Democratic Accountability of the Central Bank: A Study of the Reserve Bank of India.

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DECLARATION

I declare that the dissertation entitled **"Democratic Accountability of the Central Bank: A Study of the Reserve Bank of India"** submitted by me in partial fulfilment of the requirements for the award of the degree of Master of Philosophy of Jawaharlal Nehru University is my own work. This dissertation has not been submitted for the award of any other degree in this University or any other University.

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CERTIFICATE

We recommend that this dissertation be placed before the examiners for evaluation.

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Contents

Introduction

This dissertation is conceived in two parts. The first part is devoted to ideas related to democratic accountability that add up to provide a platform for assessment of the democratic accountability of the Reserve Bank of India. The second part deals with bank regulation viewed through the prism of the agency theory. In the end, there is an attempt to forge a link between the agency problem and the democratic accountability of the central bank in terms of Reserve Bank's efforts at achieving financial inclusion in India.

Part I

The Reserve Bank of India is one of the most eminent central banks in the developing world with a comparatively long history, having been set up in 1935 when there were around thirty five central banks in existence globally, mostly in the western industrialised world. The working of the Reserve Bank since its inception and particularly post independence, has covered a wider spectrum of activities than traditional central banking as it was called to play a direct role in India's financial and economic development without jeopardising monetary stability. Indeed for much of its working tenure, it has been perceived as an instrument of the central government, playing a subsidiary role to fiscal policy. It is submitted that the relation between the central bank and the central government could profitably be put under the scanner in terms of democratic accountability. This would enable a deconstruction of the relation between the Reserve Bank and the government up to a significant level of detail. Using the logic of principal-agent, in practice, measures of democratic accountability invariably entail a scrutiny of relations with the executive (i.e. the principal, legitimised by the electorate) based on legal provisions as well as *de facto* arrangements. The depth and emphases of the analysis would depend on the definition and the measure of democratic accountability that the study adopts. At an abstract level, democratic accountability can be viewed as a mechanism applicable in the relationship between a holder of power and those who have the power to review. However, democratic accountability of the central bank *potentially* defines its relation with all stakeholders and for such a publicly significant institution, may actually be its *raison d'etre*.

This study of the democratic accountability of the Indian central bank attempts to put various elements in perspective prior to arriving at a judgement on the Reserve Bank. Thus, the notions of accountability per se, democratic accountability and then democratic accountability in relation to central banks are explored in turn. This is considered necessary as all elements are contextual and open to various degrees of interpretation, in the literature. 'Accountability' has been termed as a 'chameleon-like term' which means different things to different people and the first chapter of this study deals with delineating the core meaning of accountability and outlining its analytical dimensions. The discourse on democratic accountability can be seen to be underpinned by a pervasive notion of *accountability* as the solution to a wide range of problems in public administration. This is when under the rubric of 'new public management', the very foundations of modern governance have undergone a shift and the traditional notions of political – bureaucratic responsibilities no longer seem to apply. According to some scholars, the dilemma of modern governance is to reconcile the two valued goals of performance and democratic accountability. As important public institutions with considerable delegated authority the central banks also become the target of the same rhetoric. In the case of central banks, yet another strand of discourse that culminates in the demand for democratic accountability is based on the economic argument for granting independence to central banks from the political class.

A review of literature on democratic accountability of central banks yields two things: one, the preponderance of the focus on advanced industrial economy central banks and two, discussion of democratic accountability in relation almost exclusively to the monetary policy function of central banks. These two characteristics of the discourse leave room for thought on whether assumptions / conclusions would differ if the contextual setting of the central bank was in an emerging market developing economy like India and whether cognisance of other important functions like ensuring credit availability or development of financial infrastructure could be reflected in the same measures of democratic accountability found in the western-centric literature.

While initiating the evaluation of RBI using a set of criteria (which will be referred to as Amtenbrink criteria) that encapsulate the thrust of the concept of democratic accountability found in the literature, this study takes the view that there is scope of expanding the meaning of democratic accountability on a number of considerations. Firstly, given that ideally the specificities of every institution are factored in while designing its accountability system, it follows that performance based measures of accountability may not be appropriate for central banks. This is because of difficulties in identifying appropriate and verifiable performance criteria since for most critical functions, the central bank's actions are only one of many influences on the outcomes that also have long gestation periods. Secondly, in case of developing countries like India, pre-determination of price stability as the single objective of monetary policy is not desirable, for many reasons, while the singular objective of monetary policy is a corner stone of accountability systems sought to be evaluated through the Amternbrink criteria. Thirdly, since monetary policy instruments are recognised as blunt instruments having wide ramifications across all sections of the population, central bankers must in principle, be accountable to the public at large. Herein, the recent extensions of the meaning of accountability in public administration literature beyond the external focus implied by being called to account (see Mulgan 2002), to embrace qualities such as responsiveness to public needs and to democratic dialogue with stakeholders provide the backdrop for broadening the idea of democratic accountability of central banks. As per these notions, democratic accountability of central banks would hinge on the requirement to provide justification and explanation to the wider public through informal and formal processes of openness and transparency. Chapters 2 and 3 of the study deal with these issues.

Part II.

In my dealings with banks as a career employee in the Reserve Bank of India I have confronted the fact that 'regulatory rules do not automatically and un-problematically bring about the rule maker's intended behavioural change'. There is a continuous tension between regulator and bank entities it seeks to regulate so that regulation and compliance assumes the nature of a process rather than an event. This is recognised in the literature on regulation and the focus on enforcement and compliance to what are by implication, collective goals, is characterised as 'the dynamic, messy and socially contextual nature of the regulatory process'. The literature on compliance has predominantly focused on enforcement within the classical command and control style of regulation but enforcement is necessitated in other regulatory forms also. Where the command takes the form of enforceable rules or mandates the very first problem encountered is of designing regulatory standards that are consistent with collective goals. Yeung gives the example of 'creative compliance' whereby 'technical compliance with rules might be achieved yet the underlying spirit and purpose of those rules might be simultaneously undermined' (2004:11). The literature also provides insights on governance by targets and measured performance indicators which rests on the assumption that targets can change the behaviour of individuals and organisations, and that 'gaming' can be kept to a minimum. 'Gaming' implies reactive subversion 'such as hitting the target and missing the point' or reducing performance where targets do not apply (ibid). In the context of gaming behaviour, based on his analysis of the failure of the UK government's reliance on monetary targets to control inflation in 1980s, Charles Goodhart came up with the eponymous law "Any observed statistical regularity will tend to collapse once pressure is placed on it for control purposes" as actors change their behaviour when they know that the data they produce will be used to control them. It would appear that the impact of regulatory tools on behaviour of individuals or organisations is of utmost importance in understanding the efficacy or otherwise, of regulator's prescriptions. It is this backdrop of complications in ensuring compliance with regulatory mandates that provided the stimulus for me to try to harness the elements of agency theory to look at issues of regulatory goals and compliance thereto since the agency theory came across as a plausible way of looking at interactions between a regulator and regulatee in terms of their self-interests.

There are two agency theories in economic literature developed almost concurrently. Stephen Ross' economic theory of agency gained greater prominence laying the foundation of academic work on incentive structures. Mitnick's agency theory can be called the institutional theory of agency and introduced the idea that institutions form around agency and evolve to deal with the essential imperfection of agency relations as behaviour never occurs as it is preferred by the principal because it does not pay the agent. Chapter 4 of the dissertation provides the framework of Mitnick's agency theory outlining the building blocks of his descriptive institutional approach, focussing on the core theory logics of agency that make it possible to generate statements about behaviour in the real world. The ultimate aim of the chapter however, is to bring out the correspondence between the processes of regulation and the dynamics of the principal-agent relation, showing how monetary policy and banking regulation can be viewed through the agency theory lens.

The last chapter looks at the efforts of the Reserve Bank to promote financial inclusion in the country through the prism of the agency theory. Financial inclusion has been high on the developmental and regulatory policy agenda of the Bank since 2005. RBI's concerns have to be viewed in tandem with the inclusive growth agenda of the Indian government which was voted to power in 2004 on that plank. It is my contention that it is the character of RBI's democratic accountability that predicates its motivations and actions in alignment with those of the elected government.

One of the earliest RBI studies on the issue of financial inclusion was the Report of the Internal Group to Examine Issues Relating to Rural Credit and Micro finance and which, in a way, laid out the blueprint of things to come. While recommending the business facilitator / business correspondent model for financial inclusion, the report identified several concerns in engaging outside entities for providing various services,

> ...some of the banks and respondents have, in fact, expressed certain apprehensions about the intermediaries to be used under the proposed arrangement, such as: (i) undue exploitation of ill-informed poor people, (ii) lack of secular and non-partisan credibility, (iii) increased cost of operations with the introduction of an additional tier, (iv) capability and long term sustainability, (v) lack of integrity and honesty leading to misuse of funds /defalcations / frauds, (vi) poor financial discipline due to local connections, (vii) customer complaints and grievances affecting the image of the bank, (viii) customer confidentiality, (ix) dilution of KYC norms, (x) improper internal control arising out of delay in accounting and reconciliation and (xi) scope for emergence of staff-agent nexus. Further, banks, which as regulated entities are required to ensure adherence to prudential norms, may be under strain to closely monitor the systemic risks that may arise out of imprudent activities of the facilitators/ correspondents, particularly when there is substantial build-up of portfolios through their intermediation (2005).

Consequently, the Report also identified a number of safeguards required to be put in place by banks such as formulating a BF / BC acceptance policy, a code of ethics, risk management strategies, rating and due diligence on BCs, monitoring and review of arrangements. All these represented specification and 'policing' costs, in the terminology of the agency theory. RBI recognised that the financial inclusion foray by the banks might not be profitable initially but hoped that with growth of volumes over time, their strategies would begin to pay off. In chapter 5, I have attempted to discuss, within the framework of agency theory, why the BC-led financial inclusion model might not prove profitable even in the long run. This provides an instance where the agency problem could seriously impact the regulatory initiative. However, an appropriate evaluation of RBI's efforts must take cognisance of the institutions over which it has regulatory jurisdiction and the conditions set by democratic accountability under which it operates.

Chapter 1

Democratic Accountability

This chapter introduces the idea of accountability, tracing the growth of the idea over time and attempting to outline what might be deemed as its core concepts in the light of the fact that in recent years accountability has come to mean 'different things to different people'. There is a brief discussion on the typologies of accountability based on the four dimensions of any accountability relation that answer to the questions To whom, By whom, For what and Why. Lastly, democratic accountability is introduced as a relation between public institutions and the people at large, in whose name they function. The yardsticks or norms by which the quality of democratic accountability maybe assessed are discussed.

1. Introduction

Modern democracies rest on a combination of two ideas: that those who rule should do so in public interest or in response to the public will and that they will be more likely to do so when they are in some way, representative of, and/or accountable to those they rule. By linking the demand that rulers rule in the interests of the people with attempts to make those rulers representative of and/or accountable to the people, democratic theory sets out a simple and seemingly attractive model of good government (Philp 2009). Democracy is said to remain on paper unless those in power can be held accountable in public for their acts and omissions, their decisions, their policies and their expenditures. Yet the concept of public accountability (used inter-changeably with democratic accountability as 'public' connotes 'openness'; account giving is done in the open and is accessible to the citizen public) is quite elusive. "It is one of those evocative political words that can be used to patch up a rambling argument, to evoke an image of trustworthiness, fidelity, and justice, or to hold critics at bay" (Bovens, 2007) and can mean different things to different people. The chameleon like character of the word 'accountability' is well recognised in Public Administration literature. 'A word which a few decades or so ago was used only rarely and with relatively restricted meaning (and which, interestingly, has no obvious equivalent in other European languages) now crops up everywhere performing all manner of analytical and rhetorical tasks and carrying most of the major burdens of democratic 'governance' (itself another conceptual newcomer)" (Mulgan, 2000). In recent years the scope and meaning of accountability has been extended in a number of directions well beyond its core sense of the process of being called to account for one's conduct by some external authority, into areas where the various features of core accountability no longer apply. Thus, Mulgan identifies four such extensions: (1). Accountability as Responsibility wherein it refers to the sense of individual responsibility and concern for public interest expected from public servants, an internal sense which goes beyond the core external focus of the term. (2). Accountability as Control applies the notion to various methods of imposing control over public organizations and is sometimes taken to be more than just a mechanism of control; it becomes identified with control itself. (3). Accountability as Responsiveness is linked with the extent to which governments pursue the wishes or needs of the their citizens regardless of whether they are induced to do so through a process of authoritative exchange and control. (4). Accountability as Dialogue is applied to the public discussion between citizens on which democracies depend and is seen as a dialectical activity even when there is no suggestion of authority or subordination between the parties involved in the accountability relation.

In contemporary political and scholarly discourse accountability often serves as a conceptual umbrella term that covers various other distinct concepts such as transparency, equity, democracy, efficiency, responsiveness, responsibility and integrity. J Kopell distinguishes no less than five different dimensions of accountability – transparency, liability, controllability, responsibility, responsiveness that are each icons and umbrella concepts themselves. In this broad sense, accountability is an evaluative concept contestable in its purport as there is no general consensus about the standards for accountable behaviour and because this 'differs from role to role, time to time, place to place and from speaker to speaker'. For analytical purposes however, it is essential to narrow down the meaning of the word and any consideration of democratic accountability must begin by defining accountability independent of democracy and also by separating the descriptive content of the concept from the normative, which very often attaches to it. The etymology of 'accountability' is an appropriate place to start the quest for meaning.

2. Etymology of 'Accountability' and Brief History

The word accountability emanated from accounting. Historically and semantically, it is closely related to accounting, in its literal book-keeping sense. In contrast to the etymological roots of word, the roots of the concept can be traced to ancient settings and biblical references, from Egypt to Athens (Dubnick, 2002). Following Dubnick, most scholars agree that the roots of the contemporary usage can be traced back to the 11^{th} century AD, the period after AD1066 Norman conquest of England. In AD1085 William I required all property holders in his realm to render a count of what they possessed. These possessions were listed by royal agents in the so-called Domesday Books. Apart from the purpose of taxation, it also served as a means to establish the foundations of royal governance. By the early twelfth century, this had evolved into a highly centralised administrative kingship that was ruled through centralised auditing and semi-annual account giving. In the centuries since the reign of William I of England, accountability has 'slowly wrestled free from its etymological bondage with accounting', and had also completely reversed the relationship. Accountability does not refer to sovereigns holding their subjects to account but the reverse i.e. authorities being held accountable by citizens. (Bovens, 2007) What started as an instrument to enhance the effectiveness and efficiency of public governance, has gradually become a goal in itself. Accountability has become an icon for good governance.

The western intellectual heritage for the traditional public-administration paradigm comes from the thinking, writing, and proselytizing of Woodrow Wilson, Frederick Winslow Taylor, and Max Weber (Behn, 1998). These thinkers are credited with having constructed the rationale for the current form of most democratic governments, not only in the West but now in most parts of the world. Wilson argued that administration should be and could be separated from politics; after those responsible for politics made the policy decisions, the task of implementing those policies could be turned over to those who were well versed in the "science of administration" and would carry out this implementation task in the most efficient way possible. This would be possible because, as Taylor argued, "among the various methods and implements used in each element of each trade there is always one method and one implement which is quicker and better than any of the rest" (1911, 25). Finally, Weber argued that bureaucracy was the most efficient organizational mechanism; thus, a bureaucracy would be ideal for implementing Taylor's scientific principles. Organising government functioning in this manner wherein policy-making was the domain of politicians and implementation the domain of bureaucracy provided a direct method of accountability to citizens, an essential characteristic of any approach to structuring the executive branch of government. Thus, the in the traditional paradigm, the notion of 'democratic accountability' refers to ways that citizens can control their government and the mechanisms for doing this. Yet the notion has not remained unchanged. According to Edward Weber (1999, 453), the meaning of the term has shifted over time: 'Each conceptualisation emphasises different institutions and locates the ultimate authority for accountability in differing combinations and types of sectors (public, private, intermediary), processes, decision rules, knowledge and values.' Providing instances of such shifts from American history, Webber referred to five conceptualisations of accountability starting from the Jacksonian period (most of the 19^{th} century), to the Progressives / New Deal model that reigned from the end of 19^{th} century to 1960s, the public-interest-egalitarian model of the 1960s and 70s, the neoconservative efficiency model of the 1980s and early 90s.

