

Central banks and the rule of law

In a constitutional democracy, the RBI is bound by the law to focus on its core mandate

ILLUSTRATION: BINAY SINHA



Two recent developments in India underline the need to imbue the rule of law in the functioning of central banks (CBs).

The Reserve Bank of India (RBI) legally became an inflation targeting CB in 2016. The Monetary Policy Committee (MPC) normally makes policy announcements in line with a predictable schedule. But on May 4, it went off the schedule and increased the policy rate by 40 basis points. Markets were surprised by this and the 10-year government bond yield jumped. Why did the RBI do this? As has been emphasised by many, nothing in the inflationary outlook had changed between the last MPC meeting of April 8 and the off-schedule announcement of May 4.

One possibility relates to the exchange rate. Over the last year, the US dollar has appreciated by 8 per cent. Holding other things constant, this means the normal rupee depreciation should be about 8 per cent. The RBI seems to be fighting this, by selling reserves, and by responding to the (amply telegraphed) large hike by the US Fed that was coming a few hours after the RBI's surprise announcement.

Wearing my economic policy hat, the pursuit of a strong rupee today appears unwise. But for the purposes of this article, we will focus only on the consequential legal and constitutional questions. The parliament has explicitly mandated the RBI to pursue an inflation target and not a currency target. To do otherwise is not in consonance with the RBI Act.

The second development is the public statement of the co-founder and chief executive officer of a NASDAQ-listed crypto exchange that his company disabled the Unified Payments Interface (UPI) sys-

tem from its platform due to informal pressure from the RBI. The company had earlier announced that they would build systems in India whereby investors could receive/send money using UPI. This is the legitimate right of a merchant in the UPI system. As a person selling salt, I can say, on my website, you will pay money using UPI. The highway is not concerned with the purpose for which trucks run on it.

The National Payments Corporation of India (NPCI) came out with a negative press release, and all Indian banks refused to do business with the exchange. UPI access is closed to non-banks. As a consequence, the exchange — which has about 100 million users in 100 countries with an annual trading volume of over \$1 trillion — backed away from its business plan. Under the present Indian financial regulatory architecture, the RBI has high power over the NPCI and all banks. Such ostracisation by banks, with or without the involvement of the RBI, is tantamount to violating the Supreme Court order striking down the RBI ban on cryptocurrency.

The parliament has created agencies in the financial sector called Statutory Regulatory Authorities (SRAs) for consumer protection and financial stability. These agencies need certain kinds of independence from politics to pursue their goals objectively, in a fair manner governed by the rule of law. However, the idea of a “simple and complete independence” is naive. Every agency in a constitutional democracy requires checks and balances; constitutionalism and the rule of law must pervade all state organisations. Even if drastic independence were required, the rule of law is inviolable in a constitutional democracy.



**AARTHIKAM
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The CB is one kind of financial agency. Its main mission is to maintain price stability. How should we construct the CB, with sound foundations of the rule of law, and the appropriate kinds of independence that is required flowing from the objectives? The Indian policy process deliberated on these questions for many years, leading up to the Financial Sector Legislative Reforms Commission (FSLRC) recommendation of three pillars.

Pillar one is the regulation-making function of all SRAs, which is relevant in India as the RBI has been given the role of financial regulation for the payments and banking industries (and some other components). There is a problem of democratic legitimacy when unelected officials write law. The solution lies in technical expertise that is displayed, in consultation and control of all regulation-making process by an expert board where private persons have a majority. All these elements address the problem of “the administrative state”, the rule of officials, and generate legitimacy in the writing of law by the agency.

Pillar two is the executive functions of investigations, prosecutions and punishments. There is a case for political independence here. It should not be possible for the political masters to trigger punishments for their foes. This requires processes, encoded in parliamentary law, which enshrine separation of powers, define and limit the powers of investigation, require due process in prosecutorial decisions, hygiene in how hearings take place, require reasoned orders, ensure proportionality of penalties, and establish the mechanisms for appellate review before courts/tribunals.

Pillar three: Monetary Policy is defined as the control of the short interest rate of the economy. There is a role for political independence here. It should not be possible for the political masters to trigger a rate cut prior to a tough election. Most of the developed world has gravitated towards an independent expert MPC structure for the discharge of this function.

Alongside this are the questions of the mandate of RBI, which at present has an improbable combination of functions ranging from running an exchange to investment banking for the Union government and state governments. The sheer scope of this mandate induces innumerable conflicts and rule of law concerns.

The recent developments leading to an inflation target and the beginnings of an independent MPC are milestones in India's history. From 1934 onwards, the preamble of the RBI Act viewed the RBI as “a temporary measure”, and effectively, these words were removed in 2016. For the first time, the RBI was no longer a temporary measure with a lack of clarity of objective: It was an inflation targeting central bank.

The recent events— the surprise rate hike and the “informal” limitations upon a global exchange — alert us to the remainder of the reform agenda. We need to move forward and carry through the remaining agenda of RBI reform.

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