

**On the Importance of Independent Regulatory Institutions –
The Case of the Central Bank**

By

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No analogy is perfect; yet, analogies help convey things better. At times, a straw man has to be set up to make succinctly a practical or even an academic point. Occasionally, however, real life examples come along beautifully to make a communicator's work easier. Let me start today with an antecedent from 2010 as it is particularly apposite for the theme of my talk:

“My time at the central bank is up and that is why I have decided to leave my post definitively, with the satisfaction of my duty fulfilled,” Mr Martin Redrado, Argentina's central bank chief, told a news conference late on Friday, January 29, 2010.

“We have arrived at this situation because of the national government's permanent trampling of institutions,” he said. *“Basically, I am defending two main concepts: the independence of the central bank in our decision-making process and that the reserves should be used for monetary and financial stability.”*

The roots of this dramatic exit lay in an emergency decree passed by the Argentine government led by Cristina Fernández on December 14, 2010, that would set up a Bicentennial Stability and Reduced Indebtedness Fund to finance public debt maturing that year. This involved the transfer of \$6.6 billion of the central bank reserves to the national treasury. The claim was that the central bank had \$18 billion in “excess reserves.” [In fact, Mr. Redrado had refused to transfer the funds; so the government attempted to fire him, by another emergency decree on January 7, 2010 for misconduct and dereliction of duty; this attempt, however, failed, as it was unconstitutional.]

Besides sparking off one of the worst constitutional crises in Argentina since its economic meltdown in 2001, the chain of events led to a grave reassessment of its sovereign risk.

Within a month of Mr. Redrado's resignation, Argentine sovereign bond yields and the annual premium cost for buying insurance against loss from default on Argentine government bonds (measured as the sovereign credit default swap spread) shot up by about 2.5% or 250 basis points, by more than a fourth of their prior levels.

¹ I am grateful to Governor Dr. Urjit R Patel, Reserve Bank of India (RBI) for his suggestion to explore this theme for a speech, for referring me to the work of the Late Deena Khatkhate (2005), and for his constant encouragement, feedback and guidance. I am also indebted to insightful exchanges with Professor Rakesh Mohan of Yale University and former Deputy Governor of the RBI; Dr. Nachiket Mor of Bill and Melinda Gates Foundation, during his term as a Central Board Member of the RBI; my fellow Deputy Governor, N. S. Vishwanathan; my colleague, Dr. Michael D. Patra, Executive Director and Monetary Policy Committee member; as well as Jose Kattoor, Mridul Saggur and Vineet Srivastava of the RBI. All errors that remain are my own.

Alberto Ramos, Argentina analyst at Goldman Sachs, noted on February 7, 2010: “*Using central bank reserves to pay government obligations is not a positive development and the concept of excess reserves is certainly open to debate. It weakens the balance sheet of the central bank and provides the wrong incentive to the government, as it weakens the incentive to control the rapid expansion of spending and to promote some consolidation of fiscal accounts in 2010.*”

Even more damagingly, a risk that Governor Redrado had warned about came to the fore. By beginning of January, 2010, Thomas Griesa, a New York judge, had frozen the Argentine central bank’s account held at the Federal Reserve Bank of New York, following claims of investors that the central bank was no longer an autonomous agency but under the thumb of the country’s executive branch.

(The above summary is based in part on *Argentina’s central bank chief resigns*, Jude Webber, Financial Times, January 30, 2010; and *Argentina: Bank independence at stake as Redrado exits*, Jason Mitchell, Euromoney, February 7, 2010)

This complex interplay of the sovereign’s exercise of its powers, the central banker’s exit, and the market’s revolt, will be at the center of my remarks today on why it is important for a well-functioning economy to have an independent central bank, *i.e.*, a central bank that is independent from the executive branch of the government. I will also try to lay out why the risks of undermining the central bank’s independence are potentially catastrophic, a “self-goal” of sorts, as it can trigger a crisis of confidence in capital markets that are tapped by governments (and others in the economy) to run their finances.

Why Nations Succeed (or Fail)

Before I delve into this complex interplay, I wish to place the independence of the central bank in a more general context.

