Political Economy of Central Banking in India[1]

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1. Introduction

Apart from matters of detail, can the political economy of an economic institution be captured in terms of the political economy of the aggregate economy? If the Indian economic policy configuration gets dictated by a confluence of elite interest groups such as bureaucrats, big business, and big farmers, does the political economy of the central bank in India not get defined by the same groups? If answers to such questions are in the affirmative, then looking into the political economy of a central bank could be superfluous. However, it has been noted, "The paradox is that while the state in India has been powerful (and often heavy-handed) in its regulatory and interventionist role, it will not be described as what the political economy literature calls a 'strong state'" (Bardhan, undated).[3] It is in this context that the political economy of central banking in India deserves special attention.

Admittedly, to a large extent, in mainstream economics, central banks have been widely seen as technocratic institutions handling monetary policy (and banking supervision in many cases), essentially enjoying a monopoly over monetary policy. Then the obvious question is: why can't a central bank perform as a specialized government department? After all, in a representative democracy, at a level of broad generalization, peoples' aspirations are expected to be reflected in the elected government's functioning. Can then existence of central banks be explained solely in terms of the intricacies of financial markets (through which monetary policy operates) and the need for associated technical knowledge? Or, are there issues relating to objectives of the government and the central bank?

There is now a large literature in mainstream economics to the effect that a democratically elected government may have a tendency to utilize the trade-off implicit in short run Philips curve that generates an inflationary bias, which could be avoided by employing an independent central banker.[4] This tension between the central bank and the government is, however, one angle to the story. In any market economy, the central banks operate through financial markets; also they often regulate financial institutions. What is the relationship between the central bank (both as a monetary policy maker as well as a financial regulator) and the financial institutions then? Recent research have revealed that the financial regulator (often the central bank but not necessarily so) being part of the financial / banking sector tends

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[3] "Political Economy of India", at http://eml.berkeley.edu/~webfac/bardhan/papers/BardhanPoliticalEconomy.pdf

[4] See Cukierman (1992) for a snapshot of this literature.

to have an in-built social bias in favour of the regulated entities.[5] Moreover, in the financially advanced Western world (the US in particular), there is a large intersecting subset between the bankers and the regulators so much so that there is a "swinging door syndrome" whereby a financial market player becomes a financial markets regulator tomorrow and back to the financial market the day after. In this tri-party game between the central bank, the government and the financial market players, are the central banks more tilted towards the interest of the financial market players? Or, is it the case that over time, financial market players have emerged as a significant pressure group that can influence government?

Thus, to a large extent, the functioning a central bank may be couched primarily in terms of two kinds of tensions: (a) between the central bank (CB) and the government; and (b) between the CB and the financial market players.[6] The present paper tries to capture the evolution of political economy of central banking in India broadly in terms of these two general forces.

However, within these forces, the interaction between the government and the central bank has been of paramount importance in India. This has been buttressed by the adoption of overall macro planning in the economy in which the central bank was largely seen as a supplier of resources via deficit financing. Additionally, after the nationalization of banking in 1969, channelization of saving via the banking sector and the related paradigm of "financial repression" got in-built into the economy-wide model of resource mobilization / allocation.

In this context, three traits of the Indian central bank (the Reserve Bank of India, the RBI) can be noted.

First, as elsewhere, central bank governors in India are appointed by the government and mostly from outside and rarely from the cadre of career central bankers. Thus, the Central bank governors could be seen as government emissaries to implement monetary and banking policy. This happens all over the world and India is no exception to this general trend. But what is unique in India is that the Governor is more powerful in the sense that all the powers of the Central Board of Directors of the RBI (the body that is supposed to govern the RBI) are also vested with him / her and that till very recently India did not follow a committee approach to monetary policy.

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[5] This tendency among the regulators has been examined in detail in Barth, Caprio and Levine (2012), who argue that, " …. regulatory bias has a natural human manifestation of the current institutional structure of financial regulation in which the financial services industry enjoys a decisive home field advantage". See, Caprio and Levine (2012).

[6] There can still be another player in this context. Given the pace of globalization and clamour for international coordination for economic policies in recent years one can add a third dimension of international financial institution like the International Monetary Fund (IMF), the Bank for International Settlement (BIS) or the Financial Stability Board as well as various standard setting bodies like International Organization of Securities Commissions (IOSCO) to this menu of tensions. This issue has not been discussed in this present paper.

Second, at the same time, it may be noted at the very outset that *de jure* RBI does not seem to be an independent institution. This is reflected in Section 30 and Section 58 of the Reserve Bank of India Act 1934. While section 30 deals with "Powers of Central Government to supersede Central Board"[7], section 58 is devoted to "Power of the Central Board to make regulations". This has invited comments like, "(The RBI is) a faithful implementer of the wishes of the Finance Ministry...almost all its practices can be traced to the orders of the Finance Ministry" (Desai, 1994).