With the emergence of the new public management paradigm, as a direct response to the perceived ineffectiveness and inadequacies of the traditional public-administration paradigm, particularly, to the inadequacies of bureaucracy, there has arisen a need to rethink or re-conceptualise democratic accountability and to discuss what an effective and legitimate system of democratic accountability should look like in a world of decentralised governance, shared power, collaborative decision processes, results-oriented management and broad civic participation (Hanberger, 2008). Yet another source of interest in issues of democratic accountability can be found in the formation of the European Union – a supranational entity that is constituted by the economic and political integration of 27 European states. Concerns of a democratic deficit flow from 'a perceived lack of accessibility to the ordinary citizen, or lack of representation of the ordinary citizen and lack of accountability of EU institutions.'[1]

3. What is Accountability ?

According to Mulgan the core sense of 'accountability' is that of being called to account for one's actions by some authority, and is the sense with the longest pedigree in the relevant literature and in the understanding of practitioners. Its major features are that: it is *external* as account is given to some other person or body outside the person or body being called to account, it involves *social interaction and exchange* as one side seeks answers and rectification while the other side responds and accepts sanctions, it also implies *rights of authority* as those calling for an account are asserting rights of superior authority including rights to demand answers and to impose sanctions.

Bovens developed a parsimonious analytical framework that could help to *establish* more systematically whether organisations or officials, exercising public authority, are subject to accountability at all. For this purpose he provides a 'narrow' sociological definition of accountability to discern when a certain practice or arrangement qualifies as a form of

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1 . See P. Schmitter, *How to Democratize the European Union . . . And Why Bother?* Rowman and Littlefield,2000; T. Bergman and E. Damgaard (eds). *Delegation and Accountability in the European Union* Frank Cass, 2000; C. Harlow, *Accountability in the European Union* Oxford University Press, 2002; D. Curtin, *Mind the Gap: The Evolving European Union Executive and the Constitution*. Third Walter van Gerven Lecture, Europe Law Publishing, 2004; W. van Gerven, *The European Union: A Polity of States and People* Hart, 2005.

accountability at all. Accountability is *a relationship between an actor and a forum, in which the actor has an obligation to explain and to justify his or her conduct, the forum can pose questions and pass judgement, and the actor may face consequences.*

A relationship qualifies as a case of accountability when it fulfils seven requirements: (1) there is a relationship between an actor and a forum (2) in which the actor is obliged (3) to explain and justify (4) his conduct; (5) the forum can pose questions; (6) pass judgement; (7) and the actor may face consequences. The *actor* in question can be an individual, an official or civil servant, or an organisation, such as a public institution or an agency. The significant other, the *accountability forum*, can be a specific person, such as a superior, a minister or a journalist, or it can be an agency, such as parliament, a court or the audit office. The *obligation* that lies upon the actor can be formal or informal. The relationship between the forum and the actor can have the nature of a principal–agent relation, a common formulation of the accountability problem in the literature. In discussions of democratic accountability, it has been a common practice to define accountability, drawing on principal-agent theory, as a problem of restricting the degree of discretion exercised by those in public office and designing ways to ensure that they serve their public to the letter. The government is seen as an agent of, and accountable to its majority 'principal' through the democratic process. However, in many accountability relations, the forums are not principals of the actors, for example courts in cases of legal accountability or professional associations in cases of professional accountability.

Scholars such as Mark Philp hold the identification of the accountability relation with the P-A relation as counter-productive. He proffers four objections. Firstly, according to the P-A theory, accountability becomes a bilateral relationship, which is not always the case. Secondly, P's capacity to reward or sanction A is an intrinsic assumption. The third objection concerns the normative, 'intellectual load' that the P-A model carries from the three academic disciplines of economics, political philosophy and law. Fourthly, thinking of accountability in terms of the P-A model causes us to pre-judge the relationship instead of distinguishing between the core elements of accountability and the contingent circumstances or additional requirements that might influence whether a certain form of accountability will bring about a certain set of results. Whether and in what form an accountability relationship exists is a descriptive claim; whether we want more or less of it, or different types or additional dimensions of it, will be driven by normative commitments, and the two should not be equated.

Another moot point of discussion has been whether the possibility of *sanctions* is a constitutive element of accountability. Scholars such as Bovens, Mulgan, Strom take the view that the possibility of sanctions of some kind is a constitutive element of narrow accountability and that it should be included in the definition. The *possibility* of sanctions—not the actual imposition of sanctions—makes the difference between non-committal provision of information and being held to account. Others argue that a judgement by the forum, or even only the stages of reporting, justifying and debating, suffices to qualify a relation as an accountability relation.

A proponent of the latter argument, Mark Philp holds that sanctioning is not essential to accountability, being only a contingent condition that may enhance the desired outcomes of holding certain office bearers to account. His definition of accountability departs from other definitions in two significant ways. It avoids the language of the principal-agent model and is devoid of the element of sanction, which he maintains is only contingently connected to accountability. *A is accountable with respect to M when some individual body or institution Y can require A to inform and explain / justify his or her conduct with respect to M (pertains to the responsibilities or domain of actions of A).*

Supplementary elements, although not necessary for accountability to exist are following : (1) Beneficiaries of A's action in respect to M may or may not be identical with Y. (2) Y may or may not be able to monitor A's conduct with respect to M – since Y may lack competence and while this weakens the effectiveness of Y, the relation is still an accountability relation. (3) A may have an obligation to explain to Y or Y may have power to elicit A's account. (4) Two cases need to be differentiated. One, where Y can sanction A for failing to give account and this is deemed essential of an accountability relation since without this condition, it cannot be realistically assumed that Y 'can require' A to explain / justify its conduct. Another, where additionally, Y can sanction A for the content of that account but this condition is not deemed essential for the existence of an accountability relation.

Philp argues that the belief of some that without sanctions an accountability relationship becomes merely a kind of transparency or openness in government, misrepresents the object of description. Transparency and openness are characteristics of people's communication and behaviour with respect to their work, and of the rules and processes to which they work while, in contrast, accountability refers to a relationship in which Y can require A to inform and explain or justify his or her conduct with respect to M, having the power of sanction for failure to do so. This 'can require' clause takes A's behaviour beyond mere openness, giving it the necessary features of accountability, but it does so without it being a requirement that Y can sanction A for the content of the report.

4. Types of Accountability

Public accountability comes in many forms as public institutions are frequently required to account for their conduct to various forums in a variety of ways. To grasp the analytics of an accountability relation, Mark Bovens (2007) postulated a typology that could be considered to render the basic building blocks of an accountability environment, any of which must address four important questions: 'To whom?' 'By whom?' 'For what?' 'Why?'

First, *to whom* is account to be rendered? This yields a classification based on the type of *forum* to which the actor is required to render account. Public organisations and officials operating in a constitutional democracy find themselves confronting at least five different types of forums i.e. political, legal, administrative, professional social, and hence at least five different kinds of accountability, demanding different kinds of information and applying different criteria as to what constitutes responsible conduct. *Political accountability* is an important type of accountability within democracies and here, accountability is conceivably exercised along the chain of principal–agent relationships representing a chain of delegation of power from voters to ultimate implementing administrative bodies. The mechanism of political accountability operates precisely in the opposite direction to that of delegation. *Legal Accountability* of public institutions is a result of the growing formalisation of social relations, and the greater trust which is placed in courts than in parliaments. Legal accountability is usually based on specific responsibilities, formally or legally conferred upon authorities and is, for that reason, less ambiguous. A*dministrative Accountability* via the media of Auditors, Inspectors and Controllers are next to the courts, constitute a wide range of quasi-legal forums, exercising independent and external, administrative and financial supervision and control. *Professional Accountability* or peer review is necessitated as public managers are often, apart from being general managers, professionals in a more technical sense, having training in specialised fields. This may imply accountability relationships with professional associations and disciplinary tribunals and would be relevant for public managers who work in professional public organisations claiming some particular expertise. *Social Accountability* to Interest Groups and Other Stakeholders arises out of an urge in many democracies for more direct and explicit accountability relations between public agencies, on the one hand, and clients, citizens and civil society, on the other hand.

The second, logical question is *who* should render account ? While in ordinary social relationships amongst citizens, it is usually clear who the actor is who will render account, this becomes a far more complicated question when it comes to public organisations. For those outside an agency, it is often difficult to unravel who has contributed in what way to the conduct of an agency or to the implementation of a policy. With large public organisations, there are four accountability models proffered of which in the first, the focus is on the organisation as a whole, and in the remaining three, on individual officials. *Corporate Accountability* holds the organisation having an independent legal status, as actor. In *Hierarchical Accountability*, prevalent in most public organisations, processes of calling to account start at the top with the highest official and while the rank and file do not appear before external forums the lower echelons can, in turn, be addressed by their superiors regarding questions of internal accountability. In *Collective Accountability*, theoretically, a forum could apply a collective strategy of accountability and pick any member of the organisation and hold him personally accountable. While this is expeditious, collective arrangements of personal accountability are not reconcilable with intuitions current in modern democracies and could be appropriate and effective in only specific circumstances, for example with small, collegiate public bodies. In *Individual Accountability* each individual official is held proportionately liable for his personal contribution to the infamous conduct of the organisation. Under this approach, each individual is judged on the basis of his actual contribution instead of on the basis of his formal position.

The third question is *about what* is account to be rendered? In accountability relationships the actor is obliged to explain and provide justification for his conduct. There are many aspects to this conduct, such as financial, procedural, product related etc. making it possible to distinguish a number of accountability relationships on the basis of the aspect that is under scrutiny by an appropriate forum and would vary with the expectations residing in a public institution.

The fourth question is *why* the actor feels compelled to render account ? This relates largely to the nature of the relationship between the actor and the forum. *Vertical* accountability refers to the situation where the forum formally wields power over the actor. The majority of political accountability arrangements, which can be viewed as based on the delegation from principals to agents, are forms of vertical accountability. At the complete other end of the spectrum is social accountability where a hierarchical relationship is generally lacking between actor and forum. Such accountability could be termed *horizontal* accountability. The obligation felt by agencies to account for themselves to the general public is usually moral in nature (although in some cases there may be formal requirements as well in their charters). Administrative accountability relations are usually an intermediary form. Though most ombudsmen, audit offices, inspectorates, supervisory authorities have no direct power over public institutions yet they report to the minister or to parliament or superior authorities and thus derive the requisite informal power from this. This indirect, two-step relation with a forum could be described as a *diagonal* accountability. A notion of *360 degree accountability* has been advocated in recent times in the context of decentralised or distributed governance models wherein, it is held justifiable to permit all those affected by a policy to 'contribute feedback' concerning performance.

Other scholars have constructed other typologies of accountability by focussing on certain aspects of an accountability relation deemed significant enough to warrant segregation on those lines. For example, Romzek and Dubnick (1987) separate four kinds of accountability according to whether the source of control is internal or external and whether the degree of control is tight or loose as shown in the table below:

Types of Accountability Systems: Romzek and Dubnick

		Source of Agency Control	
Degree of		**Internal**	**External**
Control	**High**	Bureaucratic	Legal
Over Agency			
Actions	**Low**	Professional	Political

Bureaucratic accountability systems stress the need to follow orders and close supervision. In legal accountability there are two relatively autonomous parties, one who can mandate expectations with the force of law, and another whose responsibility is to implement the law. Political accountability allows the agency to have discretion to decide whether or not to respond to external expectations; its mechanisms involve the participation of the parties whose expectations are relevant. Finally, professional accountability relies upon the integrity and trustworthiness of the expert who has the special skills to get the job done.

Another scholar, Linda Deleon (1998), on the basis of the argument that decision making is the central organisational act, the appropriateness of the methods by which accountability maybe ensured is a function of the organisation structure posited two important dimensions of decision situations and hence accountability types. These depended on answers to two questions. First, were the goals to be achieved clear or ambiguous and second, were the means for their achievement known and certain or unknown and uncertain. ? Thus where goals are clear and means known, decision making is relatively simple and such decisions can be readily codified. In such circumstances, bureaucratic accountability would be appropriate. In situations where the goals are conflicting and ambiguous but once the goals are resolved (and enshrined in laws/rules) the means to achieve the various options are well understood, such decisions are the province of politics and accountability mechanisms would have to be legal -cum-bureaucratic. In case there is agreement on goals but means to achieve them are uncertain requiring a high degree of expertise. systems of professional accountability would have to predominate. In situations where both the ends and means are unclear, decisions are said to be made by 'inspiration' and accountability mechanisms must contain elements of openness, deliberation and participation.

What is evident from the construction of various typologies of accountability is that different accountability mechanisms are appropriate in different circumstances. depending upon an organisation's structure which is in turn dependent on the types of problems it is designed to handle and very often there are overlapping accountability processes reflecting the differences on the way an organisation is perceived at different times or by different groups.

5. Democratic Accountability and Evaluation thereof

It is a founding principle of democratic societies that any independent institution bestowed with a public function should be accountable to citizens and their elected representatives for the conduct of its policies. The essential portent in the term 'democratic accountability', given the analytics of accountability relations, is to the question 'to whom' is account to be given and the answer is that in a democratic polity, it must be the body in whose name all power is exercised and which has the formal capacity to replace the holders of delegated power i.e. the citizens. According to Robert Behn, "Democratic accountability is not optional; it is an essential characteristic of any approach to structuring the executive branch of government ... Government must be responsible not just to some collection of interested stakeholders, but to the entire polity. If your system does not ensure accountability to the citizens, then it is by definition unacceptable." (2001)

Assessing democratic accountability is an exercise of evaluating the accountability relationship in terms of degree, following the logic of more or less i.e. deficit or excess and one of the ways suggested of doing this is with reference to the three recurring perspectives or normative goals of accountability: the popular control or the democratic perspective, the prevention of abuse of power or the constitutional perspective and the learning perspective that focuses on enhancing the effectiveness of the government.

In terms of the democratic perspective, public accountability is a means by which citizens may control those holding public office. This is an approach can be traced back to the tenets of Rousseau and Weber, and has been theoretically underpinned using the principal–agent model. Modern representative democracy is described as a concatenation of principal–agent relationships. Each principal in the chain of delegation seeks to monitor the execution of the delegated public tasks by calling the agent to account. Public accountability is thus an essential condition for the democratic process, providing the people with the information needed for judging the propriety and effectiveness of the conduct of public officials (Bovens 2007).

The constitutional perspective on accountability is its ability to prevent corruption and abuse of power – ideas that are found in the writings of liberals like Locke, Montesquieu and the American Federalists. The main concern underlying this perspective is that of preventing the tyranny of absolute rulers, overly presumptuous, elected leaders. The remedy against an improper or corrupt government is the organisation of 'checks and balances', of institutional countervailing powers. Other public institutions, such as an independent judicial power or a Chamber of Audit are put in place with the power to request that account be rendered over particular aspects of governance (ibid).

In the learning perspective the chief purpose of accountability is entirely different. Accountability is seen as a tool to make and keep governments, agencies and individual officials effective in delivering on their promises. The purpose of public accountability is to induce the executive branch to learn else it could face adverse consequences. Also, the public nature of the accountability process provides lessons to others in similar positions what is expected of them, what works and what does not. Accountability mechanisms induce openness and reflexivity in political and administrative systems that might otherwise be primarily inward looking. In this context, Lindblom (1965) referred to the 'intelligence of democracy': the superiority of the pluralist democracy compared to other political systems lies in the incentives inherent in it to encourage intelligence and learning in the process of policy making. Accountability is a crucial link in this approach, as it offers a regular mechanism of feedback to administrators in regard to their own functioning and forces them to reflect on the successes and failures of their past policy (Bovens 2007).