Academic discourse by political economists recognises the key role played by the rule of law and accountability of governments in enabling countries to flourish. Francis Fukuyama (*The Origins of Political Order*, 2011) considers these two elements, along with adequate state- and institution-building, as *all* being critical for “getting to Denmark,” or in other words, creating stable, peaceful, prosperous, inclusive and honest societies.

Daron Acemoglu and James Robinson (*Why Nations Fail*, 2012) summarize their body of work on the primacy of the quality of institutions in explaining the political and economic success or failure of states. Taking examples of “twin” country case studies (such as S. Korea and N. Korea), the book elaborates the following important distinction:

- *Inclusive* economic and political institutions involve plurality in decision-making which help guarantee the rule of law and foster talent and creativity; in the presence of such institutions, economics and politics do not become hostage to a set of incumbents likely to be hurt by change.

- In contrast, *extractive* institutions limit access to a country's economic and financial resources to the ruling elites, hinder change and innovation, and over time, lead to stagnation and atrophy of the country's potential.

In conversations with former colleagues at New York University's Stern School of Business (NYU Stern), it was routine to categorise economies as encouraging and supporting either *value creation*, whereby entrepreneurs believed their *mantra* of success lay in challenging orthodoxy, or *rent extraction*, wherein businesses found value primarily from joining hands with regressive state policies and crowding out others who had no such access.

Regardless of the preferred theory and terminology for the importance of institutions, it is well accepted that they include, *inter alia*, property rights and their enforcement, the judiciary, and the election office in a democracy, instituted not just *de jure* but allowed to operate independently and function effectively *de facto*.

Somewhat less celebrated is the institution of an independent central bank, perhaps not just because the central bank is a relatively new kid on the block (in most cases less than a century old), but also because it interacts less directly with the public though its true influence is far-reaching.

Government and the Central Bank – A Tale of Two Horizons

A central bank performs several important functions for the economy: it controls the money supply; sets the rate of interest on borrowing and lending money; manages the external sector including the exchange rate; supervises and regulates the financial sector, notably banks; it often regulates credit and foreign exchange markets; and, seeks to ensure financial stability, domestic as well as on the external front.

The world over, the central bank is set up as an institution *separate* from the government; put another way, it is not a department of the executive function of the government; its powers are enshrined as being separate through relevant legislation. Its tasks being somewhat complex and technical, central banks are ideally headed and manned by technocrats or field experts – typically economists, academics, commercial bankers, and occasionally private sector representatives, appointed by the government but not elected to the office. This architecture reflects the acceptance of the thesis that central banks should be allowed to exercise their powers independently.

Why is the central bank *separate* from the government? I will offer what I find to be a particularly intuitive explanation:

- (1) The first part of the explanation relates to the horizon of decision-making of a government *vis-à-vis* that of the central bank.

A government's horizon of decision-making is rendered short, like the duration of a T20 match (to use a cricketing analogy), by several considerations. There are always upcoming elections of some sort – national, state, mid-term, etc. As elections approach, delivering on proclaimed manifestos of the past acquires urgency; where manifestos cannot be delivered

upon, populist alternatives need to be arranged with immediacy. Less important in the present scenario, but only recently so, wars had to be waged, financed and won at all costs. This myopia or short-termism of governments is best summarized in history by Louis XV when he proclaimed “*Après moi, le deluge!*” (After me, the flood!).²

In contrast, a central bank plays a Test match, trying to win each session but importantly also survive it so as to have a chance to win the next session, and so on. In particular, the central bank is not directly subject to political time pressures and the induced neglect of the future; by virtue of being nominated rather than elected, central bankers have horizons of decision-making that tend to be longer than that of governments, spanning election cycles or war periods. While they clearly have to factor in the immediate consequences of their policy decisions, central bankers can afford to take a pause, reflect, and ask the question as to what would be the long-term consequences of their, as well as government's, policies. Indeed, by their mandate central banks are committed to stabilise the economy over business and financial cycles, and hence, have to peer into the medium to long term. Unsurprisingly, central banks strive to build *credibility* through a series of difficult choices that reflect sacrificing short-term gains for long-term outcomes such as price or financial stability.