Third, as in the Indian case, most of the times, Governor is a bureaucrat / technocrat or an academic of repute and rarely a financial market professional, likelihood of the "swinging door syndrome" between the financial sector and the central bank sort of tension could be somewhat low in India (Annex 1 gives a list of RBI Governors).

As the current paper tries to capture the evolution of political economy of central banking in India since independence, the historical chronicle is sliced in three distinct phases (covering three distinct sections of the paper).[8]

The first phase would cover the first three and half decades since independence (i.e., 1951 – 1985) when forces of planning were very strong. Thus, it would also cover issues like subsuming of monetary policy under credit planning of the general planning imperatives as well as bank nationalization in 1969.

The second phase would cover the period 1985 – 1997 that clamoured for reduction of net RBI credit to central government to begin with and ultimately ending at stoppage of automatic monetization. The starting point has been taken as adoption of monetary targeting in India in sync with the recommendations of the Committee to Review the Working of the Monetary System (Chairman: Sukhamoy Chakravarty, 1985). With the cessation of *ad hoc* Treasury bills in 1997 the practice of automatic monetization was brought to a close.

The third phase would cover the period from 1997 till date. During this period, Indian monetary regime moved from "monetary targeting" to a "multiple indicator approach", and moved to a system of market based monetary policy via Liquidity Adjustment Facility (LAF) introduced in June 2000. Thus, this period would illustrate much more interesting interaction of

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[7] The provisions under this section are as follows:
"(1) If in the opinion of the Central Government the Bank fails to carry out any of the obligations imposed on it by or under this Act the Central Government may, by notification in the Gazette of India, declare the Central Board to be superseded, and thereafter the general superintendence and direction of the affairs of the Bank shall be entrusted to such agency as the Central Government may determine, and such agency may exercise the powers and do all acts and things which may be exercised or done by the Central Board under this Act.
(2) When action is taken under this section the Central Government shall cause a full report of the circumstances leading to such action and of the action taken to be laid before Parliament at the earliest possible opportunity and in any case within three months from the issue of the notification superseding the Board".
[8] See Shetty and Ray (2011) and Goyal (2014) for an account of Indian monetary policy.

the central bank not only with the government but also with financial markets and with the foreign portfolio investors. In particular, it would cover issues like perceived difference of opinion between the RBI and the central government in terms of extent of opening up of the economy with special reference to capital account liberalization.

The rest of the paper is organized as follows. Sections 1, 2 and 3 are devoted to the three phases of central banking described above, while section 4 concludes the paper.

2. Central Banking till 1985: A Hindu Marriage

To begin at the beginning, it is interesting to note that, on the eve of setting up the RBI, Montague Norman, the then Governor of Bank of England, contemplated “a Hindoo marriage” between the Bank of England (the dominant spouse) and the RBI (the subservient wife), “whereby in return for formal advisory services, the RBI was, to yield to the Bank of England the right to determine the disposition of its funds and generally cooperate with it in matters affecting the good management of sterling” (Chandavarkar, 2005).[9] Retrospectively, it seems obvious that during the heydays of planning, the functioning of a central bank can essentially be captured in terms of objectives of planning. Former RBI Governor, P C Bhattacharya noted categorically, “Monetary Policy is as much as an aspect of the State’s intervention in the economic process and must naturally be attuned to the larger economic objective of the State” (Bhattacharya, 1966). A few comments are in order.

First, there cannot be any denial that central banking and monetary policy was subservient to fiscal policy during this period. The Second Five Year Plan (1956-67 to 1960-61) was candid in this regard and commented, "In a developing economy the basic trend of governmental operations in the fiscal and monetary field is inevitably expansionist". While from the vantage point of twenty-first century, this inclination of treating monetary policy as an arm of economic planning could seem inappropriate, in the context of the 1950s and the 1960s it may not be that misplaced. After all, in the early years after independence, with either low inflation or structural inflation when the problem was one of financing development, it was quite natural that monetary policy was seen as a financing source.[10] However, such a tendency of monetary policy in a *dirigisme* regime has invited comments such as:

> "Indian monetary policy, as it has come to be designed and implemented, has differed considerably from the normal concept of monetary policy in economic literature, identified with the regulation of cost and availability of credit. Its identity as an independent tool has been erased ever since India embarked on

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[9] Interestingly, purely in terms of personalities, this period witnessed the resignation of RBI Govenor, Sir Benegal Rama Rau, in January 1957 before his second extended term of office expired, due to differences with the then Finance Minister, T T Krishnamachari.

[10] In fact, till the 8th Five Year Plan (1992-1997), deficit financing was mentioned as sources of financing the Plan expenditure.

> planned, economic development in 1952. It has been operated as an adjunct of an overall economic policy which remained throughout as strongly interventionist. In actual practice it has come to be only penumbra of a fiscal policy, with much greater accent on direct methods of control" (Khatkhate, 1990; p. 1856).

