

BANKING

# Will the Rising Wave of Nationalist Leaders Sweep Away Central Bank Independence?

BY SASHI SIVRAMKRISHNA ON 06/02/2017 • LEAVE A COMMENT

Given the imperious attitude of new leaders to institutions of the old order, the questioning of central bank independence is a given. But how is this changing relationship between governments and central banks manifesting?



People walk past the Reserve Bank of India (RBI) building in New Delhi, India.

Credit: Reuters/Anindito Mukherjee

Even as the question of central bank autonomy over the issue of demonetisation is being hotly debated in the Indian media, many would be aware that the term primarily arises in the context of the formulation and conduct of monetary policy. The fear over the decline of central bank autonomy or independence is in this sense, therefore, not an issue specific to India; with the decline of neoliberalism and the emergence of a new political order that has propelled populist leaders like Donald Trump and Theresa May to power, it is now a topic of discussion around the world. Just a couple of months ago in November 2016, while *The Economist* called (<http://www.economist.com/blogs/buttonwood/2016/11/unaccountable-technocrats-or-convenient-scapegoats>) for a “Rethinking of Central Bank Independence”, the *Financial Times* was more categorical in proclaiming (<https://www.ft.com/content/a4e41f16-5b1b-11e2-8ccc-00144feab49a>) the “End of the Era of Central Bank Independence”. And it is in the context of monetary policy, rather than demonetisation, that I examine the issue of central bank autonomy both generally and with reference to India and the Reserve Bank of India (RBI).

The final quarter of the 20th century witnessed a structural break in macroeconomics with a shift in focus from stabilisation of output and employment to stabilisation of price level and inflation. The Vietnam War and the oil shocks on account of the war in the Middle East in the 1970s triggered off a crisis that had hitherto not been anticipated by Keynesians: stagflation, a situation where falling output was

accompanied by rising rates of unemployment and inflation, simultaneously. An expansionary fiscal policy to tackle the unemployment problem would then lead to accelerating inflation. Although inflation rates barely went beyond 15% in the West, the fear of inflation spiralling into unmanageable levels was enough reason to begin dismantling the post-war neo-Keynesian paradigm along with its accompanying institutional apparatus.

## **A new path**

The alternative? A new wave of economists began scripting a return to free-market capitalism, where proactive state intervention in management of the economy was considered more a hindrance to stable growth than a necessity. Inflation was the dreaded bogey in the emerging free market neoliberal narrative that could potentially distort the functioning of the price mechanism in many ways, including making it difficult for firms to distinguish changes in relative prices from changes in the general price levels so that use of lower priced inputs may not take place, rising interest rates as lenders incur losses on capital lent and eroding purchasing power of fixed-income earners that would impact consumption spending.

Left-of-centre and some heterodox economists, however, viewed this as a paradigm to dismantle Keynesianism and with it the growing share of labour in domestic output vis-à-vis the private sector capitalist class. Free trade and flow of capital, embodied in the notion of globalisation, were important instruments to tame domestic labour and check rising real wages. Stability in exchange rates was, however, a necessary condition for such global movement in goods, services and capital. With the era of fixed exchange abandoned in the early 1970s, volatility under a floating exchange rate regime had to be curbed, which in turn necessitated stable domestic inflation rates. Strong government involvement in the economy and its corollary – the welfare state – could potentially disrupt the process of globalisation and prevent the capitalist class from extracting a larger portion of the GDP pie. Pro-market forces, not always conducive to domestic businesses, were unleashed across countries supported by international institutions, particularly the IMF, the World Bank and the WTO.

The attack on Keynesianism was theoretically intense and in a race to annihilate it the baton was passed from one “great” (mostly Chicago School) economist to another: Milton Friedman, Robert Lucas, Thomas Sargent, Neil Wallace, John Muth, Eugene Fama, Finn Kydland and Edward Prescott. This new macroeconomics effectively relegated Keynes and Keynesianism to history, and in doing so altered not only the goal of macroeconomic policy but also the role of the state in managing the economy. First, activist fiscal policy was “proven” incapable of affecting output and employment not just in the longer-term but even in the short-term and second, attempts to use fiscal policy to achieve full employment only led to inflation. The solution for growth (and even development) was supply-side structural reform that called for liberalisation, privatisation and globalisation. The first point on the list of ten policy prescriptions in the Washington Consensus was fiscal discipline and adhering to it was seen as the key to both low inflation and avoiding a balance of payments crisis. The European Commission also articulated the three pillars of social and economic policy as fiscal responsibility, structural reforms and private investment, which together act as a virtuous cycle that can ensure growth and jobs. The government came to be treated as a household or private firm, with limited resources, facing an inter-temporal budget constraint. Moreover, government expenditure was considered to be funded by the private sector or taxpayers’ money. The accumulated deficits of the government or public debt would have to be repaid at some point of time, imposing a burden on future generations. “Minimum government”, a term that became a slogan in India’s 2014 election campaign, articulates the essence of neoliberal macroeconomic policy.