- (2) The second part of the explanation as to why the central bank is separate from the government relates to the observation that much of what the central bank manages or influences – money creation, credit creation, external sector management, and financial stability – involves potential front-loaded benefits to the economy but with the possibility of attendant “tail risk” in the form of back-loaded costs from financial excess or instability. For example,
- (i) Greater supply of money can facilitate ease of financial transactions, including the financing of government deficits, but this can cause economy to over-heat in due course and trigger (hyper-) inflationary pressures or even a full-blown crisis that eventually require sharper monetary contractions;
 - (ii) Excessive lowering of interest rates and/or relaxation in bank capital and liquidity requirements can lead to greater credit creation, asset-price inflation, and semblance of strong economic growth in the short term, but excessive credit growth is usually accompanied by lending down the quality curve which triggers mal-investment, asset-price crashes, and financial crises in the long term;
 - (iii) Allowing foreign capital flows to flood into the economy can temporarily ease the financing pressures for an expanding government balance-sheet and the crowded-out

² See [Acharya and Rajan \(2013\)](#) for a complete theoretical analysis modeling government myopia and populism (maximising simply the cash-flow and spending each period) in the presence of a sovereign debt market; implications for policies governing the financial sector; and attendant risks in the form of economic repression and financial crises.

private sector, but a “sudden stop” or exodus of these flows in future can trigger a collapse of the exchange rate with adverse economy-wide spillovers; and,

- (iv) Sweeping bank loan losses under the rug by compromising supervisory and regulatory standards can create a façade of financial stability in the short run, but inevitably cause the fragile deck of cards to fall in a heap at some point in future, likely with a greater taxpayer bill and loss of potential output.

While not always the case, often the required interventions for stable growth are structural reforms by the government with upfront fiscal outlay; however, these may compromise populist expenditures or require displeasing incumbents. As a result, it might seem as an expedient solution to the government to ask/task/mandate/direct the central bank to pursue strategies that generate short-term gains but effectively create tail risks for the economy. To protect the economy from such short-termism, the central bank is designed to be at a safe distance from the executive branch of the government.

Undermining the Independence of the Central Bank

Now, although the central bank is formally organised to be separate from the government, its effective horizon of decision-making can be reduced for short-term gains by the government, if it so desires, through a variety of mechanisms, *inter alia*,

- (i) Appointing government (or government-affiliated) officials rather than technocrats to key central bank positions, such as Governor, and more generally, senior management;
- (ii) Pursuing steady attrition and erosion of statutory powers of the central bank through piece-meal legislative amendments that directly or indirectly eat at separation of the central bank from the government;
- (iii) Blocking or opposing rule-based central banking policies, and favoring instead discretionary or joint decision-making with direct government interventions; and,
- (iv) Setting up parallel regulatory agencies with weaker statutory powers and/or encouraging development of unregulated (or lightly regulated) entities that perform financial intermediation functions outside the purview of the central bank.^{3,4}

³ The most striking example is the presence of government-sponsored enterprises (GSEs) to support mortgages and home ownership in the United States. The GSEs are outside of any regulatory purview of the Federal Reserve, but have been deployed by successive governments to pursue populist housing policies, contributing significantly to the imbalances that led to the Global Financial Crisis of 2007-08 and the ensuing Great Recession (see, Acharya, van Nieuwerburgh, Richardson and White, 2011, for details).

⁴ See [Acharya \(2015\)](#) for discussion on the resulting need to ensure that the central bank has regulatory scope over parts of “shadow banking” that are likely to be systemically important.

If such efforts are successful, they induce policy myopia in the economy that substitutes macroeconomic stability with punctuated arrival of financial crises.