Second, despite this, one should be careful not to compare the role of Indian monetary policy with Soviet Style command economy and infer that a submissive central bank acted as an agent of the government in India during this period. On the contrary, Bhattacharya (1966) hinted that the role of Indian monetary policy within the overall approach to planning was in some way comparable to French type indicative planning. More recent research on French indicative planning reveals the association between banking / finance and the golden age of European growth during 1954 – 1974, as Monnet (2013) observed:

> "The discrepancies between the high growth of credit and output and the many distortions in financial markets have led many economists to conclude that the Golden Age of European growth occurred despite the numerous financial restraints. …They discuss the effects of financial restraints but do not study the financial institutions and mechanisms that - as imperfect as they were - have been associated with growth. They assume that the fast development of credit and real balances has been pulled by growth rather than the contrary. On the other hand, political scientists working on the French economy ….. have highlighted the strong relationships between industrial policy and credit policy. They argued that these links benefitted growth and agreed that the French state's characteristic ability to promote investment through control over the supply of credit enabled the French to achieve rapid industrial development and industrialization in the 1950s and 1960s ….. Historians who have studied some specific industries and banks over this period also underlined the role of the state in credit development" (p. 2-3).

Indian central banking experience of this period looked remarkably similar to the French experience, wherein the central bank played a crucial role in credit allocation through banking supervision, rediscounting and various types of credit control.[11] Thus, the model followed in India was essentially one of "development central banking" whereby the RBI had built a three-pronged strategy of providing finance through: (a) developing an institutional framework of industrial financing; (b) extending the role of rural credit; and (c) designing concessional financing schemes for economic development (Singh, Shetty and Venkatachalam, 1982).[12]

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[11] In fact, Monnet's comment on economists' myopia on French central banking looks prophetic in view of the following observation of Bell and Rousseau (2001), who for India noted: "Financial development can promote economic growth and structural change even in an environment in which both industrial investment and financial activities are highly regulated. ….For India, at least, it appears that a particular form of financial development, whatever its flaws, has played an important role in the industrialization process".

[12] The RBI played a key role in establishment of a number of industrial finance institutions like, the Industrial Finance Corporation of India (1948); Refinance Corporation of India (1958), Industrial Development Bank of India (1964; which also took over the Refinance Corporation) and the Industrial Reconstruction Corporation of India (1971). The RBI had also subscribed 50 per cent of the initial capital of the Unit Trust of India. Such developmental activities by a central bank have a long history in the West; see Epstein (2005) for a discussion on the developmental activities of the central banks across the globe.

Third, did the Indian economists commenting on the central banking of this period suffer from the French-kind of myopia? This is most critically revealed in Indian experience of bank nationalization. Bank nationalization is often seen in the larger context of left-leaning of Mrs. Indira Gandhi's (occupying the positions of the Prime Minister and Finance Minister at that point of time) who favoured the young-Turks in the party, comprising leaders like Chandra Sekhar or Mohan Dharia and tried to assert herself through strategic moves against the Congress Syndicate (comprising important regional leaders like Kamaraj, Nijalingappa, Atulya Ghosh and/or SK Patil).[13] Within such differences of opinion, it was the young Turks who finally won in terms of policy outcome and in tune with Mrs. Gandhi's tilt towards socialist economic policies, the Indian government decided to nationalize fourteen private sector banks on 20 July 1969 (Torri, 1975).

Economists' community was divided in their support of bank nationalization. In terms of polar opposites (somewhat caricatured), two views emerged – the conservative opinion was in favour of introducing elements of social banking within the existing structure while the radicals wanted a newer banking structure in the form of bank nationalisation. While K N Raj, was the major exponent of bank nationalisation, P R Brahamananda spoke out against it (Brahamanda, 2000). Senior bureaucrats (like P N Haksar or P N Dhar) of the day also had their views either for or against bank nationalization.[14]

While the debate from the present-day vantage point does have the possibility of getting caricatured into left versus right ideologies, taking a more holistic framework, Nayyar (1998) described the period 1967–1980 as one of co-option and mediation. The salient features of the period have been captured succinctly by Nayyar (1998):

> "The crisis in the economy and the political setback to the Congress Party, at the very beginning of the first period in this phase, led to rethinking in economics and politics. There was a recognition of two realities. For one, the rich peasantry had emerged as a new force demanding its due share in benefits derived from economic policies and seeking an upward mobility in the political process. For another, the poor, who had not seen any improvement in their living conditions, did exercise their right to vote in a political democracy. ….. In the sphere of economics, the response was twofold. First, there was a strong, new, emphasis on agriculture. … Second, poverty alleviation programmes began life in independent India,

[13] There was, however, lack of ideological homogeneity among the Syndicate members: while Patil and Morarji Desai (who was seen as a member of a great syndicate later) were well-known rightists and spokesmen for the business community, Kamaraj and Chavan were in a slightly left-of-center position.