City workers walk past the Bank of England in the City of London, Britain, March 29, 2016. Credit: Reuters/Toby Melville/File Photo

While fiscal austerity was one pillar of neoliberal macroeconomics, monetary policy – under the control of an independent central bank – was to be the other. State control over setting interest rates was transferred to the central banks, which were in turn mandated to ensure a ‘low and stable’ inflation rate. This could act as an effective check against errant government behaviour of high deficits and low interest rates to boost the economy (but resulting in high inflation), especially prior to elections. An independent central bank could effectively counter the government’s fiscal profligacy by raising interest rates to achieve the stipulated inflation target and furthermore, inflation expectations. In many advanced countries, in response to the Great Recession of 2008, monetary policy – low interest rates and quantitative easing – took centre stage while the use of fiscal stimulus was comparatively restrained. With inflation in check, an efficient market system would supposedly propel an economy onto a path of long-term growth in an environment of competition and innovation. Raghuram Rajan exemplified this view when he remarked (<http://www.thehindubusinessline.com/money-and-banking/rbis-job-is-to-build-confidence-not-play-cheerleader-rajn/article7275505.ece>), “our [RBI’s] job is to give people confidence in the value of the rupee, in prospects of inflation and having established that confidence, create longer-term framework to take good decisions ...”

The institutional transition to central bank independence was neither smooth nor accepted at the same time by all countries. It is interesting to note that Margaret Thatcher, an epitome of neoliberalism, had refused to grant autonomy to the Bank of England (BoE); it was as late as 1997, under Tony Blair, that the BoE was ultimately given the power to set interest rates. The success of neoliberal macroeconomics was captured by the term “great moderation”, which claimed a reduction in the volatility in business cycle fluctuations and in particular, wide oscillations in the rate of real GDP growth, unemployment and industrial production. Except for 1992, the US economy did not face an economic recession over a 25 year period, while standards of living (real GDP per capita) increased from about \$30,000 to \$50,000. But underneath this façade of growth and stability, there was growing discontent with the neoliberal order that came to a boil in the aftermath of the global financial crisis of 2008; real wages had stagnated, consumption was increasingly driven by the private sector (including household) debt, a shrinking middle class (as highlighted by Bernie Sanders in his presidential campaign), widespread unemployment and rising inequalities in income and wealth.

And these trends were not restricted to the US.

It is in this context of anger, insecurity, anxiety, distrust and even *schadenfreude* (as evident in India’s demonetisation experiment) that a new economic and political order is now visibly unfolding. De-globalisation, post-truth, nationalist-populist, new or neo-nationalism – while the world has still not agreed to any single label for the phenomenon, there is general agreement of a rupture in the neoliberal order as evident in the rise of leaders like Trump, Vladimir Putin, May, Narendra Modi, Recep Tayyip Erdogan, Abdel Fattah el-Sisi and many others (see, for instance, League of Nationalists in *The Economist* of November 19, 2016 (<http://www.economist.com/news/international/21710276-all-around-world-nationalists-are-gaining-ground-why-league-nationalists>)). Given the imperious attitude of these leaders to institutions of the old order, questioning central bank independence should come as no surprise. But how is this changing relationship between governments and central banks being manifested or likely to manifest itself?