Therefore, there are several reasons why enshrining and maintaining central bank independence ends up being an *inclusive* reform for the economy; and conversely, undermining such independence a regressive, *extractive* one:

- (i) When the government is seen often making efforts to dilute the central bank's policies and effectively coercing the central bank into such dilutions, banks and private sector spend more time lobbying for policies that suit them individually, at the cost of collective good, rather than investing in value creation and growth.
- (ii) When governance of the central bank is undermined, it is unlikely to attract or be able to retain the brightest minds that thrive on the ability to debate freely, think independently, and effect change; attrition of central bank powers results in attrition of its human capital and deterioration of its efficiency and expertise over time.
- (iii) When important parts of financial intermediation are kept outside the purview of the central bank, systemic risks can build up in "shadow banking" with private gains in good times to a small set of players but at substantive costs to future generations in the form of unchecked financial fragility.

As such, the divergence in horizon of decision-making between government and the central bank that I have highlighted need not lead to any operational incompatibility as long as it is well-understood and well-accepted by both parties that it is precisely given this divergence that the central bank is formally separated from the executive office and meant to conduct its functions in an independent manner. The central bank can of course make mistakes, and is generally held publicly accountable through parliamentary scrutiny and transparency norms. This way, the institutional arrangement of independence, transparency and accountability to the public not only balance but also strengthen the central bank's autonomy. However, direct intervention and interference by the government in operational mandate of the central bank negate its functional autonomy.

"Kiss of Death" – Incurring the Wrath of Markets

Far-sighted government leaders may be able to reap benefits of convincing voters about the importance of investing in macro-economic stability; for instance, by claiming credit for the long-term nature of financial sector outcomes attained by allowing the central bank autonomy in decision-making and delivery of its core functions. When such a measured perspective of an independent central bank as a key element of durable economic prosperity is missing and/or government myopia so rife as to lead to regular inroads into central banking apparatus and decisions, unfortunate accidents can arise. Macroeconomic management can become a tug of war between securing stability and inflicting misdirection; daily operational decisions lead to power struggles; and, as the central bank is forced to bend over backwards to retain credibility in the

face of imminent pressures that would erode its independence, counter efforts to reduce its independence escalate.

As this dynamic plays out, markets watch keenly, and if uncertainty grows and confidence in central bank independence and credibility erode, then markets rap bond yields and exchange rate on the knuckles!

Let me elaborate.

Modern economies are, by and large, not autarkies; they rely on capital markets to finance their investments. This is especially true of governments as reflected in the relatively large size of sovereign (and quasi-sovereign) debt markets, denominated in domestic currency as well as foreign currency. As long-term risks such as inflation or financial instability rise, markets reprice sovereign debt and may potentially shun its financing altogether. This could have immediate spillovers to other markets such as for foreign exchange and foreign investments, potentially putting at risk also the external sector stability of the economy.

Therefore, the presence of this third player – the market – in the back and forth between a government and the central bank (more generally, regulatory institutions) is an important feedback mechanism. The market can discipline the government not to erode central bank independence, and it can also make the government pay for its transgressions. Interestingly, the market also forces central banks to remain accountable and independent when it is under government pressure.⁵

Besides the market revolt and strictures during the Argentine episode of 2010 that I recounted in my introductory remarks, it is to be noted that both of this year's emerging market sovereign bond and currency meltdowns got catalysed through a perception of government influence on central bank's monetary policy, including through sporadic communication by government with public on its desire to control the central bank's decision-making. In one case, a rate cut in the wake of rising inflation and mounting fiscal deficit did the damage; and in the other, it was a public pronouncement by the premier of the state about the "evils" of interest rate hikes even when inflation was in double digit terrain.

Indeed, the market censure need not be limited to emerging markets. The public expression of government's bewilderment and disappointment at monetary tightening in the world's largest safe-haven economy, again at a time of rising inflation and fiscal deficit, has raised in minds of investors scenarios under which its reserve currency status cannot anymore be taken for granted (*A debate about central-bank independence is overdue*, The Economist, Oct 20, 2018).