[14] P.N. Dhar, the then Principal Secretary to the Prime Minister's office (during 1973-1977) recollects in his memoir, "I had several meetings with him (P N Haksar) on the nationalisation of banks. I particularly remember two such meetings. In one, Mr. Krishna Menon made the startling point that if we nationalise banks we do not have to bother about mobilising resources! The other meeting, along with Mr. K. N. Raj, was at Mr. Haksar's house. I learnt later that the second meeting was at the suggestion of the Prime Minister, who was keen to know Dr. Raj's views on the subject. Dr. Raj was wholeheartedly for nationalisation and said it would take at least six months to prepare for it and that it should be done as an elaborate but clandestine exercise. Three days later banks were nationalized" (Dhar, 2000).

> albeit on a modest scale…The slogan of *garibi hatao*, even if it was mere words, captured the popular imagination. But the rhetoric went further to the nationalisation of banks and the abolition of privy purses. It was these steps which gave Indira Gandhi, who dominated politics in this period through the democratic, populist and authoritarian phases of her rule, a stranglehold on the political process".

There is, however, another contrarian view that in the late 1960s, Indira Gandhi's left turn was, "accompanied by concrete anti-capitalist – rather than pro-poor – policy measurers, like the Monopolies and Restrictive Trade Practices (MRTP) Act, and the nationalisation of banks in 1969, the nationalisation of coal and oil products in 1973, the Foreign Exchange Regulation Act (FERA) in 1974, and a set of other measures which further tightened the grip of the state over the economy, contributing to the creation of "one of the most comprehensive systems of control and regulation of the private sector of the non-communist world" (Maiorano, 2014).

Whatever be the interpretation, nationalization of banks appeared to be a part of a grand strategy of a left leaning Mrs. Gandhi.

In July 1967, L K Jha became RBI Governor, who as a Principal Secretary to the Prime Minister had a close working relationship with Mrs. Gandhi.[15] It was during the Governorship of L K Jha that bank nationalization took place. In fact, Dr I G Patel, the then Secretary, Economic Affairs (and later Governor of the RBI) in his autobiography mentions, "It was, I think, later in July 1969 that I was sent for once again. No one else was present. Without any fanfare, she (the Late Mrs. Indira Gandhi, the then Prime Minister) asked me whether banking was under my charge. On my telling that it was, she simply said: 'For political reasons, it has been decided to nationalise the banks....' There was no pretence that this was a political decision" (Patel, 2002; p. 135). Dr. Patel is said to have offered two suggestions to Mrs Gandhi: (a) foreign banks should not be nationalized; and (b) instead of nationalizing all banks, it would be better if only the major banks, which accounted for 85–90 per cent of the total banking business, were nationalized; both these suggestions were accepted.[16]

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[15] Interestingly, an offer of Governorship was made to B.K Nehru in 1967. He declined and made the following comment in his autobiography, "The reason why I had so far refused was the lack of independence of the Governor. I explained to him that the great battle between TTK and Rama Rao, which the latter lost, had made it clear that the Governor was a subordinate of the Ministry of Finance. Even as Joint Secretary, I used to issue orders to the Reserve Bank. I did not cherish the idea of my juniors ordering me about."

[16] What was the impact of bank nationalization on the Indian economy? Various views emerged. Illustratively, Ketkar & Ketkar (1992) noted, "The aggressive bank branch expansion program under the auspices of bank nationalization has increased financial savings, but the credit allocation program associated with it has had a negative effect on deposit mobilization and capital accumulation". Athukorala and Sen (2004), on the other hand, went on to comment: " … Bank density stands out to be a highly significant variable in explaining variations in the private saving rate. A 10% decline in population per bank branch seems to increase the private saving rate by 0.4 percentage points".

What was the nature of central banking during this period? Joshi and Little (1994) summed it as, “India does not have an independent central bank. Responsibility for major decisions on monetary policy rests with the Finance Ministry, although the Reserve Bank is closely involved. ….. For some years after independence the Reserve Bank had a lot of *de facto* power and influence, but this was severely eroded after bank nationalisation” (p. 244).

3. The Phase of Monetary Targeting: Old Dogma or Questioning Government Domination of Deficit Financing (1986 – 1998)?

This period witnessed shifting of the RBI’s framework of monetary policy, the economic foundation of which was, no doubt, provided in the Chakravarty Committee Report. As far as the framework of the monetary policy of India is concerned, Chakravarty committee advocated a simple “monetary targeting rule with feedback”. Monetary targeting was adopted as an operational strategy of monetary policy since the mid 1980s. For the first time, the central government budget for 1987-88 set out the target of net RBI credit to government as an integral part of the targeting exercise. What is the performance of the regime of monetary targeting? In pure numerical terms, the answer is “unequivocally bad” – in fact, out of the 15 years span of monetary targeting, it is for only four years during which the targets were achieved!