While all three perspectives provide platforms for evaluating accountability relations, simultaneously they make evaluation an equivocal exercise as the different approaches could be 'pulling in different directions'. For example, overly rigorous democratic control may squeeze the entrepreneurship and creativity out of public officials or may turn bureaucracies into rule obsessed agencies. Too much emphasis on administrative integrity could lead to a proceduralism that hinders reflexivity and hence efficiency and effectiveness of public organisations. A public institution is 'really' accountable when it is accountable in a way that meets its normative objectives. But the normative objectives and the relationship of accountability need to be kept apart.

Philp discusses two further broad distinctions concerning the link between the accountability and its outcomes, and the dimensions of conduct for which people might be held to account, to assess the picture of democratic accountability.

The first distinction is between integrity-based systems of public office and rule or compliance-based systems. Both are approaches to the promotion of probity in public office. The integrity-based approach expects people to be guided by the desire to act in keeping with their responsibilities and fundamental commitments which are not themselves wholly a function of the rewards or sanctions they may earn or incur. In contrast, the compliance-based model regards public office as a potential source of temptation to be guarded against by the careful shaping of behaviour through scrutiny and incentives and penalties. The distinction between these two types of institutional design with respect to public office helps disclose a major issue for accountability in democratic systems. In the case of compliance based systems, the process of accountability is itself acting as an incentive and sanction – hence the problem of moral hazard, where the substantive ends of office are neglected as those in office focus on meeting the requirements for accounting and reporting. Paradoxically, where the discretion or latitude of the office holder is eliminated in this way, he or she has nothing to explain or justify – nothing to account for. Accountability in democratic systems varies along this dimension from integrity-based to compliance-based systems. But it is essential to recognise that the more compliance-based a system becomes the less real accountability there is. A key issue is whether there are high levels of diffuse institutional trust, so that we trust the individual because we trust the institutional framework, not the other way round. Where such generalised trust exists the institutional system frames the domain of politics and the pursuit of preferences and interests. The less institutional trust there is, the less confidence there will be in the integrity of those in office and in formal systems of accountability, the more politicised accountability will necessarily become.

A second, related distinction is between formal and political accountability. Formal accountability concerns the requirement that public officials act within the formal responsibilities of their office. Formal accountability is linked to systems of regulation and reporting and has also inspired the creation of institutions such as ombudsmen, audit offices, ethics committees, which aim for a non-partisan assessment of the conduct of public officials in light of the formal designation of the powers and responsibilities attached to their office.

Political accountability', on the other hand, concerns the answerability of those in public office to partisan elements within the political system. The issue is not whether someone acted within his or her legitimate and allocated powers, but whether they exercised those powers in ways their political constituencies are willing to endorse or approve. In consolidated systems[2], formal processes and formal accountability mechanisms frame the political system and define and limit the scope of political accountability. Philp argues that in constitutional systems the democratic will is formally a function of the rules and procedures of the political system, not the other way round. On this view, the political system must entrench a range of fundamental protections for certain values and principles, and norms and procedures, that must not be overridden by either the masses' or any interest group's passionately pursued interests.

It is important to ask, whenever accountability is demanded, if the issue is one of whether the agent transgressed the rules and/or went beyond his or her formal responsibilities and authority, or whether he or she is being required to account for something he or she did that lies clearly within the parameters of his or her office. A good deal of democratic theory obscures that distinction and presses for the overriding importance of representatives and public officials acting in our interests to the exclusion of other considerations; but the concept of vertical consolidation enjoins us to recognise that the formal system must set the parameters for political accountability. Where formal accountability is politicised, and where political accountability becomes linked to a compliance based view of accountability, the vertical consolidation of the political system is weakened and it risks becoming a plebiscitary democracy, which is likely to be profoundly unstable.

[2] The concept of consolidation or (equivalently) 'institutionalisation', distinguishes between a vertical and horizontal dimension of the process. A well institutionalised social order is one in which the rules according to which political and distributional conflicts are carried out, are relatively immune from becoming themselves the object of conflict. As far as the vertical dimension is concerned, consolidated systems are those to which the following property applies: every actor's decision making is constrained by higher order decision making rules i.e. rules that are not at the disposition of the actor himself, but to which the actor can refer as a licence for or legitimation of his own decision making. (E.g., Parliamentarians decide on a piece of legislation but not at the same time ... on the rules that govern law making itself). In case consolidation is strong (or equally, if civility is developed), a spill-over is unlikely to occur from disagreement about rules to disagreements about those second order rules that are supposed to govern the conditions of our disagreements on the rules.
Jon Elster, Claus Offe, Ulrich K Preuss (ed) "Institutional Design in Post-Communist Societies: Rebuilding the Ship at Sea", page 28.

A qualitative evaluation of the Reserve Bank of India based on some of the above concepts is attempted in Chapter 3 of this study. The next chapter considers the notion of democratic accountability when applied to the institution of central banks.

Chapter 2

Democratic Accountability and Central Banks

1. Introduction

Two sets of rationale maybe adduced for postulating a need for democratic accountability in respect of central banks. One stems from the democratic constitutional perspective, and the second from the economic perspective. In the discourse on democratic accountability of central banks the second line is dominant and the chapter provides a brief review of the relevant literature tracing the concern in respect of democratic accountability to ideas on the independence of central banks. Definitions and measures of democratic accountability are discussed and a set of criteria crystallised by Fabian Amtenbrink, incorporating the common elements found in the literature, are outlined by which an evaluation of the Reserve Bank of India is proposed in a subsequent chapter. However, it is deemed that the criteria have certain shortfalls as they do not take account of the peculiar features of central bank functioning and hence a case is made out to broaden the scope of democratic accountability so as to attune the measure of accountability with the circumstances of the institution and the problems they are created to handle.

2. Why Democratic Accountability for Central Banks ?

Where power is delegated by the executive or the legislative branch to independent government agencies or independent bodies which are not considered a part of government (often called quangos or quasi autonomous non-governmental organisations) mechanisms of democratic accountability are not very evident as the latter could be practically out of reach of democratic elections, answerability to Parliament or even control by executive government, unless specifically and by design subject to such mechanisms. Majone refers to these as 'non-majoritarian institutions' characterised by lack of direct accountability to the electorate or elected politicians and which include central banks (1993). Using the logic of democratic constitutions, Amtenbrink (1999) explains the case for democratic accountability from two points. First, the constitutional point of view, which emphasises the legal nature of a central bank and its position within the democratic system. Most central banks are a creation of Parliament but there is ambiguity in the description of a central bank as a legal entity, being referred as 'independent within government' or 'sub-government' or 'institution sui generis'. The need for democratic accountability derives from their exceptional position, outside the classical three-branch system of government featuring checks and balances, to legitimise their power within the constitutional system. Secondly, the functional point of view emphasises the tasks performed by the central bank in regard to monetary policy which forms part of the broader definition of economic policy that is the domain of the democratically elected executive government. In respect to monetary policy, central banks perform executive tasks in that they both formulate and implement the policy. Unless, there are mechanisms of accountability, executive action by the central bank evades legislative scrutiny, a basic requirement of the three- branch constitutional system of government. Although the initial act of delegation of monetary policy to a central bank through an Act of Parliament serves as the basic democratic legitimation of the central bank, explicit mechanisms of accountability serve to re-validate the central bank legitimacy on an on-going basis.

Another perspective on democratic accountability points out that delegation to 'independent' bureaucrats is a central feature of government policy making in many different domains. It can be beneficial when there are gains to be realised from allowing individuals to specialise in a particular area of policy. It can also be useful if politicians face incentives to act opportunistically if they chose policies directly. This has been the primary argument in favour of central bank independence in recent years. Bureaucratic delegation poses potential problems however, to the extent that it involves handing power to unelected officials who may themselves face incentives to pursue policies that serve narrow private goals rather than the interests of the public at large. Those who emphasise the need to guard against this possibility argue for steps to make bureaucratic activities transparent as well as for provisions to make bureaucrats accountable to elected politicians. In this context, central banking and especially monetary policy is seen as a specialist's task that requires an environment free of political vicissitudes but of accountability to the public to offset its independent status.

3. Democratic Accountability of Central Banks in the literature

In the literature on democratic accountability of central banks, a large share is pre-occupied by the second perspective wherein many issues surrounding democratic accountability of central banks can only be appreciated in the background of the strong case for central bank independence .

The origins of the re-emergence of the 'independence' debate can be found in the re-focussing of the discussions on the efficacy of monetary policy (Tietmeyer 1991). In economics, the notion of monetary policy aimed at directly promoting economic growth and full employment in the long run had been laid to rest, the view being that monetary policy was neutral in the long run but could affect growth and employment in the short run. The world-wide experiences of high inflation of the 1970s had the effect of directing the discussions on the objective of monetary policy to price control especially in view of the recognition that high inflation had considerable capacity for welfare losses while price stability promoted employment and growth in the long run. One way to achieve the coveted position of stable prices was to have an independent central bank with mandate to maintain the price line.

The theoretical view favouring central bank independence (CBI) is found in the new macroeconomics approach, where beyond other aspects, it became important to know how to set up the right institutions to achieve the best economic outcomes. Theoretically. CBI emerged as a solution to three different but related problems, that of relative dominance of fiscal policy over monetary policy, distortions caused by electoral business or partisan cycles and the time or dynamic inconsistency of monetary policy. In regard to the first problem, Sargent and Wallace (1981) showed that if monetary authorities are in a position to move first, then fiscal authorities will accommodate in order to satisfy the long run budget constraint and inflation will correspond to the monetary authorities' wishes. Secondly, empirical evidence demonstrated that in the post war period, OECD countries had pre-electoral expansionary policies and also post electoral partisan cycles (Sousa 2002). The first models of political business cycles with opportunistic governments were presented by Nordhaus (1975) and Lindbeck (1976) which showed that self-interested office-motivated politicians use fiscal and monetary policy in order to influence the economy and so prior to an election expansionary policies are undertaken, reducing unemployment and increasing the popularity of the government; following the election victory, contractionary policies are implemented to reduce the inflationary consequences of the pre-election measure. The first model of partisan cycles is attributed to Hibbs (1977) according to which there is a difference in the policy stances and outcomes, with respect to inflation among others, of partisan governments that act in the interest of the ideological preferences of their political constituencies. Though these theories originally rested on adaptive expectations augmented Phillips Curve, myopic voters and backward looking agents who were systematically fooled, the electoral and partisan cycles remain valid even with rational expectations when voters are imperfectly informed about their governments or their implemented policies. The asymmetry of information allows incumbents to create economic cycles while CBI provides for isolating monetary policies from these opportunistic and partisan influences. The third problem of dynamic inconsistency is a consequence of the time frames over which monetary policy has its effects. In the words of Ben Bernanke. "To achieve both price stability and maximum sustainable employment, monetary policymakers must attempt to guide the economy over time toward a growth rate consistent with the expansion in its underlying productive capacity. Because monetary policy works with lags that can be substantial. achieving this objective requires that monetary policymakers take a longer-term perspective when making their decisions." If monetary policy is subservient to the wishes of the executive. then the latter is tempted stimulate the economy by abandoning earlier commitments to low inflation rate after the private sector has incorporated that information in its expectations and decisions. The outcome is higher inflation without any gain in real output because the private sector knows the model and anticipates the opportunist behaviour of policymakers. This theory, initiated by Kydland and Prescott (1977) and developed by Barro and Gordon (1983), highlights the credibility problem of monetary policy and calls for limiting the policymaker's behaviour by some rules of by other form of commitment that could influence policymakers' incentives directly.

The solutions provided by literature to the inflation bias problem was to advocate delegating monetary policy to an independent authority with one objective function either by way of a statutory mandate (Rogoff,1985) or by way of a contract (Walsh 1995; Persson and Tabellini, 1993; Svensson, 1997,1998).The case in favour of CBI, besides being justified on theoretical grounds, also finds support in empirical studies that show that more-independent central banks tend to deliver better inflation outcomes than less independent central banks. without compromising economic growth[3].

In spite of being backed by empirical and theoretical reasoning, CBI is subject to several critiques[4]. The assumptions behind the dynamic inconsistency models have been questioned (e.g. McCallum, 1995). Problems have been raised about the conclusions of empirical evidence, particularly the difficulty of measuring independence; the neglect of significant variables in the explanation of inflation; the lack of robustness in statistical correlations; the absence of causality relationships and the sensitivity of the relationship to data samples. Others have argued that CBI is neither a sufficient nor a necessary condition for price

[3] E.gs Alesina (1988); Grilli, Masciandaro, and Tabellini (1991); Cukierman (1992); Cukierman. Webb. and Neyapti (1992); Alesina and Summers (1993); Cukierman. Kalaitzidakis. Summers, and Webb (1993); and Cukierman. Miller. and Neyapti (2002).

[4] see Blinder (1999); Bassoni and Cartapanis (1995); Neumann (1995); Goodhart and Huang (1995)

stability and recent increase of independence of central banks may be attributed to special legal, political and economic systems obtaining in particular countries with respect to factors like higher costs of changing the legal status of central banks and nature of labour markets characterised by weak unions (Hayo and Hefeker, 2001). Another order of criticism is based on the disconnect between the fiscal and monetary authorities that could entail upon CBI. It also gives rise to a possibility that the independent central bank would be free to act as it deems fit, irrespective of the effect on social welfare and assumes special significance in times of large economic shocks when government's objectives do not correspond with that of the central bank. This last argument brings up the central bank accountability theme.

In the literature, concerns about the democratic accountability of central banks are mostly an outgrowth of the trend towards granting more 'independence' to central banks. Central bank autonomy must be understood as a means to an end, not an end in itself and democratic accountability as a countervailing mechanism to maintain a rein on what is ultimately an unelected authority. There is a broad consensus around the world that the goals of monetary policy should be established by the political authorities, in keeping with the democratic principle, but that the conduct of monetary policy in pursuit of those goals should be free from political control, through free choice of settings for monetary policy instruments. In other words, the democratic principle warrants goal-dependence and instrument-independence for central banks. However, countries vary considerably in the specificity of the mandated goals which in practice affords a degree of discretion to central banks in the conduct of monetary policy.

Attempts have been made by scholars to define democratic accountability of central banks and construct an accountability index primarily in an effort to examine the relationship between CBI and central bank accountability (CBA).

Finding an accurate index for CBA has proved as problematic as finding an appropriate index for CBI. The first attempt at constructing an accountability index is attributed to Havrilesky (1995). As the CBA parameters included by Havrilesky overlapped with those in CBI index, this was considered as inappropriate and Briault et al. (1996) suggested an index based on four criteria depending on 'whether the central bank is subject to external monitoring by parliament; whether the minutes of meetings to decide monetary policy are published; whether the central bank publishes an inflation or monetary report of some kind, in addition to standard central bank bulletins; and whether there is a clause that allows the central bank to be overridden in the event of certain shocks'. Using their CBA index, they evaluated 14 central banks and found an inverse relationship, statistically significant, between CBA and central bank goal independence. Their study showed that central banks with a good record of fighting inflation seemed to be display low accountability levels with the opposite happening in case of countries with a lesser reputation, supporting a view that accountability could partially substitute for central bank reputation / independence, when the goals were not fully specified. Nolan and Schaling (1996) using Briault et al.'s accountability index, found a negative correlation between CBI and CBA as well. De Haan et al. (1998) studied the relation between CBI and different aspects of accountability, using a more detailed quantification of the CBA index and analysis of statutes of 16 central banks as they existed in 1997. Their index was drawn up based on answers to three groups of questions regarding what are deemed to be the three main features of democratic accountability. The first group related to decisions about the final objectives of monetary policy and embrace four aspects : whether the central bank statute stipulates the objective of monetary policy, clearly prioritises them, defines and quantifies them. The second group contained issues of transparency of monetary policy and dealt with the obligations of the central bank to publish an inflation or monetary policy report, to publish the minutes of the meeting of monetary policy decision board within a reasonable time, to explain to what extent it had reached its objective. In the third group were questions relating to the final responsibility of monetary policy covering six aspects: monitoring of the central bank by parliament, right of government or parliament to give instructions, existence of reviews as part of procedure to apply the override mechanism, right of central bank to appeal against the override decision, parliamentary right to change the legal basis by a simple majority vote and whether the dismissal clause is performance based. They concluded a positive (but weak) relationship between CBI and the 'objectives' accountability and a negative relation between CBI and the other two accountability aspects : transparency and final responsibility for monetary policy. Other studies attempted to reduce the conflict between independence by devising scenarios that would increase both dejure and defacto accountability without any relevant losses in independence by increasing parliamentary monitoring and transparency (Sousa 2002) or by a system of contract between the central bank and government.