Barry Eichengreen, Professor of Economics and Political Science at the University of California, Berkeley, covers superbly, in his recent piece (2018), this critical feedback role of the market:

⁵ An interesting suggestion from Michael Patra is that perhaps economies should not only have rules that delineate clearly the roles of the government and the central bank, but also a dispute resolution mechanism *a la* the World Trade Organisation (WTO). The very presence of a referee would recognise that differences in objectives and horizons of decision-making arise; central bank and government can (to borrow his exact words) "*go in there, slug it out, come out battered, but in understanding, since there has to be a clear winner whose hand will be upheld by the jury.*"

“There are good reasons why countries ... delegate monetary policy decisions to technocrats appointed for their expertise. They can take the long view. They can resist the temptation to manipulate monetary conditions for short-term gain. Privileging long-term stability, as history has shown, is positive for economic performance. And it is on this performance that elected leaders, rightly or wrongly, are judged.

Thoughtful politicians understand this. Hence their support for central bank independence and their respect for the convention that they should refrain from seeking to influence central bank decisions. Unfortunately, not all politicians are thoughtful. Not all have the patience to wait for long-term gains. Not all are pleased when appointees refuse to bow to their wishes. And not all are respectful of inherited institutions and conventions, be they central bank independence or, more broadly, the division of powers.

The question is whether they pay attention to markets.”

What Barry Eichengreen is perceptively observing is that if a government were to pay attention to markets, it would realize that central bank independence is in fact its strength and the central bank a sort of a true friend, someone who will tell the government unpleasant but brutally honest truths and correct to the extent it can any adverse long-term consequences of government policies.

Let me now turn to how all this relates to the Reserve Bank of India.

The Late Deena Khatkhate provides a masterful and scholarly assessment in *Reserve Bank of India: A Study in the Separation and Attrition of Powers* (2005). Some of the discussion below draws heavily from his assessment and is updated for developments since then. Other excellent discussions of the central bank’s autonomy and independence in the Indian context are contained in lectures by the Reserve Bank of India’s former Governors, Dr. C. Rangarajan (1993) and Dr. Y. V. Reddy (2001, 2007). As we will see below, other Governors and Deputy Governors have also carried this abiding theme through their tenures. For some of them, even when the Reserve Bank’s independence has been unclear *de jure*, governments have in the end have had the wisdom to support it *de facto*; for others, however, the Reserve Bank’s independence has remained a work in progress, an enduring challenge that the nation has been grappling with on an ongoing basis.

Progressive Evolution in Restoring Independence of the Reserve Bank of India

While the Reserve Bank has always derived several important powers from the Reserve Bank Act, 1935 and the Banking Regulation Act, 1949, what matters is the effective independence with which these powers can be exercised in practice. Over time, great strides have been undertaken by successive governments at the behest of the central bank, several economists, and umpteen committee reports, to restore the operational independence of the Reserve Bank. I will touch upon three such areas of healthy progress.

- (1) **Monetary Policy:** The Reserve Bank, like many central banks of the time, got quickly trapped into the socialist planning policies of post-independence government, setting not just the rate of interest on money but practically all rates of credit at different maturities, as well as doing sectoral credit allocation to the real economy.

Post the deregulation of interest rates in the 1990s, monetary policy achieved a more modern dimension. To start with, there was a “multiple indicators” approach to setting interest rates. Having too many objectives for monetary policy violates the Tinbergen principle of “*one objective, one instrument*”; it also renders it difficult to understand or communicate what the interest-rate setting is attempting to achieve at any point of time. Importantly, this approach entertained much regulatory discretion, often at the level of an individual, *viz.* the Reserve Bank Governor. This made independence of monetary policy individual-specific; in other words, it allowed for government pressure to creep in easily for keeping rates low at times of fiscal expansion under one guise or the other.

This is exactly a setting where rules would be better than discretion, in particular to avoid the time-inconsistency problem, highlighted in the work of Nobel laureates Finn Kydland and Edward Prescott in 1970s and early 1980s. Kydland and Prescott (1977) consider the implication that people, including investors, could look into the future and anticipate the behavior of self-interested governments, so that a discretionary monetary policy could end up being compromised by government pressures, leaving inflationary expectations unanchored, whereas a monetary policy committed to a rule would be harder to bend and keep inflationary expectations at bay.⁶

Following several episodic bouts of double-digit inflation, a war on inflation and inflationary expectations, was finally launched in September 2013 by the then Governor Raghuram G Rajan; the Urjit Patel Committee Report to Revise and Strengthen the Monetary Policy Framework was released in 2014; and, finally, the Reserve Bank of India Act was modified in August 2016 to constitute the Monetary Policy Committee (MPC).