Generalisations are always questionable but we, nonetheless, attempt a few. Fiscal austerity may soon be passé or as the *Financial Times* already believes (<https://twitter.com/FT/status/796834887802220544>), “the era of fiscal restraint is over.” Signs of this are already visible in Trump’s plan for massive infrastructure building. Nationalist governments will actively intervene to protect and support domestic business and jobs through fiscal spending and lower taxes, relaxing adherence to fiscal deficit targets in the short-term but hoping that buoyant revenues will bridge the deficit in the longer-term. The low interest policy followed by the central banks as a way of reviving growth, especially in the Western world, is now coming under scrutiny for its “bad side effects”, as May put it. Small savers are being unduly penalised while the affluent with a certain class of assets have benefitted from the low interest rate regime. The ongoing war of words (with action yet to follow) between May and Mark Carney

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[in the US is a clear pointer that the idea of central bank independence is under attack. Finally, protectionism of domestic industry from foreign competition, restricted capital flows and restriction to the movement of labour will deal a definitive blow to globalisation.](https://www.google.co.in/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&cad=rja&uact=8&ved=0ahUKEwj_3LOAr_vRAhVIMo8KHfY2DmQQFgghMAE&url=http%3A%2F%2Fwww.marketwatch.com%2Fstory%2Fyellen-may-be-the-foil-of-the-trump-administration-2017-01-26&usg=AFQjCNEG1SDCLFaE6GJoPXJu2SHcITCBCQ&sig2=bq8LZ-1zLRrDoCzy_WurNQ)

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In India, neoliberal macroeconomics – as reflected in the centrality of inflation and adherence to fiscal deficit targets – took root post-1991.

By institutionalising a cap on the fiscal deficit with the Fiscal Responsibility and Budget Management (FRBM) Act

(<http://finmin.nic.in/law/frbmact2003.pdf>) of 2003, governments have

repeatedly signalled supply-side structural reforms as the key to stable growth in which the private sector would take the lead role. In his 2015 budget presentation, India’s finance minister underscored the present government’s commitment to reaching the 3% of GDP

fiscal target by 2017-18 as per the FRBM Act. Every year, as the day of the Budget announcement draws near, the media is replete with warnings for the government on the need to adhere to its fiscal deficit target. Any failure to live up to its deficit commitments can unleash the wrath of international rating agencies.

## **Simmering tensions**

It was the proposed revised draft of the Indian Financial Code ([http://finmin.nic.in/suggestion\\_comments/Revised\\_Draft\\_IFC.pdf](http://finmin.nic.in/suggestion_comments/Revised_Draft_IFC.pdf)) (IFC) in July 2015, which set off debate on the simmering tensions between the government and the RBI over the setting of interest rates. The reformed code proposed to vest the decision on rates from the sole purview of the central bank with a seven-member monetary policy committee (MPC), four of whom were to be appointees of the central government, while three would be from the RBI. This legislation would have not only taken away veto power of the RBI governor in setting key interest rates but in effect, with the majority of appointees being of the central government, neither would the RBI governor nor even the RBI be the final authority over the primary instrument of monetary policy. Even though the proposal was amended to a six-member panel with an equal number of members elected by the government and the RBI, and the veto power of the governor restored in case of a tie, the majority of opinion in the press and media reacted adversely on the proposed MPC that seemed to be an assault on central bank autonomy. However, with Rajan, the then RBI governor, supporting the MPC and reiterating confidence that the RBI would continue to wield de facto power over monetary policy, resentment towards the MPC gradually receded.

The underlying implications of the revised IFC can only be understood when seen in conjunction with the inflation targeting agreement reached between the Ministry of Finance and the RBI in early 2015, wherein it was decided that the inflation target would be pegged at less than 6% by January 2016 and further reduced to 4% plus or minus 2% for subsequent financial years. At the time of this agreement, control over interest rates was unequivocally with the RBI governor. This after all was the instrument that he could use to achieve the inflation target agreed upon. In case of failure to reach the target over three successive quarters, he had to explain to the government reasons for failure and corrective action proposed. The

government accepted the validity of the RBI's (Urjit Patel Committee) recommendations in favour of a "low and stable" inflation target. The essence of neoliberal macroeconomics – inflation targeting – was actually institutionalised in India at the eve of its decay in the West.