Research has also focussed on identifying and explaining the detailed and complex relationships between monetary frameworks and economic performance. For e.g., Schaling, Hoebrichts and Eijffinger (1998) sought to demonstrate that transparency and the explanation of policy decisions in particular, have an important role in reducing uncertainty by increasing the public's understanding of the monetary policy objectives. Stasavage (2003) in a study addressed the issue how transparency and accountability provisions for central banks effect economic outcomes or more particularly, the cost of disinflation, using the historic experience of 44 central banks during the 1990s. The forms of accountability he considered were the requirement for the central banker to appear before legislative committees and possibility for finance ministers to override decisions regarding interest rates. His empirical results showed that transparency is associated with lower disinflation costs while override provisions have no perceptible effect on these costs, suggesting that the ability of the central bank to convince the public of their commitment to a given policy may depend more on being transparent than on ensuring that central bankers have absolute independence from political interference. Fry et al. (2000) in a survey of 94 central banks to measure and interpret the diversity of monetary frameworks, in the sub-area of institutional frameworks, came up with a measure that assessed two forms of accountability. One, in relation to a specific monetary policy target, whether or not it existed and whether the government had a role in setting it; what procedures came into play if it was missed. Second, was more general, relating to parliamentary and government monitoring of the central bank.

IMF views on democratic accountability of central banks, acting as a benchmark for central banks world-wide, maybe found in the IMF document on the Code of Good Practices on Transparency in Monetary and Financial Policies (1999). Without defining the concept explicitly, the IMF advocates central bank accountability for the conduct of monetary policy within a paradigm of transparency embracing (1) clarity of roles, responsibilities and objectives of central banks (2) the processes for formulating and reporting of monetary policy decisions by the central bank (3) public availability of information on monetary policies, in the process setting out the parameters that delineate for what the central bank may be held accountable.

4. Measure of Democratic Accountability of Central Banks :

There is recognition in the literature on public administration that the specificities of every institution need to be taken into consideration while designing an accountability system of the institution. 'The appropriateness of a specific accountability system is linked to three factors: the nature of the agency's tasks; the management strategy adopted by those heading the agency; and the institutional context of the agency's operation'(Romzek and Dubnick 1987). While the other two factors might differ in different jurisdictions, there are certain technicalities of central banking (i.e. the nature of the tasks) that need to be heeded while discussing the accountability of central banks.

4.1 Special features of central banks' operations

While holding the central bank accountable, three special features of a central bank's functioning must be kept in mind.

Firstly, the aims of monetary policy, the dominant of which is maintaining low inflation, are not entirely in the control of the central bank. Evaluating performance against monetary and inflation targets is complicated by the fact that the central bank typically has only imperfect control over broader monetary aggregates and inflation, important variables outside its control being the fiscal policy, other government policies and a plethora of exogenous events. Central bankers choose policies based on anticipated outcomes where actual outcomes are affected by unanticipated events.

Secondly, an important challenge for accountability is that monetary policy actions tend to take a long time to affect macroeconomic outcomes (typically around two years for inflation). It is therefore difficult to establish an exact correspondence between action and outcome. The lags in monetary policy transmission imply that ex post accountability based on a comparison of realised outcomes with targets actually evaluates the central bank's actions in the (distant) past. It also uses the benefit of hindsight, which may not be fair. There is a murkiness of outcomes that is caused by economic uncertainties and time lags which do not make evaluation of central bank action, straightforward. (BIS, 2010)

Thirdly, because of the preceding two features among others, transparency holds an entirely different dimension for central banks - being both a tool of central banking and also a mechanism for accountability. Transparency for a central bank is not only a virtue but a necessity. Clarity about the aims of future policy and about how the central bank would likely react under various economic circumstances reduces uncertainty and anchors expectations, helping households and firms to make decisions. The greater clarity and reduced uncertainty, in turn, increase the ability of policymakers to influence economic growth and inflation. As Alan Greenspan put it, "Openness is more than just useful in shaping better economic performance. Openness is an obligation of a central bank in a free and democratic society. Transparency of our activities is the means by which we make ourselves accountable to our fellow citizens to aid them in judging whether we are worthy of that task".

4.2 Criteria for measuring democratic accountability of central banks

Notwithstanding the difficulties in designing accountability mechanisms for central banks this study begins by adopting the approach found in the literature towards delineating parameters for mapping democratic accountability of central banks in a legal, procedural sort of way. It follows Fabian Amtenbrink (1999) who offers eight criteria, including transparency, that encapsulate the different aspects of central bank accountability appearing in recent scholarly writings. These criteria in general, relate to the extent and manner in which a central bank is answerable to or can be influenced by democratically legitimised institutions and the degree of sanction that the latter can exercise. The following are the eight criteria, none of which stands completely by itself, all being largely interdependent:

(1) The *legal basis* is the initial Act which sets up the central bank as an institution establishing its democratic legitimacy, laying down its structure, tasks and powers and also the formal basis of its accountability underpinning all the criteria listed hereafter. Whether and to what extent parliament can change the legal basis of the central bank is important to observe, because the possibility of changing the legal basis, ultimately itself acts as a mechanism for holding the central bank accountable. (2) *Monetary objectives* determine the purpose that the central bank aims to achieve and also answer the question as to what the central bank can be held accountable for. Several characteristics of monetary policy objectives play a role in the determining the accountability framework. Whether the objective(s) is statutorily fixed or subject to discretionary decisions by the central bank or the government; whether there is a *single* objective or *multiple* objectives and in the case of the latter, whether there is clear prioritisation and in case of the former, whether there is quantification of the objective. (3) *Relation with the executive branch of government* is a foundation of a central bank's (indirect) democratic accountability since the executive is a branch that is legitimised by the electorate. These maybe based on both legal provisions and *de facto* arrangements. Since such arrangements may also become channels of political influence that do not necessarily coincide with a high degree of democratic accountability, it is to be observed whether and to what extent the government itself is accountable to the legislature in respect to its handling the relationship with the central bank. (4) A*ppointment, re-appointment and dismissal procedures* of central bank officials refer to the delegation of central banking powers to particular delegatees and the conditions under which the latter may lose the confidence of their appointers, amounting to a mechanism of ex-post accountability. (5) *Override Mechanisms* describe instruments available with the government to approve, suspend, annul, defer or overrule central bank decisions or even to take over the conduct of monetary policy on grounds of recognition of the ultimate responsibility of the government for monetary policy. From the democratic accountability perspective, this criterion could be considered effective only if the procedure for application of the 'override' is transparent. (6) *Relationship with Parliament* is an important element of democratic accountability of a central bank as it is the parliament that delegates power to the central bank in the first place

on behalf of the people and maybe deemed as the principal actor charged for holding the central bank accountable, and in case of 'deviance', use its capacity to change the terms of delegation. Yet, it is recognised that 'risks' of politicisation of monetary policy associated with a role of parliament in the democratic accountability of the central bank can be minimised only with introduction of clear yardsticks by which performance of the central bank may be judged. (7) *Budgetary accountability* depends on the extent to which a central bank is subject to the appropriations process of parliament and is important since most central banks are publicly owned and profits from its operations belong to the public. (8) *Transparency* – determines the extent to which a central bank is open to public scrutiny and judgement. Not only is transparency itself a mechanism of democratic accountability but also determines how well the other criteria work since without sufficient and timely information the scope of all accountability arrangements would be restricted.

4.3 A case for widening the scope of democratic accountability?

The criteria developed above refer to the obligations and arrangements existing between a central bank and the government or parliament to hold the former accountable that are generally enshrined in relevant laws but may also be a matter of practice. Yet, these criteria do not appear to take cognisance of the special nature of central bank tasks discussed in the last section. There are several challenges in designing suitable accountability mechanisms for central banks such as the difficulty in defining performance yardsticks that are clear, measurable and non-conflicting. It may be hard to identify appropriate and verifiable performance criteria with respect to objectives that are identified. These, coupled with the fact that for most critical functions of central banks, the central bank's actions are only one of the many influences on the outcomes that have long gestation periods, makes it difficult to pin responsibility on specific actions. Recognising these complexities, many countries have chosen to rely less on formal ex post accountability mechanisms and more on an obligation for decision-makers to be transparent about the basis for their actions, more or less at the time the decision is made (BIS, 2010).

Further, given the very wide ramifications of their policies, central bankers must in principle, be accountable to the public at large for their decisions, transcending the more limited representative forums. The design of effective governance arrangements for central banks, especially for their core functions, can be quite complex. The process frequently requires making choices and compromises between competing societal objectives. The trade-offs, and the compromises they require, differ from one country to another. It must be understood that steps to encourage accountability also offer opportunities for political pressure. Both government and parliament are majoritarian political institutions that are supposed to mirror the public will. Yet vested interests are often expressed through parliament and in government, either private or public. In the circumstance of disagreement, the response of Dr.I.G Patel, former Governor of Reserve Bank of India in 1970s, i.e. prior to the paradigm shift towards greater independence of the central banks, was to emphasise that the Governor was foremost a public servant with loyalty to the country and the Constitution-not just to a government in transit, whose responsibility would lie in starting a debate and steering the argument in a certain direction. His ultimate defence was democracy and the tradition of free debate. Speaking at the bicentennial celebrations of Banque de France in 2012, Governor Jean-Claude Trichet, in answer to the question: "To whom is the central bank accountable?" had said "In the end, I think it is accountable to public opinion itself."

True democratic accountability of central banks would hinge on the requirement to provide justification and explanation to the wider public through informal and formal processes of openness and transparency. Wherever leeway is available to the central bank, it would have to act in a way so as to serve public welfare as embodied in constitutional principles giving due consideration to structural issues such as stage of economic and financial development as also the role of state intervention in the economic architecture. Central banks have to be sensitive to render accountability for their actions as well as for the results of those actions. Transparency and regular scrutiny afford legitimacy to central bank's operations. They also give the central bank stronger incentives to fulfil its mandate and motivate the bank to develop proficiency in conduct of monetary policy and other regulatory actions, thereby creating greater institutional trust that is reinforced over time through positive feedback loops. An evaluation of the democratic accountability of central banks would have to factor the responsiveness of its policy actions to emerging public needs and the extent of institutional trust it enjoys.

Chapter 3

The Reserve Bank of India and Democratic Accountability

1. Introduction

It was mentioned in the preceding chapter that the issue of accountability of central banks came into prominence on account of the emerging emphasis on *independence* of central banks from the political executive. Insofar as democratic accountability is seen to be the answerability to the ultimate electorate or any body that is legitimised by the electorate, it follows that in a situation where an institution (in this case the central bank) is not independent of the executive and the latter can exercise considerable control over its operations, the question of democratic accountability loses much of its relevance. It is contended that this was the case of Reserve Bank of India for much its tenure in the 20th century, right up to its last decade. That monetary policy played little or only a subservient role to fiscal policy is borne out by a cursory look at the history of monetary policy operations of the Reserve Bank in the twentieth century.

2. Subservience of Monetary Policy to Fiscal Policy

In its foundation phase which maybe said to have lasted from 1935 to its nationalisation in 1949, the operations were confined primarily to the traditional central banking functions i.e. currency management and banker to government. In the sphere of monetary policy, except for maintaining exchange rate stability, the management of money supply or inflation was not warranted due to the low levels of economic activities of the colonial era. The next forty years up to 1990s that maybe labelled as the development phase, saw the introduction of centralised planning, emphasising RBI's monetary and credit policy roles aimed at maintaining price stability and regulation of investment and business activities (RBI 2008a). It also saw the advent of deficit financing with RBI playing an ever expanding role of financing Plan expenditure by recourse to issue of ad hoc Treasury Bills. While it was customary for a central bank to extend temporary short term advances to the Government to cover mismatches between the latter's receipts and expenditure, the practice (of ad hoc TBs) made routine since 1955 gave the Central Government an unlimited right to borrow from the Reserve Bank (Balachandran 1998). Similarly, the State governments also began to draw unauthorised overdraft from the Bank so that the Bank became a source of cheap credit to both the Central and State Governments. Traditional instruments of credit control viz. the

Bank Rate and OMOs soon proved inadequate to control credit creation as rising deposits with commercial banks under the impact of deficit financing made it unnecessary for them to approach the RBI for accommodation and the absence of an articulate and broad based market for government securities meant that OMOs had a limited effect as a policy instrument. Manipulation of Reserve Requirements became the most active policy instrument. The regime of Selective Credit Controls and proliferation of administered interest rates foreclosed the interest rate channel for monetary policy. "Monetary policy in the 1980s had to address itself to the task of neutralising the inflationary impact of growing deficits by continually mopping up the large increases in reserve money......The Chakravarty Committee, formed to review the working of the monetary system in 1985, recognised the dangerous trajectory that monetary – fiscal policy was on and strongly recommended a fundamental restructuring of the monetary system" (RBI 2010). Though a monetary framework for money supply targeting was adopted in the 1980s, C Rangarajan, Governor of RBI – speaking in 1993 on autonomy of central banks, pointed out that only "with the moving away from automatic monetisation of the deficit, monetary policy will come into its own." The regulation of money and credit would be determined by the overall perception of the monetary authority on what the appropriate level of expansion of money and credit should be, which in turn would depend on how the real factors in the economy were evolving. In this context, the phasing out of the ad hoc Treasury Bills (1997) and the enactment of the Fiscal Responsibility and Budget Management (FRBM) legislation in 2004 have been metamorphic in redefining government - central bank relations, with the Reserve Bank 'regaining control of its balance sheet' as it were. It is only in the post reform phase, that it is meaningful to talk about democratic accountability of the central bank as the RBI endeavours to deliver in terms of its monetary policy objectives and other non-monetary roles assigned to it.

Yet, the behaviour of the Indian government with relation to the central bank during the period was in tune with the thinking of the times. While the doctrine of central bank *independence* was an important plank when the RBI law was enacted given the experience of war-induced inflationary financing required of the central banks during the first World War, by the time RBI was nationalised and India had embarked on the path of planned development, the doctrine had lost its import. Under the influence of the Keyensian orthodoxy, "...the world over in the 1950s, central bank autonomy was thought to be a relic of the past. In an age dominated by government, many central banks were content to be relevant and grateful for influence" (Balachandran 1998). A reversal of the intellectual climate and concerns about the independence of central banks came back to the centre stage in the last quarter of the century with the advent of new classical economics and the theory of Rational Expectations. "The new classical contributions demonstrate that the effect of a particular policy depends critically on the expectations of economic agents about the policy... The rational expectations revolution has also highlighted the importance of credibility to the success of anti-inflation policies... Achieving credibility should then be an important goal for policy makers. In order to achieve credibility, policy makers would have to pursue consistency in their policy actions." (Jadhav 2003). Insofar as governments were prone to act inconsistently as per the dictates of the political business cycle, consistency of monetary policy required that this responsibility be placed in the domain of the central bank, acting independently of the government but accountable for achieving its assigned tasks.

3. Democratic Accountability of Reserve Bank by Amtenbrink's criteria

The criteria formulated by Amtenbrink provide a somewhat narrow legalistic view of central bank accountability outlined in the preceding chapter. This can be used as the point of departure to assess democratic accountability of RBI, keeping in mind that the context in which the Indian central bank is located is different from that of the 'data set' used by Amtenbrink.