The MPC consists of three RBI members, including the Governor who reserves a casting vote, and three external members appointed by the government. The MPC has been legislatively awarded a flexible inflation-targeting mandate of achieving 4% consumer price index (CPI) inflation in the medium term, while paying attention to growth, with operational independence to achieve it, and with accountability in terms of transparency around the MPC’s resolution, minutes summarising each individual committee member’s decision, bi-annual monetary policy reports, and a written report to the government in case a +/- 2% band around the target inflation level is violated for three quarters in a row.

⁶ See also Buiters and Sibert (2000), who lay out the theoretical basis for the required legal and institutional arrangements, primarily operational independence of the central bank, for an effective monetary policy.

The MPC, two years old since, has attempted steadfastly through its rate-setting decisions to build credibility of the inflation target, a process that is generally believed, and empirically documented, to help lower the long-term bond yields as well as stabilise the exchange rate. While the jury will remain out for some time on the economic impact of the flexible inflation-targeting framework, it is incontrovertible that the MPC has given monetary policy an independent institutional foundation. The government deserves much credit for its far-sightedness in legislating the required changes to strengthen this aspect of central bank's independence and distancing itself in the process from monetary decision-making (other than through the appointment of external members on the MPC).

- (2) **Debt Management:** For several decades post-independence, the Reserve Bank participated in short-term Treasury Bill issuances of the Government of India (bearing extraordinarily low interest rates) to fund its fiscal deficits. The Reserve Bank also publicly acknowledged that its open market operations (OMOs) were primarily geared to manage the government bond yields. This implied that the central bank balance-sheet was always available as a resource – just like tax receipts – ready to monetise excessive government spending. Unsurprisingly, high inflation in India was engineered to please both Milton Friedman and Thomas Sargent, *i.e.*, it was always both a monetary and a fiscal phenomenon, as these two Nobel laureates in economics had respectively argued (Friedman, 1970 and Sargent, 1982).

Eventually, recognizing the fiscal imprudence and inflationary risks engendered by such automatic monetization of government deficits, joint efforts between the Reserve Bank and the government during 1994-1997 limited deficit financing from the Reserve Bank to the capped Ways and Means Advances (WMA). The Fiscal Responsibility and Budget Management (FRBM) Act of 2003 explicitly prohibited the Reserve Bank from participating in primary issuances of the government securities. Open market operations came to be designed to sterilise the impact on domestic money supply of foreign exchange interventions and/or to meet durable liquidity needs of the economy, rather than to fund deficits. While there have been relapses to old habits, overall these changes have left the task of government debt management with the Reserve Bank as primarily being one of auctioning government debt and helping it switch between securities or conduct buybacks, rather than of intricate involvement in fiscal planning, and more importantly, in its funding.

Furthermore, the repressive levels of Statutory Liquid Ratio (SLR) and Cash Reserve Ratio (CRR), which ensured substantial portions of bank deposits were channeled to the government or were readily available to debase in value through monetary expansion, have now been rationalised to be more or less in line with international prudential standards. For instance, in case of SLR, the level has been steadily reduced and the plan is to harmonise it with the Basel III Liquidity Coverage Ratio (LCR).

- (3) **Exchange Rate Management:** In the Five Year Plans post-independence, prices including the exchange rate were assumed to be constant; however, since the true value of the Rupee fluctuated with market prices and macroeconomic conditions, the Sterling holdings had no choice but to take an undue hit. The underlying true value of the Rupee was also affected heavily — but not reflected in reality — by monetary policy and debt management operations that were implicitly supporting the ballooning of government deficits. The result of the fixed exchange rate regime in the midst of “fiscal dominance” was that the Reserve Bank was essentially a silent spectator in the build-up to the inevitable exchange rate disequilibrium (though arguably this was true of much of the world at that time).