A key personality in this experimentation of monetary targeting in India has been C Rangarajan. Unlike a career bureaucrat who tends to be much more eclectic, Rangarajan came from academia and his economic ideology was titled towards monetarism in the sense that perhaps he tended to believe that, “inflation is a monetary phenomenon”. He served as a Deputy Governor of the RBI (in charge of monetary policy, research, statistics and external investment) from 1982 to 1991 and after a brief stint at the Planning Commission he came back to the RBI as Governor and was there in that capacity during December 1992 to December 1997.

But why is the performance of monetary targeting dismal in India? It is well-known that a monetary targeting strategy comprises three elements: 1) reliance on information conveyed by a monetary aggregate to conduct monetary policy; 2) announcement of targets for monetary aggregates; and 3) some accountability mechanism to preclude large and systematic deviations from the monetary targets (Mishkin, 2000).[17] Empirically, a standard way for

[17] While monetary targeting is shown to be a failure in the U.S, Canada and the U.K, illustrations of successful monetary targeters would include Germany and Switzerland.

assessment of such a regime would be to do a before-after analysis. A comparison of the key macro indicators indicates that there has been a marginal reduction in average M3 growth; while growth was higher, inflation too turned out to be higher (Mohanty, 2010). The most striking feature was the presence of higher fiscal deficit, which was the main factor responsible for the dismal performance of monetary targeting. In fact, it has been observed that: "The latter half of the 1980s have been rather unheroic years for monetary policy in India. The phase of explicit monetary targeting unfortunately coincided with a period of fiscal profligacy with the result that the credibility of monetary planning has been seriously eroded" (Mujumdar, 1989).

There are perhaps two distinct ways in which one can view adoption of monetary targeting in India.

First, it can be seen as following an old dogma which by the late 1980s had already been discredited in a number of countries and whose theoretical foundation has been questioned. Illustratively, it has been observed that, "Monetary targeting of the type recommended will not lead us anywhere except the quagmire of stagnation; Milton Friedman is not a suitable seer for India" (Ghosh, 1987). Contrary opinions of course existed, e.g., C Rangarajan in 2001 noted that, "the scheme of fixing monetary targets based on expected increase in output and the tolerable level of inflation is far removed from the Friedmanite or any other version of monetarism."

Second, from a political economy angle (may be from a strategic consideration from the Central Bank) it may be seen as a expression of a somewhat feeble protest on the part of the Central Bank against the Central Government's rampant usage of deficit financing *via* the practice of *ad-hoc* Treasury bills. This could be a charitable explanation of this phase of monetary targeting. After all, during this period, the central bank tried to communicate different aspects of monetary-fiscal nexus.

The monetary-fiscal nexus of the Indian economy during this period is amply illustrated in the increasing trends in net RBI credit to Central Government till at least 1994. The way this used to be operated was through a system of *ad hoc* Treasury bills. As the name indicates, under the system of *ad hoc* Treasury bills, there was no limit of deficit financing and money was created against the backing of ad hoc Treasury bills with a fixed coupon of 4.6 percent. It is as if a constant tap of monetary flows was available for the Central Government from the RBI at 4.6 percent per annum – no matter what the situation in the financial markets was. Furthermore, due to Government's inability to redeem these *ad hoc* Treasury bills, the Treasury bills were periodically funded into long-term securities. This system made the monetary policy completely subservient to the needs of the fisc. There was constant discomfort about this system and it was repeatedly emphasized in the writings of the senior officials of the RBI. Illustratively, Rangarajan in his Presidential address to the Indian Economic Association at Calcutta in December 1988 went on to say:

> "….The essence of coordination 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 monetization and thereby provide greater manoeuvrability 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".

In order to check the unbridled automatic monetization, a series of measures were initiated. An Agreement was signed between the RBI and the Central Government on September 9, 1994 to put in place a system of limiting the creation of *ad hoc* Treasury bills during the three-year period ending 1996-97. It was mutually agreed that the *ad hoc* Treasury bills would be completely eliminated by April 1997. Subsequently a second Agreement was signed between the RBI and the Central Government in April 1997 and the *ad hoc* Treasury Bills were completely phased out by funding *ad hoc* Treasury Bills (as on end-March 1997) into special undated securities at an interest rate of 4.6 per cent on April 1997. This marked a new beginning of the fiscal-monetary interface in India. A new system of Way and Means Advances (WMA) for the Central Government was introduced in place of the ad hoc Treasury bills from April 1, 1997. These new arrangements and the declining trend in deficit financing was noticeable since the early 1990s in the monetary data.

Was monetary targeting a technocratic solution to a political bias of the fiscal authorities to run a deficit perennially? There is a minority view that perhaps it was not. It may be instructive to turn to Lohmann (2006), who went on to say:

> "In the 1960 and 1970s, monetarists proposed monetary targeting rules arguing that monetary policy matters rather than fiscal policy (their Keynesian opponents argued the opposite) and that stabilizing the money supply would serve to stabilize employment and output (ditto) …. In other words, monetary targeting rules were celebrated for their economic properties and not their political properties. The reason why policy-makers adopted monetary targeting regimes in the 1970s, however, was because in the oil price shock era monetary targeting rules turned out to be a useful political device to fend off political pressures to inflate. In the political implementation of monetary targeting rules, their political properties prevailed."