(1) Legal Basis: The Reserve Bank came into existence on April 1, 1935 on the passage of the Reserve Bank of India Bill 1934. The Bank was thus set up in British India and though the Act has been amended many times to remove the vestiges of its colonial history and add to its functions, there has not been any fundamental overhaul of its basic structure in the 78 years of its existence, including at the time of its nationalisation. This was not on account of difficulty in bringing about such an amendment but was a matter of conscious choice. The draft nationalisation Bill prepared by the Bank contained minimum modifications necessary to give effect to the change of ownership, leaving the operational and other features of the existing organisation undisturbed, as the Bank felt that as it was then organised, "it was sufficiently responsive to broad Government control and had not hampered the pursuit of State policies" (RBI 1970). The Bill for nationalisation was moved in the Legislative Assembly in September 1948 by the Minister of Finance and was passed in one day with the assurance that the Government would take up "the complete revision of the Act at an early date" (ibid: 524) but till date the revision has not been attempted. The fact that there is no constitutional recognition of the Indian central bank and the central bank statute

can be amended in the ordinary process of law making, functions as a mechanism of ex ante democratic control whereby Parliament sets the rules with which the Bank must comply. It also functions as a mechanism of ex post accountability as Parliament may decide to change the legal basis of the Bank as a reaction to some kind of behaviour. That this type of reaction is in the realm of possibility is borne by the fact that up to 2009, the RBI Act has been modified no less than 79 times through acts, ordinances, regulations and adapting orders. The constitutional position of the Bank was open to review in the year 2000 with the setting up of National Commission to Review the Working of the Constitution (NCRWC). The Background Paper on Review of Fiscal and Monetary Policies broached the subject of a constitutional status for the central bank and safeguard of tenure for the Top Management of RBI "in the light of the developments during the last fifty years as also the evolving role of central banks the world over". The paper noted that the international position regarding the need for constitutional provisions was not unambiguous. In countries where the institutional framework was weak there was merit in bolstering the position of the central bank by having certain constitutional safeguards. The underlying rationale for providing a special status for the central bank in the Constitution was that the power to spend should be separated from the power to create money. In the final report of the NCRWC, no recommendations were made in respect of the constitutional status of the central bank. The Commission however recommended that the Union Government take necessary steps for the early enactment of the Fiscal Responsibility Bill pending before Parliament and also suggested that the State Assemblies enact similar legislation to put their respective fiscal houses in order. It would appear that the Commission took the view that requisite independence of the central bank could be maintained if the government was statutorily compelled to limit its fiscal deficits.

(2) Objectives of Monetary Policy: precision of statement of monetary policy objectives within an accountability framework serves as the required benchmark and the central bank can be held accountable for any deviation from this benchmark. Fuzziness of objectives or presence of multiple objectives make it hard, if not impossible, to assess the monetary policy performance of a central bank as the multiple objectives may pull in different directions and failures in one dimension are explained away, through claims that the other goal was being pursued.

In case of the Reserve Bank, the preamble of the Act enjoins the Bank "... to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage".

This statement of objectives clearly bears the imprint of the situation obtaining in India prior to 1935 in respect of currency, exchange and banking which the central bank sought to address. Historically speaking, alongside the organised banking sector, there existed foreign banks and a fairly extensive indigenous banking sector having loose links with the organised sector that itself was not integrated. "Principally on account of the dual system, Indian money market was inelastic with deficiencies and defects such as seasonal and regional imbalances between the need for and supply of currency and credit and marked variations in interest rates" (RBI 1970:40). The principal channel through which expansion and contraction of money occurred was foreign remittance. In the absence of a central bank this was inevitable on account of adherence to an international monetary standard with a fixed exchange rate. Today, the ground situation is very different and in the absence of a legislative reformulation of its objectives the RBI has to interpret its mandate to suit current realities. In a speech in 2007 Dr.Y.V.Reddy stated "The twin objectives of monetary policy in India have evolved over the years as those of maintaining price stability and ensuring adequate flow of credit to facilitate the growth process. The relative emphasis between the twin objectives is modulated as per the prevailing circumstances and is articulated in the policy statements by the Reserve Bank from time to time. Consideration of macro-economic and financial stability is also subsumed in the mandate." Within the Amtenbrink framework, the result in terms of accountability is not ideal and has been admitted. According to one view, "There is a great comfort in a multiple objective approach in that precision is not required in defining the objectives and the Reserve Bank in turn does not have much accountability as it juggles with the almost impossible task of fulfilling contradictory objectives and as such accountability is blurred" (RBI 2000).

(3) Relations with the Executive: "Under the Reserve Bank of India Act, the Bank is under the control of the central government" (Balachandran 1997: 713). Although this is the general assessment of the Act, it is interesting that independence of the central bank – manifested in the question of ownership and management - had become a hotly contested issue at the time of debating the proposed Act (RBI 1970: 5) so much so that the Bill introduced in 1927 had to be dropped altogether till 1933, when extraneous political considerations dominated by prospective constitutional reforms, literally propelled the Reserve Bank bill through the legislature. Introducing the Bill in September 1933, Sir George Schuster, the Finance Member underscored the importance of independence of the central bank in the following words

> "...when the direction of public finance is in the hands of a ministry responsible to a popularly elected Legislature, a ministry which would for that reason be liable to frequent change with the changing political situation, it is desirable that the control of currency and credit in the country should be in the hands of an independent authority which can act with continuity . . . Further, the experience of all countries is again united in leading to the conclusion that the best and indeed the only practical device for securing this independence and continuity is to set up a central bank, independent of political influence" (RBI 1970).

Setting up the central bank with private ownership was the way the Government sought to impart an 'independent' status to the institution and in 1935, RBI was set up as a share holders bank but the government retained strong mechanisms of control. At the time of nationalisation in 1948, only minimal amendments were brought to the Act so as to give effect to the change of ownership leaving the rest of the organisation undisturbed on the grounds that, as it was then organised, 'it was sufficiently responsive to broad Government control and had not hampered the pursuit of State policies'.

Under the RBI Act, the Central Government is responsible for the appointment of the Governor and four Deputy Governors who hold office at the pleasure of the Government and also all other Directors, including a non-voting Government nominee, to the Central Board and the Local Boards of the Bank (Sections 8 and 9). Any Board Member can be removed from office by the Government at will (Section 11(1)). The pay and allowances of the Governor and Deputy Governors are determined by the Central Board with the approval of the Central Government (Section 8(2)). In terms of Section 7(1), the Central Government may from time to time give directions to the Bank in public interest, after consultation with the Governor. Under Section 30, the Government has the power to supersede the Central Board if it deems that the Board failed to carry out any of the obligations imposed on it but would have to furnish a full report of the circumstances leading to action under this clause to Parliament within 3 month. The Act enjoins on the Bank to transact the banking business of the Government of India and manage its public debt on such conditions as maybe mutually agreed upon (Sec 20 and 21). In case of failure to reach an agreement on the conditions, the Central Government can decide the conditions suo moto and place them before Parliament. The Act permits the Bank to make short term advances to the Central Government repayable within three months. The wide-ranging powers of the Government, makes the Bank subordinate de jure. In the circumstances it is hard to envision the Bank adopting seriously contrarian views to that of the Central Government as the latter has several levers, even a threat of use of which could suffice to discourage or make such views unsustainable. In the early part of the history of Reserve Bank there have been a couple cases wherein conflict of opinion with the Government led to the resignation of the concerned Governors[5].

It has been pointed out that actual, as opposed to formal independence, "hinges not only on legislation but also on several factors such as informal arrangements with governments, the quality of the personnel in the bank as well as Government and the personal characteristics of key individuals" (Reddy 2001) all of which are virtually impossible to quantify. As such legal independence measures may only be a proxy for actual independence and an imperfect one at that, where informal relations are dominant. The Reserve Bank, historically, has had close relations with the Ministry of Finance, given the major role it played in establishing credit institutions in the country since the 1950s and especially so after nationalisation of major banks, when banks became the prime instrument of government's socio-economic policies. Post 1997, in the realm of monetary policy, the Bank became relatively free to conduct operations as it deemed fit but 'old habits die hard' and as Dr.Y.V.Reddy noted in 2001- there remained scope to reduce micro management issues in the relations between the Government and the RBI and increase transparency by avoiding the temptation to continue what had been termed as the 'joint-family' approach ignoring basic tenets of accounting principles and giving satisfaction to all participants that all of them are working together for growth and stability (2001).

In the matter of monetary policy, there has been an increased institutionalisation of the relations between the Reserve Bank and the Central Government in the post reform period and the role of informal channels in policy decisions have been concomitantly reduced. Even as coordination between monetary and fiscal policies has been emphasised, there has been an attempt to report the transactions between the Bank and the government as transparently as possible to maintain the integrity of their individual balance sheets. There is recognition in the Government today that in spite of its dominant legal position vis a vis the Reserve Bank, an arm's length relationship was a better position to be in for more favourable overall outcomes. In this environment, it is meaningful to talk of accountability of the central bank not merely to the Ministry but to the public at large at whom its policy measures are aimed, ultimately.

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[5] Resignations of Osborne Smith in 1937 and Benegal Rama Rau in 1956.

(4) and (5) Appointment, Re-appointment, Dismissal Procedures and Override Mechanisms: Strictly speaking, these features fall under the category of 'relations with the executive government' but are considered separately, in view of their importance to the democratic accountability framework. While appointments are a point of ex ante control, re-appointment and dismissal procedures are seen to hold the key to ex post accountability of central bank officials. The length of the term of office is also indicative of the independence of central banks with long, non- renewable terms associated with more independence.

In the Indian case, the Central Government has prerogative of appointing the Governor, Deputy Governors for any term not exceeding five years and may also re-appoint them. All Directors are appointed for a term of four years and are eligible for re-appointment. Of the 17 tenured Governors of the Reserve Bank till date (5 Governors had been appointed on temporary basis for periods ranging from less than a month to 7 months), nearly all had been civil servants prior to their joining the Bank and this was considered inimical to the spirit of independence of the central bank as they would have a bias in favour of government thinking. The issue had been raised by legislators on certain occasions with the Finance Ministry such as in 1968, when Parliamentarian Madhu Limaye questioned the practice of appointing civil servants to the post of Governor. Deputy Prime Minister and Finance Minister, Morarji Desai had given an assurance that in future civil servants would not be appointed as Governors. The government however, did not keep this promise (RBI 2005a: 456). While the Act permitted tenures up to 5 years for Governors and Deputy Governors, the appointments have been for varying periods especially those of Deputy Governors who, after completion of their first terms, were sometimes granted extension. The government thus firmly held the reins of appointment to the top positions in the Reserve Bank. The decisions on awarding of varying tenures are not transparent and risk the appearance of being motivated. In this connection, a recent decision not to extend Subir Gokarn's three year term as Deputy Governor, age 53, in spite of being recommended by the Governor, maybe cited. The issue gave rise to speculation that Shri Gokarn had been made the 'fall guy' for not heeding the government's wishes on interest rates. An article in Business Standard, Jan 9, 2013 inter alia stated "....Perhaps Mr Gokarn became the fall guy for resisting calls for interest rate cuts by the government and industry lobby groups, despite uncomfortably high inflation and/or for the handling of the rupee...The irony of his unfair fall is that the government, struggling for credibility and whose actions limited the degree of freedom of the RBI in dealing with massive rupee depreciation and stubbornly high inflation, decided who should pay the price." The succeeding Deputy

Governor Urjit Patel, has been given only a two-year term compared to a typical three-year term.

Override mechanisms generally describe powers conferred on the government to approve, suspend, annul or defer central bank decisions or one step further, to issue directions for the conduct of monetary policy. "The existence of override mechanisms has been described as a recognition of the government's ultimate responsibility and as the true check on an autonomous central bank" (Amtenbrink 1999:51). In the Indian case, the power to give directions to the Bank in public interest (Section 7(1)) and to supersede the Central Board for failure to carry out any of its obligations (Section 30) are in the nature of override mechanisms.

In regard to dismissal and override mechanisms, the most important question is under what conditions these powers can be exercised. For instance, in the absence of clear cut circumstances for dismissal in the law, there is the danger of its 'misuse' as such a discretionary decision may be made based on political considerations rather than on monetary policy performance or to obscure actual responsibilities, making the central bank the scapegoat for developments which are beyond its control. The supersession of the Central Board by the government under Indian law, is somewhat circumscribed by the fact that the government has to place a full report of the circumstances leading to such action within three months of its occurrence. However, unlike in some other countries the action does not have to be approved by Parliament. The Indian law does not provide the eligible circumstances under which the dismissal or override mechanisms maybe invoked. It is evident that these are very potent instruments which, although might not have been used, their very existence suffices to characterise the Reserve Bank as legally not independent and the government bearing the ultimate responsibility for monetary policy. Also, in the absence of clarity regarding conditions for application of these provisions, their mere presence may not add to the democratic accountability of the central bank.

(6) <u>Relations with Parliament:</u> It is Parliament which delegates power over monetary policy to the central bank and holds the ultimate mechanism for holding it accountable, i.e. by changing its legal basis. Being the body representing, in a sense, the public will, reporting requirement to Parliament appears an attractive mechanism for democratic accountability.

In India, the Reserve Bank does not have an obligation to appear before the Parliament to explain and/or answer questions on its conduct of monetary policy. The Governor or other officials can be called to depose before parliamentary committees in regard to specific issues.

The Parliament can however make use of ministerial accountability to review the position of the government in holding the central bank accountable which amounts to indirect accountability to Parliament. But here too, the problem is the absence of a clear yardstick against which the performance of the Bank may be judged. Without such a yardstick, participation of the Reserve Bank in Parliament runs the risk of an undesirable politicisation of monetary policy.

(7) Transparency: This feature by itself amounts to a mechanism of democratic accountability and is a means by which the central bank can gain the confidence of the public directly. Transparency is also a pre-condition for other mechanisms of democratic accountability. Whatever other arrangements for accountability may exist, they would be hamstrung without transparency, since information is crucial to evaluate the central bank and hold it accountable. As such, transparency may be considered to be the cornerstone of democratic accountability.

The Reserve Bank has come a long way in regard to its transparency practices from the traditional approach to policy formulation characterised by secrecy. In the matter of monetary policy (as also in various other policy matters), the Reserve Bank has adopted a consultative approach, setting up a Technical Advisory Committee on Monetary Policy in 2005 with external experts in the areas of monetary economics, central banking, financial markets and public finance, that meets at least once a quarter and advises the Bank on the stance of monetary policy. The Minutes of TAC meetings are nowadays published with a lag of about one month. The Bank also takes pains to articulate and explain its decisions via the detailed Annual Monetary and Credit Policy Statement and thereafter in the Quarterly and mid-Quarterly Reviews of monetary policy. The attempt to improve two-way communication not only on monetary policy but across the entire spectrum of the Bank's mandate is seen explicitly as an effort to improve the quality of its decision making, including its accountability to the society at large.

(8) Budgetary Accountability: For any public institution, democratic accountability requires that its financial resources are used wisely, transparently and according to explicit standards of the institution. Though most central banks finance themselves through their operations, their profits are generally transferred to the government and hence they are accountable for the way they manage their budgets. This calls for a review of central bank finances.

The balance sheet of the Reserve Bank portrays the financial outcome of its diverse roles and responsibilities and reflects a confluence of accounting principles and macro policies. The Reserve Bank prepares two balance sheets – one for the Issue Department reflecting its currency management actions and for the Banking Department reflecting its monetary management and banker to government and banks function. It meets the basic requirements of income recognition on an accrual basis, periodic revaluation of the investment portfolio and annual external audit as prescribed by the International Accounting Standards (IAS). In certain matters, it follows even stricter norms than the IAS prescription. The period, since the late 1990s, has been marked by a sea change in the direction of increasing transparency in the financial statements of the Reserve Bank (RBI 2008a: 261). In terms of Section 53 of the RBI Act, the annual accounts of the Bank are transmitted to the Central Government within two months of closure, signed by Governor, Deputy Governors and the Chief Accounting Officer-certified by the external auditors. A Report by the Central Board of Directors on the working of the Bank throughout the year is submitted therewith and the report, together with the accounts is published in the Gazette of India. The budget of the Reserve Bank is thus open to scrutiny by the government and the public.