A police officer keeps watch in front of the US Federal Reserve building in Washington, DC, US on October 12, 2016. Credit: Reuters/Kevin Lamarque/File Photo

By accepting the inflation target, the Indian government had imposed a constraint on itself in leveraging its fiscal space for broader growth and developmental objectives including infrastructure building, social sector spending and employment generation. As long as its commitment to a low and stable inflation target remains intact, interest rate per se is not critical; in case it turns out inadequate in achieving the inflation target, the onus would instead fall on fiscal policy. Consider, for argument sake, what happens when the inflation target remains in place but the government appointees the MPC decides to cut rates sharply? How can the RBI be then held answerable for its failure to achieve the inflation target? I see only one way out of this dilemma and perhaps the one that neoliberal economists anticipate: the government will have to ensure fiscal policy, in particular the fiscal deficit, is in sync with its inflation target.

Unlike Western economies, where low interest rates are now being viewed unfavourably by the government, the Indian government was not happy with the RBI over high interest rates and its unwillingness to cut rates and kick start private investment. This may have been one

reason why Rajan's term may not have been extended; however, by getting the government to agree upon a low and stable inflation target, Rajan had won the war (for neoliberalism) even if he lost the battle (an extension of his terms as RBI governor). If the recent demonetisation is reflective of the RBI loss of autonomy, we may soon find the RBI obliging the government with interest rate cuts. But will "pushing on a string" be sufficient to put the economy on a higher growth trajectory? This is far from certain. Ultimately, the government may have to break out of its self-imposed fiscal constraint of 3% of GDP with more proactive fiscal policy. This is not unlikely as there are indications that the idea of "minimum government" is already fraying, while a tilt in favour of more populist schemes is on the cards.

At first the disagreement between central banks and governments seem to be over (low or high) interest rates but it will soon become obvious that the actual contention is over a low and unmalleable inflation target. And it is not the actual rate but just the possibility of higher inflation which severely constrains the fiscal deficit.

Relegating their commitment to a specific inflation target could give governments a degree of freedom to not only increase spending and the fiscal deficit, but also set interest rates at a level they consider appropriate. Greater discretion on inflation rate will, however, mean the abrogation of neoliberal macroeconomics and with it, of central bank autonomy as well.

### **Implications of a more accommodative inflation target**

Questions then arise as to the implications of a more accommodative inflation target; first, with regards to growth and second, on who decides the acceptable inflation target.

On the relationship between growth and inflation, the empirical evidence remains tentative. While several studies have shown that inflation targeting does enhance growth, there are others which claim that no such generalised conclusion can be drawn, especially for developing countries. It also wouldn't be out of place to mention, though not as proof, that a study done by the IMF in 2010 found that inflation up to a threshold of 10% brought positive increases in GDP, although this threshold may be even higher for emerging markets. Another paper published by the International Labor Organisation in

2011 computed that the threshold limit of inflation for positive or zero increments in real GDP growth in developing countries could be as high as 17%.

On the second question – are people willing to settle for higher growth of output and employment opportunities with more flexibility on inflation – it is legitimate to argue that the growth-inflation trade-off is ultimately a challenge that must be confronted by political parties and not “unaccountable technocrats” (central bankers as referred to by *The Economist*). Moody’s Analytics commented on the revised IFC that “politics would drive decisions”, but is this necessarily wrong? The standard argument in favour of central bank autonomy is that governments will be irresponsible in containing expenditure. Is this generalisable and valid, say for instance, in the Indian context? Corruption and inflation are after all two issues which can bring down governments. Political parties may therefore be extremely cautious in taking chances with just a higher inflation rate, let alone an accelerating one. The government is also in a better position than a professional economist to judge the aspirations and perhaps desperation of people at the grassroots for jobs and economic opportunities. On the other hand, the concern that elected representatives may act irresponsibly, taking the country into a scenario of spiralling inflation and instability, is a serious one and cannot be dismissed lightly.

In the days ahead we are likely to see heightened arguments and conflict over these questions. Meanwhile, let me conclude by saying that with its short-term success, neoliberal macroeconomics has lost sight of what was the *raison d’être* of macroeconomic policy – full employment. Not only has this objective been left to the private sector but more importantly, unemployment has been transformed into a “buffer stock” (the non-accelerating inflation rate of unemployment or NAIRU) to meet the inflation target. Under the emerging regime across the world, it may well be the turn of (low and stable) inflation targeting to take a back seat (and with it central banks too), while populist-nationalist governments utilise their fiscal policy space and exert greater control over interest rates and trade policy to address the restlessness of their citizens. The process has already begun even as the outcome is awaited with uncertainty and, for some, with fear.

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