this case, the accountability of RBI can be established only if the Governor is given the power of veto.

If the veto power is not given, accountability gets diffused. It can be argued that even such a committee can be held accountable and responsible for fulfilling the inflation mandate. But this would be really difficult. The best option is either alternative 1 or 2. The crux of the issue is accountability. The members can be either full time or part

time. If they are full time, the 'external' character gets diminished. If they are part time, care has to be taken in choosing members so that they are not connected even distantly with any institution which can benefit from policy decisions.

Role of MPC

The Monetary Policy Committee (MPC) is identified with its suggestions on the policy rate. However, this does not really exhaust the functions of the MPC. Changes in policy rate do play an important role. They act as signals from the central bank. They also affect the borrowings of banks from the central bank, which, in turn, lead to changes in other rates. Central banks cannot act as King Canute. They cannot simply order the interest rate. They must adjust the liquidity in the system such that changes announced are effective. Without corresponding action on the liquidity in the system, the rate changes can at best have only an announcement effect. That is why in U.S., the Federal Open Markets Committee (FOMC) became important. In the earlier days any announcement in the change in the bank rate by the Fed was accompanied by suitable instructions to the FOMC.

Thus the MPC must focus not only on policy rate but also other important ingredients of monetary policy. After all, with policy interest rates hovering near zero level in the developed countries, central banks are more focused on 'quantitative easing'. Even though money supply does not figure much in recent policy statements in India, overall liquidity is a relevant variable. Ultimately, quantity and price are interrelated.

Tasks ahead

The recent monetary policy framework, entered into between the Reserve Bank of India and the Government, is an important landmark in the evolution of monetary policy in our country. By clarifying the objective of the Reserve Bank of India, it has enhanced its autonomy. Nothing should be done to dilute the authority that goes with this responsibility. There is some concern whether the pursuit of the objective of price stability compromises its ability to take care of other objectives, most notably growth. This is not necessarily so. So long as inflation stays within the agreed zone, it becomes easy for the central bank to take care of other objectives. It is only when inflation goes beyond the limits, control of inflation becomes the exclusive concern of the Reserve Bank of India. In fact the agreed inflation target of 4 per cent with a band of +/- 2 per cent is really liberal. If inflation is allowed to be at the upper band of 6 per cent for 12 years, prices will double. We should actually work towards a much lower level of inflation. Imperceptibly, we have moved away from 'price stability' to 'inflation stability' as the objective.

However even this task is going to be difficult because of many structural features. Adopting inflation targeting does not make the task of formulating monetary policy any easier. It is true that when inflation stays outside the comfort zone, the direction of policy is clear. However, when inflation stays within the comfort zone, the direction and extent of change in policy rate depends on the assessment of inflation trajectory and the overall economic environment. On this, there can be differences of opinion as we are witnessing today. Any mechanism that we create such as a Monetary Policy Committee should not weaken but, on the other hand, strengthen the hands of Reserve Bank of India to deal effectively with inflation.

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