4. Assessment by Amtenbrink criteria

Of the eight criteria for measuring democratic accountability suggested by Amtenbrink, the Reserve Bank does not score well in respect of four of them viz. (1) Objective(s) of monetary policy (2) Appointment, Re-appointment and Dismissal procedures (3) Override mechanism and (4) Parliamentary Oversight. The problem, evidently, is that the RBI Act is ¾ of a century old and was enacted in the colonial era when the British government had no intention to slacken its hold on monetary administration although it spoke the language of 'independence' from the Finance Department, which it feared, would come under control of an elected Minister responsible to the Indian legislature under the constitutional reforms of 1935 (Balachandran 1997: 700). Upon nationalisation in 1949, other than ownership and abrogation of shareholders' Directors, no major structural changes were undertaken in the RBI Act and so the Bank remained firmly under government control. It must be remembered that, democratic accountability emerged as a concern only in the late 20th century under the impetus of a shifting discourse in the direction of a greater policy focus on inflation control by central banks and 'independence' as a means of allowing it to do so. Accountability, as an issue, took serious proportions in the light of efforts to make central banks independent and as such, those central banks whose statutes were written or re-written at this time[6] took care to include mechanisms of accountability within the central bank statute. In the absence of an overhaul to its legal framework, the Reserve Bank had to resort to what may be termed as 'business process re-engineering' in regard to conduct of monetary policy to the extent allowed by the new 'hands-off' approach of the government and thus it scores satisfactorily in respect of the remaining accountability criteria of Amtenbrink that are not embedded in the legal structure. The new approach reflected in the move towards placing their relationship on an institutional footing and granting a higher degree of operational autonomy to the central bank in recent years has been underpinned by legal and near-legal developments such as the passing of the Fiscal Responsibility and Budget Management Act, joint endeavours to implement fiscal and monetary transparency practices of the International Financial Standards and Codes and the Finance Minister publicly articulating intent to accord greater operational flexibility to the RBI for the conduct of monetary policy and regulation of the financial system in view of the fast changing world of modern finance (Reddy 2001). It is with the self-same intentions that presently, changes in the RBI Act are being considered as part of bigger changes within the financial infrastructure by the Financial Sector Legislative Reforms Committee (FSLRC).

In the circumstances, transparency and specification of its monetary policy objective(s) according to emerging situations, would seem to be the most important aspects of RBI's current accountability framework. Even though a single objective eludes RBI, the Bank spells out its monetary policy stance in advance, providing extensive rationale for its changing emphases. It discloses detailed reasoning for undertaking monetary policy actions that is widely available in public domain even though the Governor is not required to face the Parliament on this issue. Given that conduct of monetary policy is like tight rope walking and given the highly politically surcharged atmosphere prevalent in the Indian Parliament, such an exercise might not yield any additional insights into policy formation over what is already available in the public domain but become an occasion for political one-upmanship.

[6] Countries which undertook changes in existing central bank legislation between 1989-99: Austria 1998, Greece 1997, Argentina 1992, Belgium 1993 / 98, Hungary 1991, Chile 1989, France 1993 / 98, Japan 1998, Colombia 1992, Finland 1998, Korea 1998, Ecuador 1992, Germany 1993 /94 /98, Mexico 1994, Egypt 1992, Ireland 1998, New Zealand 1989, Honduras 1995, Italy 1992 /93 /97, Poland 1991 /97, Indonesia 1998, Luxembourg 1998, Sweden 1998, Pakistan 1994, Netherlands 1994 /95 /98, Turkey 1989, Peru 1992, Portugal 1990 /95-98, UK 1998, Philippines 1993, Spain 1994 / 97, South Africa 1989, Uganda 1993, Venezuela 1992. Source: Michael King, *The Politics of Central Bank Independence*, LSE 2002

4.1 In defence of multiple objectives framework for India – inappropriateness of Amtenbrink criteria.

In the final analysis, objectives of monetary policy, as part of macroeconomic policy, are formulated foremost, for achieving beneficial outcomes for the economy as a whole and not primarily for acting as a yardstick to measure performance, which they may do incidentally. In this context, against a global tendency towards a single objective framework the RBI has adopted a well-argued position in which discretion is combined with a multiple indicator approach to achieve its monetary policy objectives. RBI uses multi-sector macroeconomic models that endeavour to provide detailed structural analysis of supply and demand sides of real activities and prices, as also Taylor type monetary reaction functions that provide possible trade-offs between inflation and growth. At a theoretical level, the exercise of discretion is based on the argument that "the continuous flow of new information and the process of expectation formation adding to the base level information about the current state of the economy might make the application of rigid rules – based on historical information or abstract hypotheses – ineffective in addressing the unfolding problems" (Vasudevan 2003). At the practical level, it is explained that the difficulty of pursuing a single objective such as inflation targeting is that structural factors and supply shocks render inflation dependent on both monetary and non-monetary factors. Further, a fully dependable measure of inflation is yet to be developed and given the institutional features such as persisting fiscal dominance, debt management function being linked up with monetary management via its repercussion on interest rates and a less than effective transmission mechanism because of absence of fully integrated financial markets, it is felt necessary " to carefully measure and balance the possible outcomes, taking into account the movements in a variety of monetary and other indicators" (RBI 2008a:119).

It would appear that inflation control as the single objective of monetary policy was a kind of fad which gathered momentum on the back of a trend towards granting more independence to central banks in the 1990s that coincided with low inflation world-wide. In India, the pursuit of price stability acquired urgency in the early 1990s in the light of enormous capital flows that were threatening to push inflation into double digits. "The very fact that the RBI was able to rein in inflation by the mid-1990s by tightening monetary conditions appeared to demonstrate the potency of inflation targeting ... it is in this context that Advisory Group on Monetary and Financial Policies, (Chairman: M.Narasimhan), recommended that the Reserve Bank should be mandated a sole price stability objective. But the emerging consensus in favour of inflation targeting was 'halted in its tracks' in late 1990s with a slow-down in economic activity from 1997-98 which called for countervailing easing of monetary conditions to create enabling conditions for revival" (Jadhav 2003).

The episodic nature of the consensus for sole inflation targeting was put in perspective by Governor Jalan when he said in 2000,

> ...There is a growing consensus now – in theory as well as in practice – that central bank should have instrumental independence, and concentrate on a single target of inflation control with the use of a single instrument. The position is no doubt theoretically sound but as I look at the history of economic thought and the changing fashions in economic policy-making, I must confess to a sense of discomfort on whether the current dominant view on 'one target one instrument' will survive the test of time ... It seems to me that a certain amount of target flexibility and balancing of conflicting objectives are unavoidable.

The RBI might fall short of the accountability criteria of Amtenbrink based on the existing law but the reason is that in India, the law enacted in 1935, was not made to make the RBI accountable.

5. Why Amterbrink Criteria Is Not Sufficient ?

The democratic accountability profile of Reserve Bank that emerges on the basis of Amtenbrink criteria, originally used in a study to examine the existing arrangements with regard to democratic accountability of central banks in seven industrialised countries, maybe treated as a starting evaluation template. Thereafter, points of departure need to be identified, emanating from the fact that the Reserve Bank is a developing-country central bank situated in its own historical, economic context. The variation in circumstances surrounding the origins of central banks means that their roles and functions have not all evolved in the same way, even within categories such as developing or emerging market economies.

Amtenbrink's premise is that for an effective accountability framework, performance must be judged against a single objective. The accountability framework is based on processes of sanction designed around the failure to perform as per the stated objective. However, where the objective of the central bank is not limited to one component for whatever reason, the main plank of the accountability framework falls away. The fact is that India, like many emerging market economies (EMEs) has multiple objectives of monetary policy (see Sec

4.1). Again, like most statutes by which central banks have been set up in developing / EM economies, the RBI Act does not provide for pursuing only a single objective. There is no consensus yet as to whether a superior outcome from the point of view of general welfare of a society would emerge by pursuing only one objective. From a practical point of view, economic complexities have sharply increased, rendering the pursuit of a single objective, more often than not - price stability, quite problematic. For example, "inflation targeting which in the early 1990s caught the fancy of a number of central banks and academicians, has by 2000/2001 lost much of its glamour, partly because of the unfortunate Japanese experience of almost zero inflation alongside negligible growth in recent years and partly because inflation performance of most industrial economies that pursued more than one objective during 1990s has been low and stable. Economic uncertainties also contributed to lack of consensus as to which of the objectives could be worked out operationally and on priority basis" (Vasudevan 2003). In even more recent times, inflation targeting by central banks has been positively discredited in the backdrop of the sub-prime crisis build-up eluding the attention of the US central bank because of its unwavering concern with low inflation and has raised voices against inflation targeting as the sole object even in industrialised nations. According to C A E Goodhart, "In the years prior to August 2007, Central banks had appeared to have almost perfected the conduct of monetary policy. The standard regime was one in which the central bank was delegated operational independence to vary the official short term interest rate in order to achieve an inflation target, which target in turn was mandated either in general terms or in specific numerical terms by the democratically elected government. What we now recognize is that the achievement of price stability by this procedure does not guarantee financial stability." (2010). The current financial crisis has brought various unsettled issues to the fore and has thus renewed some uncertainties about the future shape of central bank functions and objectives.

A set of differences which need to be kept in mind, that would point to the unsuitability of extrapolating the single objective accountability framework of an industrialised economy central bank to a developing economy like India, relate to the differences in the institutions and the structure of the economy and make central banking in a developing country significantly different from central banking by its advanced country counterpart. According to DeRosa, central banks in developing EMEs often need to contend with characteristics like, i) Presence of two-tier economies, one a fully documented market segment that forms part of the world economy and the other a local segment that functions outside the documented and taxed economy and this impedes effective monetary policy. ii) Large fiscal deficits with the risk of the central bank absorbing the debts of the treasury, leading to the undermining of public confidence in the central bank and the currency. iii) Proneness to macro-economic dislocations. These could be triggered by exogenous shocks like hike in oil prices or weather conditions like drought or floods. iv) Immature financial sectors and fragile banking systems which make transmission of monetary policy difficult and circumscribe the policy options open to a central bank. v) Pronounced vulnerability to the ebb and flow of international capital wherein these countries are exposed to risk from global imbalances. Resultantly, central banking in EMEs is more challenging than in developed countries (2009).

Broadly speaking, central banks from emerging market economies have a wider range of functions than central banks from industrialised economies for three main reasons and this has to do with the differences in regard to the stage of financial and economic development. First, in less well developed economies, the central bank is often a source of expertise that can be used in a wide range of applications. Second, central banks are often responsible for guiding the development of immature financial systems, a function that is less needed once critical financial structures are in place. Third, industrialised economy central banks tend to have narrowed their range of functions over time, perhaps reflecting an evolutionary path consistent with the first two observations (BIS 2009).

Thus, apart from its primary monetary policy function of manoeuvring the quantity and cost of money and credit for the purposes of stimulating growth or suppressing inflation, the Reserve Bank is entrusted with several non-monetary functions such as exchange rate management, lender of last resort functions, prudential supervision of specified financial institutions and markets, development of financial infrastructure, payment systems oversight payment, public debt management besides quasi fiscal functions like subsidisation of specific sectors, equity participation in financial institutions, deposit insurance and licensing. Given the plethora of roles that the Reserve Bank is called to perform, there could be conflicts between non-monetary tasks and monetary policy functions, as also conflicts of objectives within monetary policy. To meet this situation, there would need to be "mechanisms which help align the motivations of the central bank, as monetary agent, with those objectives" and these include "arrangements which facilitate public understanding and monitoring of monetary policy, as also those that assist the central bank in its day to day operations to maintain a clear focus on its final objective" (Swinburne and Castello-Branco 1991). If it is not feasible to reallocate or reorganise central bank functions in the short run or because the central bank is in the best position to fulfil the objectives , there need to be transparent conflict resolution mechanisms or reconciliation rules, rather than elimination of all but one objective. On the other hand, if in spite of there being multiple objectives of central bank functions, only one is highlighted for the purpose of fixing accountability of the central bank, then this constitutes clear condition for moral hazard.

Yet another reason why the accountability framework of Amtenbrink does not agree well with the situation facing a developing country central bank like the Reserve Bank, is because in respect of the executive branch, the central bank can never be quite independent. A difference between industrial economies and developing economies such as India, is that although there is an increasing sphere of the market in the latter, the role played by the government is very significant as facilitator and participant in the economic processes. As such, it needs to be emphasised that central bank independence by itself cannot ensure monetary policy credibility, since it also depends on the overall credibility of Government policy as a whole, of which it is a part. To fulfil its mandate, there needs to be an appropriate division of responsibility between the monetary and the fiscal authority, policy coordination and articulation of the division of responsibility and policy priorities, for the benefit of economic agents (Reddy 2001). The occasions for an EME central bank to interact with the government are many and diverse. For instance, to pursue market development or financial sector reforms, the central bank would necessarily have to interface with governments at different levels, central and local. Further, "... particularly in emerging markets, the perception of close coordination between the central bank and the ministry of finance is of crucial importance to investors, particularly in periods of financial stress. In addition, the regulatory functions or advisory responsibilities of the central bank may call for close coordination with the government. Liaison will be needed if the central bank performs banking or debt management services for the government. Participation in international forums also calls for coordination" (BIS 2009: 91). Moreover, there is widespread recognition that "... same separation and independence is not really feasible in the pursuit, by the central bank, of its financial stability objective...we have already discussed how a central bank's liquidity management, and especially its unconventional measures, will have both fiscal and distributional consequences" (Goodhart 2010) and to that extent will involve the government.

What is of utmost importance to the central bank's conduct of monetary policy however, is the extent and manner in which it is required, if at all, to finance the government's fiscal deficits. The critical issue relates to the independence of central bank in this matter or "the degrees of freedom the central bank has in deciding whether or not to fund the Government's expenditure out of created money" (Reddy 2001). In this connection, it is therefore more appropriate to talk of an 'optimum' degree of independence of the central bank rather than outright independence from the executive government and this 'optimum' is likely to vary from country to country.

6. Assessment of Democratic Accountability by a Broader Criteria

It has been contended above that the Amtenbrink criteria are not very suitable to assess the democratic accountability of a central bank like the Reserve Bank of India and accountability mechanisms would need to be custom designed to meet the institutional structures available in India. The Approach Paper of the FSLRC, published in October 2012 provides guidance on the general principles on which the commission would base its recommendations on the issue of accountability of regulators. It has mentioned four 'pathways' to accountability as : avoiding conflicting objectives, a well-structured rule making process, the rule of law and reporting requirements. As things stand at present, the Reserve Bank would be viewed as fairly compliant with all but one principle, viz. having multiple objectives and possible conflicts of interest. However, with the central bank policies having economically very significant objectives such as maintaining low inflation, promoting growth and financial stability, it is not clear that separation of agencies for achieving these objectives, whereby the agencies could be separately acting at cross purposes, would be better than having one agency trying to reconcile the objectives in terms of known rules.

Further, there needs to be recognition that the main task of the central bank i.e. implementation of monetary policy, encounters special challenges in regard to delineating the performance yardsticks that it is measured against. This is so because for many of its functions, and especially the most critical ones, the central bank's actions are only one out of many influences on the outcomes. It may require a specialist's expertise and a lot of judgment to relate specific actions to intended outcomes and to assess their contribution to the achievement of objectives because of the varying time lags involved in economic reaction functions and the unanticipated transmission disturbances. Economic uncertainties and the time lags in monetary policy transmission imply that ex post accountability based on a comparison of realised outcomes with targets may not be fair, as it has the benefit of hindsight and so reliance must be placed on real-time accountability based on an assessment of the anticipated effects of the current actions of the central bank. Under these conditions, transparency becomes the basic pillar of accountability. It has been said that over and above formal accountability arrangements, de facto central bank accountability is typically much more extensive and relies on more informal, yet arguably more effective mechanisms (BIS 2009), the most powerful of which are reports to financial markets and the general public. Central banks are nowadays closely scrutinised by the financial press and central bank watchers. For example, lack of confidence of financial markets in the sustainability of a currency peg often incites powerful speculative attacks that force the central bank to abandon the peg. In this way, financial markets can have a tremendous disciplining effect on central banks (ibid).