4. More Recent Period: Tensions of Capital Inflows or a Conflict between a Conservative Central Bank and a Liberal Government?

The influence of personalities was perhaps evident in RBI's abandonment of monetary targeting in 1998.[18] After Rangarajan's term was over, Bimal Jalan became RBI Governor on 22 November 1997 and on 29 April 1998, while presenting the "Monetary and Credit Policy for the First Half of 1998-99", Jalan went on say:

> " Monetary policy in the past has been fashioned largely on the lines of specification of the desirable rate of expansion in broad money (M3) which is worked out on the basis of the response of demand for real

[18] Interestingly, Friedman (1962) argued that central banks are hostage to the individuals who head them.

> money to income growth and the tolerable rate of inflation. Most studies in India have shown that money demand functions have so far been fairly stable. However, the financial innovations that have recently emerged in the economy provide some evidence that the dominant effect on the demand for money in near future need not necessarily be real income, as in the past. Interest rates too seem to exercise some influence on the decisions to hold money. It is not easy to evolve, in the present circumstances, a monetary conditions index or a clear-cut interest rate channel of transmission of effects of monetary policy. The information base required for such an exercise is substantial. … *As a first step to move in this direction, it is necessary to adopt a multiple indicator approach wherein interest rates or rates of return in different markets (money, capital and government securities markets) along with such data as on currency, credit extended by banks and financial institutions, fiscal position, trade, capital flows, inflation rate, exchange rate, refinancing and transactions in foreign exchange available on high frequency basis are juxtaposed with output data for drawing policy perspectives* (emphasis added).

Thus, the RBI switched over to a more broad-based "multiple indicators approach" since 1998-99.

While the earlier issue of difference of opinion between the RBI and Government about the centrality of RBI credit to central government in monetary expansion got reasonably settled during this period with the agreements signed between the RBI and the Government and gradual withdrawal of the RBI from primary market of government securities, a newer dimension was added. This related to the opening up of the Indian economy in general and to the extent of capital account convertibility in particular.

The pattern of Indian's Balance of Payments since 2000 is well-known. In most of the years, India experienced a deficit in its current account, which was primarily financed through capital inflows – emanating from foreign direct investment (FDI), foreign portfolio investment (FPI) and external commercial borrowing (ECB). While the restriction on the flows from FDI and ECB was less controversial – over the years significant difference of opinion between the government and the RBI emerged insofar as FPI is concerned. At the risk of caricaturing RBI's position on this issue, perhaps the RBI's stance can be summed up as follows. The milestones mentioned by Tarapore Committee II were three: low inflation, low non-performing assets of the banking sector and low government deficit. Of these, the most important lacuna around early 2000 was on account of Government Deficit. Thus, till the time some semblance of order is restored in the Government's budgetary operations, exposing the country's debt to foreign players could be risky and would expose India to the "original sin" of floating debt in a currency that was not its own. This is particularly true for Sovereign debt. Equity could be different as it would entail risk sharing by the foreign investor as well. This apart, a difference of opinion was reflected regarding the huge flow of foreign inflows through participatory notes (PNs).[19]

[19] Participatory Notes (PN) is a general name used for the investment by Foreign Institutional Investors (FIIs) through Offshore Derivative Instruments (ODIs) such as Participatory Notes, Equity-Linked Notes, Capped Return Notes and Participating Return Notes.

The difference of viewpoint between the RBI and the Central Government was most clearly observed in the context of the 2005 Report of the "Expert Group on Encouraging FII Flows and Checking the Vulnerability of Capital Markets to Speculative flows (Chairman: Ashok Lahiri)[20] to which the RBI attached a dissent note. An instance of adding a dissent note to a Government (actually Ministry of Finance) appointed committee was almost unheard of. The difference of opinion occurred along various dimensions. First, "in view of macroeconomic implications, impact on financial stability, especially on exchange rate, and fiscal vulnerability, apart from monetary management", the RBI wanted a special group to be constituted to study measures to contain large volatility in FII flows. Second, the RBI differed on the threshold limits of different caps to be imposed on FDI and FII. Third, the RBI wanted the PNs to be wound up. Fourth, there was also difference of opinion regarding treatment of hedge funds, ceiling on holding of shares by FII and sub-accounts, operational flexibility to impart stability to the markets. To the popular press, the stance was caricatured as a debate of pro-market and anti-market and was often interpreted as, "RBI's yearning for more capital controls" (Shah, 2006).[21]

This difference of opinion seemed to have prolonged further. Subsequent attempts to liberalize India's capital accounts did not have much RBI involvement. This was reflected in the reports of the 2007 High Powered Expert Committee on Making Mumbai an International Financial Centre (Chairman: Percy Mistry) and the 2009 Committee on Financial Sector Reforms (Chairman: Raghuram Rajan). In fact, both these committees did not have any RBI representatives. In view of the fact that both these committees were to do with the financial sector, it is indeed surprising.