Since 1976, when the level of the Rupee moved to being a “managed float” against a basket of currencies, and especially since 1993, the exchange rate has gradually evolved from being entirely a fixed rate to being market-determined for all practical purposes. The Reserve Bank deploys reserves management and macro-prudential controls on foreign capital flows to manage excessively large movements. With a flexible inflation-targeting mandate for interest-rate policy and funding of fiscal deficit no longer the objective of monetary operations, the desired exchange rate management rests with the Reserve Bank.

Ongoing Challenges in Maintaining Independence of the Reserve Bank of India

Few important pockets of persistent weakness, however, remain in maintaining independence of the Reserve Bank. Some of these areas were also identified in the 2017 Financial Sector Assessment Programme (FSAP) of India by the International Monetary Fund (IMF) and the World Bank (WB) as ways to strengthen the independence of the Reserve Bank, an area in which the FSAP rates India as “*materially non-compliant*”.

- (1) **Regulation of Public Sector Banks:** One important limitation is that the Reserve Bank is statutorily limited in undertaking the full scope of actions against public sector banks (PSBs) – such as asset divestiture, replacement of management and Board, license revocation, and resolution actions such as mergers or sales — all of which it can and does deploy effectively in case of private banks. The significant implications of this limitation were highlighted in detail in Governor Patel’s speech in March 2018, [*Banking Regulatory Powers should be Ownership Neutral*](#). To reiterate from the FSAP (Para 39 in Summing up Responsibilities, Objectives, Powers, Independence, and Accountabilities, the Basel Core Principles Detailed Assessment Report):

“Legislation should be amended to enable the RBI to extend all the powers currently exercised over private sector banks to PSBs; in particular, regarding Board member dismissals, mergers and license revocation. ... It should also remove the option of an appeal to the government when the RBI revokes a license. If statutory changes are difficult, the RBI and the government should consider adopting a framework agreement

whereby the government would acknowledge the RBI's full operational authority and independence in supervision and regulation, as they did recently for monetary policy."

- (2) **The Reserve Bank's Balance-sheet Strength:** Having adequate reserves to bear any losses that arise from central bank operations and having appropriate rules to allocate profits (including rules that govern the accumulation of capital and reserves) is considered an important part of central bank's independence from the government (see, for example, Moser-Boehm, 2006). A thorny ongoing issue on this front has been that of the rules for surplus transfer from the Reserve Bank to the government (*Cogencis*, 2018, "Govt pegs RBI excess capital at 3.6 trln rupees, seeks it as surplus"), an issue that relates closely to the leading Argentine example in my introductory remarks. It has been covered deftly by Rakesh Mohan (2018) in the last of his three-part series of recent articles on the Reserve Bank, titled [*Protect the RBI's balance-sheet*](#); therein, he elucidates why a central bank needs a strong balance-sheet to perform its full range of critical functions for the economy. I quote his main points below:

"First, ... The longer-term fiscal consequences would be the same if the government issued new securities today to fund the expenditure. [R]aiding the RBI's capital creates no new government revenue on a net basis over time, and only provides an illusion of free money in the short term."

"Second, ... The use of such a transfer would erode whatever confidence that exists in the government's intention to practice fiscal prudence."

"Third, ... In theory, a central bank can implement monetary policy appropriately with a wide range of capital levels, including levels below zero. In practice, the danger is that it may lose credibility with the financial markets and public at large, and may then be unable to attain its objective if it has substantial losses and is seen as having insufficient capital."

Are fears with regard to possible central bank losses illusory? According to the Bank for International Settlements (BIS), 43 out of 108 central banks reported losses for at least one year between 1984 and 2005.

It is also argued by some that the government can always recapitalise a central bank when necessary. This is certainly true in principle but is practically difficult when the government itself suffers from fiscal pressures and maintains a relatively high debt-GDP ratio, as is the case in India. What is also important is the erosion of central bank independence both in reality and perhaps, even more importantly, in optics. ...

Once again, better sense has prevailed and the government has not raided the RBI's balance sheet."