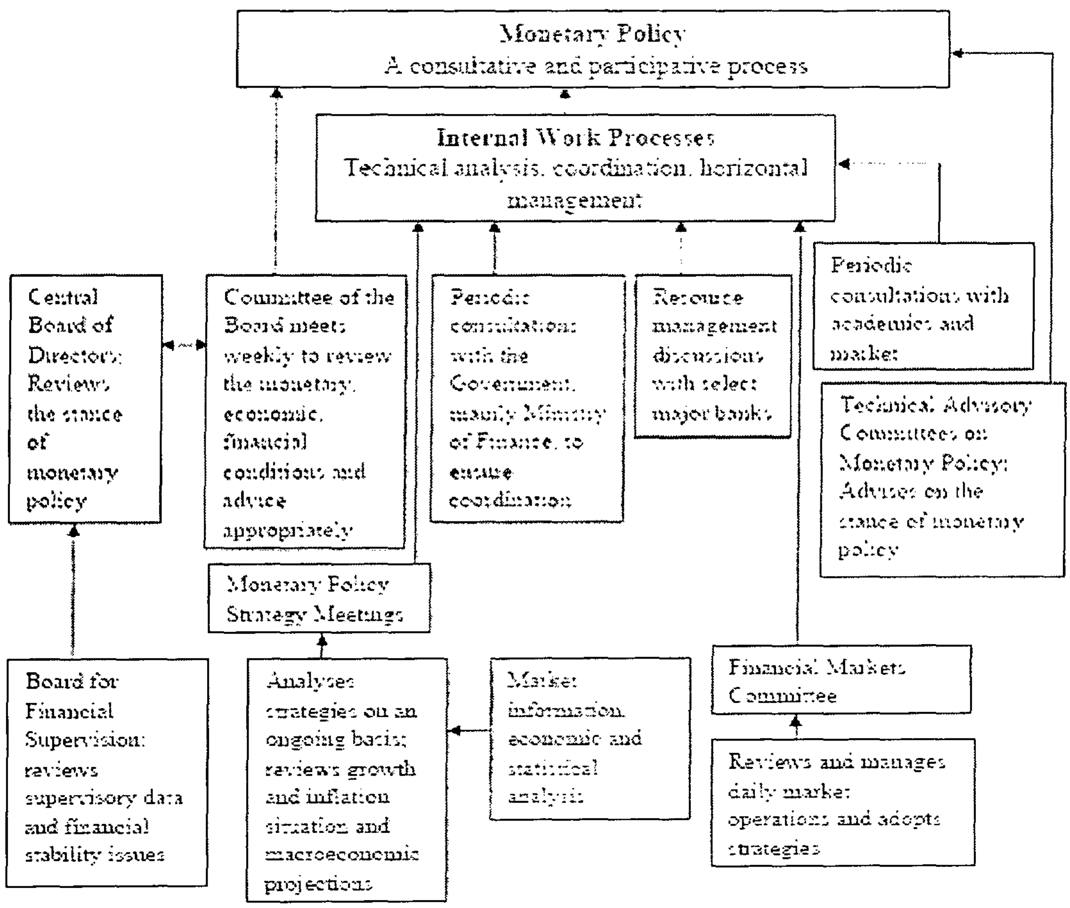
The Reserve Bank recognises the informal channels of accountability and the vital role of financial markets in this regard. It has made its communications policy a critical component of its policy that allows it to influence expectations of inflation and interest rates, to enhance policy effectiveness. At present, RBI's transparency practices far exceed that mandated by formal disclosure requirements. Speaking way back in 2000, Dr.Y.V.Reddy, then Deputy Governor of Reserve Bank of India, had said of the communications practices of the Bank. "Available evidence on international comparisons of level of transparency as well as quality and timeliness of information clearly shows that the RBI comes out well. Professional standards and credibility are ranked very high." The Bank makes efforts to provide quality data to the public at large, which emanates from a robust statistical system established and strengthened over the years and adhering to the basic attributes of a good statistical system i.e. credibility, timeliness and adequacy through various ways such as updating of data on its website, daily press releases, its weekly, monthly, quarterly and annual publications. More significantly, the RBI releases several periodical publications which contain a comprehensive rationale and account of its operations and a vast volume of data together with an account of the trends and developments in the economy as a whole on money, banking, external sector and other financial sectors which provide a backdrop to its actions. Periodical statements on monetary and credit policy by the Governor, official press releases of the RBI, speeches and interviews given by top management add to the articulation of the RBI's assessment of the economy and its policies. The on-going presentation and interaction of the RBI with the media has to be seen in the broader context of creating public awareness, and obtaining continuous feedback. RBI is subject to the Right To Information Act, 2005 and of late, has taken to publishing semi-annual Financial Stability Reports as also the Minutes of monetary policy meetings. In 2012, Dr.D Subbarao was able to say of the Reserve Bank, "... we have tried to improve communication not only on monetary policy but across the entire spectrum of our mandate. We have made efforts to demystify the Reserve Bank."

Finally, given that for a central bank, there is no clear one-to-one correspondence between its actions and outcomes on the monetary policy front – the conventional way in which performance is judged and the aspect that is generally sought to be scrutinised in all formal accountability frameworks, there is a case for extending the meaning of democratic accountability beyond traditional boundaries to refer to the degree of responsiveness and dialogue that a central bank engages in with its ultimate constituency i.e. the general public. That these characteristics are not easy to measure objectively is evident and would need to be assessed through a qualitative appraisal. However, at a broad level, the very fact that the Reserve Bank is perceived to 'follow the Government line', is indication of its democratic credentials for in a democracy the government must be construed to be the repository of public interest. Mention has already been made of the transformation of the policy and regulations formulation process in RBI through consultations and feedback. Apart from its efforts to strengthen the banking sector and develop financial markets infrastructure, the people-orientation of the Reserve Bank would be evident from the numerous initiatives taken by it, since the onset of the Reform Phase, to introduce institutions, products and services catering to the needs of the common man. One notable initiative in this direction has been the financial inclusion drive aiming at universalising access to banking services by mandating the opening of 'no frill' accounts, issuance of Kissan Credit Cards, innovating delivery channels through use of IT and Banking Correspondents and Banking Facilitators. Overhaul of payments infrastructure in recent years has enabled a much greater speed and convenience of financial transactions for ordinary citizens. Focus on customer services was behind setting up the Banking Codes and Standards Board of India (BCSBI) for enunciation of citizen charters by financial intermediaries as well as assessment of actual services thereagainst and also Offices of the Banking Ombudsman for redressal of complaints of retail customers. The open, deliberative approach of the Reserve Bank is best summarised in the words of Dr.Y. V. Reddy, one of the best communicators to head the institution, speaking at a village congregation, "Why do we explain in detail about our work and dilemmas ? It is because RBI is a public institution and we explain to you so that you can understand, appreciate. criticise and guide us. It is not a publicity drive but it is meant to enhance our efficiency and accountability to the common public." (2007).

7. Evaluating RBI's Democratic Accountability

How does democratic accountability of Reserve Bank measure up to the three recurring normative goals of accountability: popular control, prevention of abuse of power and enhancing the effectiveness of government? It must be recognised that the answer to all three perspectives may not be the same. In regard to its primary function i.e. monetary policy at least, the democratic principle itself is generally taken for granted in the RBI as the legitimate way to organize the collective decision-making process. The process leading to monetary policy actions entails a wide range of inputs involving the internal staff, market participants, academics, financial market experts and the Bank's Board shown schematically in Chart 3 below (Mohanty 2010). The intensely consultative and participatory process leaves little scope for arbitrariness or misuse of power in this most sensitive of matters.

Chart 3: Processes of Monetary Policy Formulation



The transparency practices of Reserve Bank in general, create the prospect of public scrutiny. This provides the inducement and the wherewithal for high-quality decision-making by the central bank. For instance, the publication of forward projections is likely to make the central bank care more about the reliability of those projections and hence hone its economic modelling / analytical skills. Feedback from public helps to fine-tune policy and regulatory measures over time. From the learning or the effective governance perspective, the current accountability framework leads to favourable outcomes.

The Reserve Bank as an institution is in the nature of an IRA (Independent Regulatory Agency) which is set up for certain ends, by an enactment of Parliament representing a one-time democratic delegation of powers. The expectation is that because of its efficiency and/or credibility, it will prove to be more proficient in producing qualitatively superior policy outputs than democratic institutions can do (Magetti 2010). In terms of the democratic perspective, public accountability is a means by which citizens may control those holding public office, on the analogy of the principal – agent model, through their elected representatives. As discussed earlier, the government exercises firm control over the Reserve Bank but not within an accountability framework since the government can in law, resort to arbitrary punitive action even without reference to the Bank's failure to perform as per its mandate. The Parliament too, as per current arrangements, does not exercise oversight over the Bank in the normal course. Thus, in respect of the popular control perspective, democratic accountability of the Reserve Bank could be construed to fall short in qualitative terms but at the same time be excessive in quantitative (control) terms.

Mark Philp's notions on the quality of democratic accountability rest on two sets of distinctions as mentioned in Chapter 1. One is between integrity based systems of public office and rule or compliance based systems. Compliance based systems of accountability are imbued with moral hazard as the process of compliance itself acts as an incentive and sanction to the neglect of the substantive objects of office as against integrity based systems of accountability that rely on a fundamental commitment to the institution's responsibilities. In the context of the Reserve Bank, the public scrutiny to which it is subjected is with reference to its enunciated objectives which vary between price stability and growth via ensuring adequate flow of credit to the productive sectors of the economy. The extensive presentation of the rationale behind its policy announcements which seek to explain the grounds for unleashing its monetary policy tools in specific ways conform to the integrity based system of accountability. Such a system is marked by trust, wherein the institution is relied upon to use its discretion and initiative and thereafter to account for the use of its discretion in terms of its responsibilities. The conceptual counterpart of institutional trust in the case of a central bank is credibility or reputation. The degree of credibility or institutional trust for a central bank depends not so much on the actual achievement of monetary goals as the consistent and transparent pursuit of them over time and on this score, the Reserve Bank is generally ranked high. The distinction between compliance based and integrity based systems serves to highlight the imprudence of limiting monetary policy objectives to the single point of price stability at the expense of other substantive goals like growth. The fundamental characteristic of trust risks being lost if for the sake of demonstrating accountability, the central bank pursues only price stability. Moral hazard would have been introduced as the Bank would strive to achieve price stability, by disfavouring all actions that encourage productive activity since high growth would ultimately threaten price stability.

Philp's second distinction is between formal and political accountability. While the former concerns the requirement that public officials act within their formal responsibilities, the latter concerns the answerability of those in public office to partisan elements within the political system. The tension between the two gets reduced as there is progressive 'vertical consolidation' of the political system whereby each actor's political participation is constrained by higher-order decision rules that are not open to contestation. In the case of the Reserve Bank, there has been a consolidation of sorts in that, now, there is a broad agreement across the board that the central bank of the country must not be treated as a source of ready finance by the government of the day and to that extent has led to the entrenchment of monetary policy independence of the Reserve Bank. It has also created the basic condition to hold the RBI formally accountable for monetary policy.

CHAPTER 4

Regulation and the Principal – Agent Problem

1. Introduction

The intent of this chapter is to bring out the correspondence between the processes of regulation and the dynamics of the principal-agent relation developed in economic theory. To that end, the idea of regulation is outlined with its aims and modes of operation. In the process, it becomes clear that the crux of regulation involves changing collective/individual behaviour to conform to a certain norm, using regulatory tools. The chapter then outlines the framework of the agency theory as formalised by Barry Mitnick and goes on to show how the framework fits in to the analysis of regulatory behaviour. It stands to reason then that the central bank acting as the banking regulator, with its set of regulatory goals, and can be viewed as the principal in its relation to banking entities, acting as agents. The relation between the central bank and banking entities then can be usefully viewed through the prism of agency.

2. What is Regulation ?

In legal and economic literature, there is no fixed definition of the term regulation but at a prosaic, utilitarian level, regulation could be defined as 'the employment of legal instruments for the implementation of social-economic policy objectives' (Hertog 1999). Regulation is difficult to define since its meaning and scope of inquiry are unsettled and contested. Using a more functional approach to regulation, it is widely accepted by social scientists that

> ...any (regulatory) control system in art or nature must by definition contain a minimum of three components ... There must be some capacity for *standard setting*, to allow a distinction to be made between more or less preferred states of the system. There must also be some capacity for *information -gathering* or monitoring to produce knowledge about current or changing states of the system. On top of that must be some capacity for *behaviour-modification* to change the state of the system. (Hood et al 2001)

At the narrowest, definitions of regulations tend to centre on 'deliberate attempts by the state to influence socially valuable behaviour which may have adverse side effects by establishing, monitoring and enforcing legal rules and at its broadest, regulation is seen as encompassing all forms of social control whether intentional or not, whether imposed by the state or other institutions' (Morgan and Yeung 2007). From the traditional legal perspective, a statute promulgated by a sovereign legislature or an agency authorised by the legislature is the paradigmatic form of regulation. When the social context in which the law operates is emphasised, the examination of regulation extends to the ways in which law gives expression to particular values. Thus the fundamental features of regulation are intent to modify behaviour of target participants according to some accepted norm or standard and a system of information-gathering to assess conformity of behaviour with the norms.

Purposive attempts to influence and control economic and social activity have a long history. The politics of regulation in many different countries, including India, is pervaded by a broad sense that state intervention into the economy either bolsters markets or tempers their effects by adding a dimension of social inclusion. The scope of regulatory politics has widened to newer areas in recent years leading to an expansion in the 'regulatory state' but underlying 'ideological battles over the basis and extent of justifiable state intervention into collective choices,' continue to rage (ibid). A large part of the literature on regulation deals with why regulation emerges in the way it does and the justifiability thereof. The rationales forwarded by scholars can be grouped in terms of theories of regulation each having a different perspective rather than being fundamentally opposed to each other. Broadly there are three kinds of theories which may be categorised as public interest theories, private interest theories and institutionalist theories.

3. The Aims of Regulation

The fundamental aims of regulation could be said to be enunciated in the public interest theories of regulation which have the oldest vintage. Private interest theories appear to be an outcome of the dissatisfaction with public interest theories which had fallen into disrepute through empirical and theoretical research in developed democracies by 1970s. Public interest theories place emphasis on the goals, functions and values that justify regulation; private interest theories are concerned with explaining why regulation emerges in the way it does; and institutional theories focus on the process of how regulatory institutions work, drawn from an understanding of implementation dynamics (ibid). Since the object is to understand the aims of regulation, this section will focus primarily on the prescriptive elements of public interest theories identifying the goal(s) that regulation *should* pursue.

Public Interest theories of regulation ascribe to legislators and others responsible for design and implementation of regulation, a desire to pursue collective goals with the aim of promoting general welfare of the community and can be further subdivided into those that articulate regulatory goals in terms of economic efficiency and those which include other political goals. The 'economic version' of public interest theory is perhaps the most discussed in academic literature. According to Anthony Ogus,

> We can see regulation as the necessary exercise of collective power through government in order to cure 'market failures' to protect the public from such evils as monopoly behaviour, "destructive" competition, the abuse of private economic power, or the effects of externalities... Regulation is justified because the regulatory regime can do what the market cannot...Many instances of market failure are remediable, in theory at least, by private law and thus by instruments which are compatible with the market system ... But private law cannot always provide an effective solution. Where then, 'market failure' is accompanied by 'private law failure'...there is prima facie case for regulatory intervention in public interest. (2004)

Since conditions under which the market mechanisms lead to optimal allocation of resources frequently don't exist the demand for methods for improving allocation arises. Government regulation is one such method and serves as the instrument for overcoming the disadvantages of imperfect competition, unbalanced market operation, missing markets and undesirable market results (Hertog 1999). However, the 'market failure' explanation of government regulation has itself been criticised on some counts (Cowen 1988). It has been said that in practice, it appears that the market mechanism itself is often able to compensate for any inefficiencies. Secondly, government regulation can also be inefficient with its own underlying transaction and information costs. The public interest theory has been criticised as being incomplete since it does not indicate how a given view of the public interest translates into action that maximise economic welfare (Posner 1974). These critiques have been followed by attempts at formulating a more sophisticated version public interest theory by letting go of many unrealistic assumptions and showing that under normal circumstances government regulation is the most effective way of combatting market failures which do exist (Hertog 1999)

The underlying conception of public interest at the root of welfare economics versions of theories of regulation is rather narrow wherein the collective welfare is defined exclusively in terms of efficient resource use. By contrast, 'political versions' of public interest theory admit of broader notions of welfare. Values such as social justice, redistribution or paternalism figure in assessments of what justifies regulation. They also place greater emphasis on the intrinsic value of participation through dialogue and the attendant process of collective learning. A range of non-economic substantive goals justify regulatory intervention which include public-interested redistribution, reducing social subordination, promoting diversity of interest, preventing harm to future generations, embodying collective desires and shaping endogenous preferences (Morgan and Yeung 2007). According to Cass Sunstein, the choices people make as political participants are different from those they make as consumers and 'democracy thus calls for an intrusion into markets' as 'statutes safeguard non-commodity values that an unregulated market protects inadequately' (1990).