Can there be any political economy angle to this difference of opinion between the government and the RBI? This is perhaps best illustrated through the following incident. The then Governor Y V Reddy gave a speech on the "Current Status of the Indian Economy" on February 9 2005 at the release function of the IGIDR *India Development Report 2004-05* in Mumbai. In that speech he dealt at length of various issues on capital account management and went on to say:

> "First, a view needs to be taken on the quantity and quality of FII flows. While quotas or ceilings, as practiced by certain countries, may not be desirable at this stage, there is merit in our keeping such an option open and exercising it selectively as needed, after due notice to the FIIs. Second, there is scope for enhancing quality of flows through a review of policies relating to eligibility for registration as FIIs, and assessment of risks involved in flows through hedge funds, participatory notes, sub-accounts, etc. Strict adherence to 'Know Your Investor' principle, especially in regard to flows from tax-havens, including beneficial ownership would enhance quality. Third, price-based measures such as taxes could be examined though their effectiveness is arguable and hence may not be desirable" (Reddy, 2005).

[20] Available at http://finmin.nic.in/the_ministry/dept_eco_affairs/capital_market_div/ReportEGFII.pdf
[21] http://ajayshahblog.blogspot.in/2006/02/rbis-yearning-for-more-capital.html

Apprehending that the RBI is contemplating some Tobin-type tax on FII inflows, select FIIS made a hue and cry and, if press reports are to be believed, they effectively conveyed that feeling to the Ministry of Finance. The then Finance Minister, Chidambaram (after discussing with Reddy) appeared on TV channels to clarify that there was no proposal to cap portfolio inflows or tax them.[22] The rest of the evening's happenings is summarized in the *Business Standard* as: "At an unscheduled press conference late that same evening at RBI headquarters on Mint Road, Reddy had to say that personally he was "not in favour" of a ceiling on foreign fund inflows. By that time, minor changes had been made to his IGIDR speech on the Indian central bank's website."

Is the incident indicative of the fact that in the political economy of the monetary policy there is now a new pressure group called foreign portfolio investors, who can be amply influential, given India's dependence on FII inflows? Does it mean that given the tensions of impossible trinity and India's fragility on the capital account front, monetary policy is now a hostage to FII influence? In absence of any further research one can only speculate. It is, however, instructive to refer to D N Ghosh, who, in reviewing a recent book of Reddy commented:

> "First, liberalisation of the financial markets was a critical area where Reddy had been consistently advocating caution even as private financial market participants, egged on by the major Wall Street operators, had turned into strong lobbyists calling for rapid liberalisation on the plea that India was being denied the benefits of many new financial instruments that promoted efficiency in the markets. They were joined by operators in the real sector whose argument was that a cautionary policy was depriving them of the benefits of different types of financial instruments that could enable them to manage costs and risks better. The RBI and the government were both committed to a healthy development of the financial market, but Reddy, as governor, had been stressing, and quite often at that, on the need to maintain a proper balance between the different components of what goes on in the name of liberalisation. He was of the view that unless development of the domestic bond market was put on a firm footing, it would be premature to open it up to foreign investors. His particular concern was that, in the matter of the development of the bond market, the RBI, as the central bank of the country, had a stake, given its importance in the transmission of monetary policy and financing of infrastructure. In several areas, such as capital flows, the fiscal deficit and current account gap, there are well-known vulnerabilities in emerging market economies and the RBI was greatly concerned that we could be swept off our feet. It stuck to its conviction, even in the face of intense pressure from the political government to liberalise fast and thereby push up the growth rate. In hindsight, it is not difficult to visualise how pitiable a condition we would have found ourselves in if Reddy had succumbed!"

[22] In fact, in a leading business news channel, one of the spokespersons of the FII community used abusive language against Reddy about the issue of taxing FII outflows. The Channel has distanced itself from the comment of the individual next day.

5. Concluding Observations

The paper has made an attempt to gauge various dimensions of political economy of central banking primarily in terms of its interaction with the Government. In doing so and in an effort towards summarizing trends of central banking since 1950s, various bends and swings were detected in the relationship between the Central Bank and Government in India. In fact, while stating the obvious without being necessarily informative, it may not be an exaggeration to say that the political economy of the central banking in India followed the *zeitgeist* of the Indian economy. Admittedly, the clamor for independence of the RBI so far can essentially be couched in terms of "independence within government". As far as the recent period is concerned, one can see the emergence of foreign investors as a distinct interest group in this context.

While concluding the paper, it may be worthwhile to speculate on the shape of things to come in the immediate future. A few comments are in order.