- (3) **Regulatory Scope:** A final issue is one of regulatory scope, the most recent case in point being the recommendation to bypass the central bank's powers over payment and settlement systems by appointing a separate payments regulator (also covered by Rakesh Mohan in his series, *ibid*). The Reserve Bank has published its [dissent note](#) against this recommendation on October 19, 2018.

Conclusion

Let me conclude with some notes of gratitude and dedication as well as some for further reflection.

Mr. Malegam has been a long-time adviser, friend and well-wisher of the Reserve Bank of India, as well as its former Board Member. He is someone I personally admire for his intellect, clarity of thinking and sagacity. I thank you, Mr. Malegam, for inviting me to deliver the A D Shroff Memorial Lecture for this year.

The Late Ardashir Darabshaw Shroff served as India's non-official delegate in 1944 at the United Nations "Bretton Woods Conference" on post-war financial and monetary arrangements. One of his primary concerns was to seek a permanent seat on the executive board of the International Monetary Fund and the World Bank, which unfortunately did not materialise. To me, his most important contribution was the co-founding in 1954 of the Free Forum Enterprise think tank which through open dialogue presented a counterpoint to the socialist tendencies that were taking root in the country in the post-independence era government. Sucheta Dalal's biography, *A. D. Shroff - Titan of Finance and Free Enterprise* (2000), notes that George Woods, one of the most popular presidents of the World Bank, said of him:

"Nobody could accuse A. D. Shroff of hiding his opinions and in the later years of his life, very rarely were those opinions fashionable in India. Yet few patriots did more than he [did] to make friends for the Indian nation and to build confidence in that nation among those throughout the world whose business it is to provide capital for sound investment opportunities."

In all humility, to emulate A. D. Shroff's freedom to criticize policy "*actuated by the single motive of trying to promote the good of my country*" (from his letter to Sir Osborne Smith, the first Governor of the Reserve Bank), I chose for today's occasion the theme of the importance of independent regulatory institutions, and in particular, that of a central bank that is independent from an over-arching reach of the state. This theme is certainly one of great sensitivity but I contend it is of even greater importance to our economic prospects. I earnestly hope that I have done some justice to his immortal legacy to independent economic discourse and policy-making.

In the process, I have attempted to convince you that we have made good progress in earning the Reserve Bank's independence, most notably in the monetary policy framework (changes wherein, along with the Insolvency and Bankruptcy Code and the Goods and Services Tax, were considered as crucial structural reforms by Moody's in upgrading India's sovereign rating eleven months back). To secure greater financial and macroeconomic stability, these efforts need to be extended to effective independence for the Reserve Bank in its regulatory and supervisory

powers over public sector banks, its balance-sheet strength, and its regulatory scope. Such endeavor would be a true *inclusive* reform for the Indian economy's future. Thankfully, it is *only* a matter of making the right choices, which I believe as a society we can with adequately thoughtful “what-if” analysis; I have sketched a scenario, which several parts of the world are presently witnessing, of great risk to nations from undermining the independence of their central banks.

In his excellent biography, *Volcker: The Triumph of Persistence* (2012), my former NYU Stern colleague, Bill Silber, describes in vivid detail how in the 1980s, the then Federal Reserve Governor Paul Volcker adopted a curmudgeonly approach to setting interest rates to target inflation. Besides resisting any and all pressure to keep rates low, which would have effectively allowed cheap funding – in the short term – of President Reagan's expansionary deficit-based manifesto, Volcker engaged personally with the President to convey the perils of running high fiscal deficits right after double-digit inflation had just been tamed. In the end, Volcker won the day as wise counsel prevailed, deficits were reined in, and inflation tamed even further. I would argue that through Volcker's tough stance on inflation and candour on risks from government's fiscal plans, the institution of the Federal Reserve had in fact been President Reagan's true friend.

As many parts of the world today await greater government respect for central bank independence, independent central bankers will remain undeterred. Governments that do not respect central bank independence will sooner or later incur the wrath of financial markets, ignite economic fire, and come to rue the day they undermined an important regulatory institution; their wiser counterparts who invest in central bank independence will enjoy lower costs of borrowing, the love of international investors, and longer life spans.

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