First, the recommendation of the Financial Sector Legislative Reforms Commission (FSLRC) of creating a unified financial regulator is largely seen as curbing the powers of the Central Bank.[23] Governor Rajan went on record to say:

> "The FSLRC also seems to be inconsistent in its emphasis on synergies and regulatory uniformity. It proposes all regulation of trading should move under one roof, all regulation of consumer protection should move under another roof, but the regulation of credit should be balkanised – banks should continue to be regulated by the RBI but the regulation of the quasi-bank NBFCs should move to the Unified Financial Agency, a regulatory behemoth that would combine supervision of trading as well as credit. This balkanisation would hamper regulatory uniformity, the supervision of credit growth, and the conduct of monetary policy. ….(W)hile negotiations and cooperation between regulators can overcome organisational barriers, it is not wise to give a regulator a responsibility and leave the tools for exercising that responsibility in other hands. The RBI has responsibility for managing the internal and external value of the rupee, and more broadly, for macroeconomic stability. As a number of multilateral agencies and academics have recognised, the ability to shape capital inflows is now a recognised part of the macro-prudential tool kit. But by taking away control over internal capital inflows from the RBI, isn't the FSLRC taking away an important tool from the RBI?" (Rajan, 2014).

Does it mean going forward unless such recommendations of FSLRC are rationalized there will be serious issues of co-ordination between the RBI and the Government?

Second, the talk of adoption of inflation targeting as a strategy of monetary policy is round the corner. There is a large literature on inflation targeting by now. This literature has given birth to a large body of knowledge in which an independent central banker is responsible for delivering a low and stable inflation and is often accountable directly to the legislature.[24]

[23] Meanwhile, consequent to the amendment of the RBI Act in 2012, there are now two representatives from the Ministry of Finance in the RBI Board since 2012.
[24] See, for example, Walsh (2009).

Over the last two decades, in a large number of countries inflation targeting has emerged as a monetary policy paradigm giving birth to a new dimension in the political economy of central banking. What started with New Zealand in 1989 soon spread to the United Kingdom and host of Asian countries like Thailand and the Philippines. At the current juncture, two caveats on inflation targeting are in order. *First*, the idea of central bank independence and associated inflation targeting paradigm received a big jolt during the recent global financial crisis which showed that a country may suffer from financial instability even with a stable inflation rate. *Second*, even with clamor for (and also with reasonable attainment of) Central Bank independence, political economy of central banking remains a live issue. Japan is a case in point. Japan adopted central bank independence over a decade ago, but there are ample evidence that Japanese politicians have tried to influence monetary policy through the power of appointments, threats of legal reform, and public suasion virtually ever since (Dwyer, 2012). Interestingly, in India, both the 2008 Report of the Committee on Financial Sector Reform (Chairman: Raghuram Rajan) as well as FSLRC spoke in favour of it and more recently the Report of a RBI appointed Expert Committee to Revise and Strengthen the Monetary Policy Framework (Chairman: Urjit Patel) recommended, "inflation should be the nominal anchor for the monetary policy framework". While a single-minded focus on inflation control may not be appropriate for a country like India (Subbarao, 2011), as long as a short-run trade-off between inflation and unemployment is a reality, recent research on political economy of inflation targeting also points out to adverse distributional consequence arising out of inflation targeting (Jayadev, 2008). Notwithstanding such critiques, any possible adoption of inflation targeting in India would have interesting ramifications on the political economy of central banking.

Annex 1: List of RBI Governors

1. Osborne Smith (1 April 1935 – 30 June 1937)
2. James Braid Taylor (1 July 1937 – 17 February 1943)
3. C. D. Deshmukh (11 August 1943 – 30 June 1949)
4. Benegal Rama Rau (1 July 1949 – 14 January 1957)
5. K. G. Ambegaonkar (14 February 1957 –28 February 1957)
6. H. V. R. Iyengar (1 March 1957 – 28 February 1962)
7. P. C. Bhattacharya (1 March 1962 – 30 June 1967)
8. L. K. Jha (1 July 1967 – 3 May 1970)
9. B. N. Adarkar (4 May 1970 – 15 June 1970)
10. S. Jagannathan (16 June 1970 – 19 May 1975)
11. N. C. Sen Gupta (19 May 1975 – 19 August 1975)
12. K. R. Puri (20 August 1975 – 2 May 1977)
13. M. Narasimham (2 May 1977 – 30 November 1977)
14. I. G. Patel (1 December 1977 – 15 September 1982)
15. Manmohan Singh (16 September 1982 – 14 January 1985)
16. A. Ghosh (15 January 1985 – 4 February 1985)
17. R. N. Malhotra (4 February 1985 – 22 December 1990)
18. S. Venkitaramanan (22 December 1990 – 21 December 1992)
19. C. Rangarajan (22 December 1992 – 21 November 1997)
20. Bimal Jalan (22 November 1997 – 6 September 2003)
21. Y . V. Reddy (6 September 2003 – 5 September 2008)
22. D. Subbarao (6 September 2008 – 4th September 2013)
23. Raghuram Rajan (4 September 2013 – Present)

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