Private Interest theories of regulation by contrast, are sceptical of 'public interestedness' of legislatures and policy makers. According to these theories, regulation emerges from the actions of individuals or groups motivated to maximise their self-interest. On this view, regulation may or may not enhance public interest but it does so only incidentally. The private interest theories, as evident from above, focus on ways by which regulatory processes are, in a sense, 'taken over' by private interests rather than why they arise in the first place. They tend to give causal accounts of the emergence of regulatory regimes the way they do while public interest theories are more prescriptive, highlighting the goals that regulatory law should ideally facilitate.

4. How regulation works ?

This section deals with the question of how regulation seeks to achieve its goals and involves using specific mechanisms or tools through which social behaviour is sought to be influenced. One kind of classification of the many available tools, elucidated by Morgan and Yeoung, is by distinguishing between them based on their underlying technique or 'modality of control'. A broad categorisation along this line yields five types of instrument-classes: command, competition, consensus, communication and code. Each instrument is associated with specific 'properties' that impinge on the ultimate choice of instrument(s) when seen in relation to the objectives for which they are invoked. In reality, there are likely to be many 'hybrid' type of regulatory tools having features of more than one class type.

The oldest and the most familiar regulatory instruments are command-based instruments called **command-and-control** or CAC regulations, for short. These involve the state promulgation of legal rules prohibiting or mandating specified conduct, underpinned by coercive sanctions if violated. On the subject, T Daintith, uses the term *imperium* to describe the government's use of the command law and the term *dominium* to describe the use of government's wealth in aid of its policy objectives

> In earlier centuries, however, regulatory laws, with some rather haphazard enforcement mechanisms, were about the only resource for economic management available to the government for influencing private behaviour. Today government has available, in addition to a much greater enforcement capacity, enormous resources of public funds and public property, accumulated through taxation, borrowing and purchase...government still has the plenty of scope for *buying* compliance with policy by offering such incentives as grants, soft loans, tax concessions, free or cheap public services and like inducements to those who act consistently with its plans. Normally, therefore, the policy maker can at least consider the use of *dominium* as a possible solution to all or part of his problem (1994).

It would appear that imperium, in contrast to dominium, comes cheap. While enforcement costs need to be factored, costs of compliance with policy are *placed wholly on those whose behaviour is affected.* Yet attitudes to compliance costs are changing and it is felt that imposing cost on those who cannot afford to pay should be avoided. According to studies by American economists, it is now understood that even where costs can be absorbed, they may, if excessive, significantly diminish national welfare (ibid). However, the most vexing problem associated with command and control style of regulation is that of uncertainty or more precisely the lack of reliable information. To operate efficient policies that seek to change people's behaviour, government needs adequate information first about how they should behave i.e. the standard or target that should be set and secondly about how they are behaving now and why; thirdly about what sanctions or incentives will align their behaviour with the desired standard or target. None of this information is easy to obtain and getting any of these answers wrong could vitiate the policy program. "The problem is one of knowing how a large number of individuals will react to financial incentives. The same is true of reactions to taxes, less obviously to regulatory measures, even those carrying criminal penalties. Not everyone obeys. People will calculate the costs and benefits of compliance or non-compliance with regulations much as they calculate the incidence of taxes ... Information requirements furnish a valuable key to understanding of government choices among instruments available for implementation of policies." (ibid)

The drawbacks based on command-based techniques explain the turn towards regulatory tools that harness the **competitive** forces arising from rivalry between competing units as a means for regulating social behaviour. Such tools, often referred to as economic instruments (EI) come in a wide variety and include charges, taxes, subsidies, tradeable emission/property rights and changes in liability rules and rely on encouraging desired behaviour by financial incentives rather than legal compulsion. Some of the grounds on which EIs have been advocated

> First, while CAC often gives rise to a complex and detailed set of centrally formulated standards, EIs can function on the basis of broad target goals, with a reduction in information and administrative costs for both the regulators and the firms. Secondly, the greater freedom conferred by EIs on firms creates incentives for technical development. Thirdly, whereas the enforcement of CAC is subject to considerable uncertainty as regards apprehension, prosecution and the level of sanctions, EIs entail the certain payment of specific sums. Fourthly, negative EIs (i.e. charges) generate funds which can be used to compensate the victims of externalities; CAC regimes rarely allow victims to be compensated ... (Ogus 1994)

Regulation by **consensus** and **communication** are distinct from other classes in that the mechanism on which they rely to influence or constrain behaviour depend on the consent of the participants and include self-regulation. Communication based techniques also seek to harness the force of social norms and consensus and include efforts to persuade and educate people or those affected by the regulated activity to act in a manner that will serve the achievement of regulatory goals by providing them with relevant information to enable more informed choices. Unlike all the other classes, **code** based techniques operate by eliminating undesirable behaviour by means of excluding the possibility of its occurrence. An example would be the use of speed humps on public roads to slow down traffic on certain stretches for public safety. It is evident however, that regulation – by whatever technique – seeks to bring about a certain change or action which otherwise would have been passed over or neglected and leads to an increase in public good, howsoever that maybe defined by the regulatory authority.

5. The Agency Theory

The Agency Theory, otherwise also known as the Principal Agent theory is generally considered as an outgrowth of the new paradigm in economics called the economics of information. Under the traditional paradigm, markets were efficient and self- clearing given that a certain set of assumptions held true, of which the assumption of perfect information was a prime one. Once, it was recognised that information available with economic agents was almost always flawed or incomplete, the standard results of economics changed drastically (see Stiglitz 2002). Information or the lack of it, affected decision-making in every context - not just inside firms and households. In a world of imperfect information, prices were no longer the sole signal for influencing decisions. 'The most fundamental reason that markets with imperfect information differ from those in which information is complete is that, with imperfect information, market actions or choices convey information. Market participants know this and respond accordingly' (Stiglitz). Thus, information (or lack of it) moulded market behaviour. Over and above incomplete information, information asymmetries i.e. situations where the transacting parties have different sets of information, including that of their different interests, created their own problems typically called principal-agent problems. It is in the context of information imperfections that economic literature in recent years has evinced interest in the agency problem. In agency, a certain kind of relationship is presumed that gives rise to characteristic responses and hence the utility of understanding this class of relationships so as to be able to mould the behaviour of transacting parties in a predictable manner, by contracting, say.

The first scholars to explicitly formulate a theory of agency were Stephen Ross and Barry Mitnick, independently and roughly at the same time (Mitnick 2013). Ross was responsible for the origin of the economic theory of agency and Mitnick for the institutional theory of agency. Both the approaches employed similar underlying concepts. While Ross introduced the study of agency in terms of compensation contracting, looking at agency as an incentives problem at a unit level (Ross 1973) and which was subsequently followed by a large literature on optimal and equilibrium incentive schemes in labour, capital, and insurance markets, Mitnick introduced the insight that institutions form around agency. According to Mitnick, institutions evolve to deal with the essential imperfection of agency relations as behaviour never occurs as it is preferred by the principal because it does not pay the agent. In the strain of agency theory developed following Ross, the contexts that actually constitute the agency relationship are removed from the analysis and are reduced to their contributions of incentives or contractual constraints or risk/uncertainty conditions to decisions. Barry Mitnick's work followed parallel, if overlapping lines of literature that were more institutional in character, in which the context of decision making assumed importance.

In regard to the origins of his approach, Mitnick refers, among others, to Oliver E Williamson's work on the employment relationship (Williamson 1975, 1985) as well as his older work on managerial discretion (1964). A key question with which Williamson began was why organizations were ever preferred to markets, given that market exchange would seem to be capable of doing what organizations do. The existence of costs of control, however, suggested to Mitnick that a theory of *control* centred on agency – not just a theory of *exchanges* – might generate new insights into common social institutions. That the costs of detecting and policing manager's actions did not apply only to firms but could be applied more generally to a number of agency relationships was the idea that led Mitnick to create a vertical theory of control focussing on the mechanisms, and costs, of specifying what the agent is to do, as well as the costs of observing and policing him or her. The approach became vertically relational, as institutions were created to instruct and manage agents, and to deal with the inevitable (and sometimes rationally tolerated) imperfections of control (Mitnick 2013).

In a major critical assessment in the Annual Review of Sociology, Susan Shapiro wrote that "a general theory of agency emerged in political science (Mitnick 1973) at the same time that it did in economics (Ross 1973), apparently independently. ... In a series of papers spanning at least 25 years, political scientist Barry Mitnick broke the monopoly on agency theory enjoyed by the economics paradigm and offered an alternative to the assorted baggage that comes with it." (2005)

5.1 Mitnick's Framework of the Theory of Agency

Mitnick's 1973 paper and 1974 dissertation presented a detailed set of agency concepts and sorted them in typologies, identified types of agency relationships as well as a language for describing agency and for developing theoretical explanations for behaviour in agency, demonstrating applications to such diverse social relationships as advisers and clients, lawyers negotiating with one another, the advocacy of interest groups, regulators as agents subject to policing by public observers, regulatory incentive systems, and so on.

In this section an outline of the building blocks of Mitnick's descriptive institutional approach is given, focussing on the core theory logics of agency that make it possible to generate statements about behaviour in the real world.

A relation of agency is said to exist when one party, 'the agent', is acting for another party, 'the principal'. 'Acting for' is taken in a broad sense including such behaviours as performing acts beneficial to a goal of the principal, acting as representative of the principal, acting as employee of the principal and so on. A self- goal (or self- interestedness) is an objective of an actor whose successful pursuit by the actor would in some sense directly benefit himself.

Goals maybe revealed, inferred, or imputed from behaviour, and/or divulged by consideration of the structural features of the agency situation. It is generally assumed that the actors are rational in the sense of having consistent preferences for given goals. Use of the term 'self-goal' is not synonymous with 'preference'. Other-goal (or other-interests) is an objective of an actor whose successful pursuit by the actor would in some sense directly benefit an entity other than the actor himself. The formulation does not exclude the possibility that pursuit of an other-goal may not also benefit the self, or vice versa. The categorisation of referent 'entities' or principals of other-goals according to level is given in Table 1 :

Table 1 Typology of Referent Entities or Principals

Category of Referent Entity	Examples		
	Entity or Principal	Agent	Other- goal
Personal			
Particular	charismatic leader	follower	national control
Role or class	supervisor	worker	task success
Organisational			
Particular	General Motors	manager	Profit
Class	auto companies	lobbyist	low pollution controls
Systemic			
Particular	United States	ambassador	stable currency
Class	general public	Ralph Nader	public interest
Ideational			
Particular	Socialism	socialist MP	nationalisation of industry
Class	Justice	prosecutor	justice

Agents as well as principals may be of various levels. The agent maybe a person, organisation, system or even an idea. The agent subject to analysis maybe a particular entity or a class. Agency relations may 'telescope'; a person may be an agent for an organisation which is an agent for a system. Hence the person may indirectly be agent for the system. The question of transference of agency and any incumbent normative obligations across levels maybe a problem not only of logical inference in modelling, but a problem for the individuals involved and for the design of effective institutions.

The typology of agencies by ideal types is presented in Table 2. Agency, a relationship grounded basically in consent, is divided into contractual and non-contractual and the latter divided according to whether the agent gives his consent to the acts he performs. Under each grouping, some common behaviours and some important norms are given. The behaviour maybe generally characterised as to (i) the nature of the consent, (ii) the source of specification of the agent's acts, (iii) the degree of discretion of the agent and (iv) conditional or idiosyncratic features. (For more detailed exposition of the above ideal types, see Section B of Mitnick 1973)

Table 2	**Typology of Agency**		
Agencies			
State of agreement regarding agent's acts	Contractual	Non Contractual	
		Symmetric-Consensual	Asymmetric-Consensual
Common behaviours	Discretion: Contractual Trusteeship Authority: Post contractually specified with extremes: Sales relation Contractual slavery According to Discretion: Type I authority Type II authority	Altruism Consensual Autonomous Agency Non contractual Reciprocity Consensual Directed agency or Consensual imperative	Coercion
Sample norms:	Norms of contractual obligation: Fiduciary Obedience to authority Self- actualisation Reciprocity under contract	Norms of non-contractual obligation: Giving Helping Reciprocity (non-contractual)	Resistance to non- consensual direction

5.2 Problems of Agency

<u>The principal's problem</u>: assuming that the parties to the agency are rational, it is the problem of the principal to motivate the agent to act for the principal's goal in the manner the principal prefers. Motivation does not only involve straightforward exchange of resources including financial and solidary incentives for agent action, the principal's employment of the sanctions he may have at his disposal regarding the agent, but also the supplying of information which may activate agent norms and preferences that lead to agent specification which the principal prefers. The process of agent motivation and of agent or principal specification may occur under general conditions of uncertainty and maybe subject to the

'imperfections' of agency, notably the problem of resolving conflicting preferences between the goal sets of the participants.

The agent's problem: the agent's problem is basically that of choice of acts to best satisfy his preferences for self and other-goals, where he may be constrained in regard to these goals by the particular agency relation.

Policing mechanism and incentive systems: Policing mechanisms are mechanisms which restrict the discretion of the agent by restricting the agent's set of discretionary choices. They maybe consciously executed programs of surveillance and control exercised by the principal or embedded in the structure of the particular agency relation. Incentive systems are sets of mechanisms which increase the return to the self-goals of the agent for acting in accord with the preferences of the principal i.e. for pursuing the goals of the principal. Incentives make it relatively more "expensive" with respect to return to self-goals for the agent not to pursue the principal's goals. Given that actors are rational, it can be seen that incentive systems are a type of policing mechanism. In addition to controlling agent discretion through an incentive system, a principal may try to solve his 'problem' by trying to alter or manipulate the preferences of the agent. He may encourage, for example, norms like the fiduciary or obedience. The choice of policing mechanism may depend on the degree of discretion possessed by the agent, on the cost to the principal of implementing and maintaining the particular mechanism and on whether that cost is offset by the gains he received by limiting his agent.

The agency approach may be used as an analytical tool and an aid to understanding not only situations where the agency is overt, such as the case of legislative representatives, but also in the context of social and organisational structures. In the latter case, the theorist may have to use the formal definitions to analytically map the interactions of agency.

6. Regulation as an Agency Relation

That the agency theory lends itself rather well to the study of regulatory behaviour was strongly advocated by Mitnick himself, the originator of the institutional agency theory, since it is capable of handling all the stages in the policy process - how regulation is created (policy formation and decision), how it is implemented, how it is administered, how it impacts, and how it is (if ever) evaluated and terminated (deregulation).

It is simple to identify regulation as a generic relationship that can be understood in terms of agency, when regulation is defined as "the intentional restriction of a subject's choice of activity, by an entity not directly party to or involved in that activity" in an attempt to modify the subject's behaviour with reference to certain standards. The entity that attempts to modify behaviour or the regulator is identified as the principal and the subject whose choices are sought to be restricted as the agent. Regulation centres on those acts of the regulators (principal) that interfere in the choices available to regulatees (agents) such that the regulatee is caused to act for some goals held by the regulator, by some means of influence. Furthermore, the regulator does not actually perform the agent's activity; he seeks to control or influence the agent's activities as a party outside the agent's normal activity set. This implies that the agent's set of self-goals, more often than not, will differ from the goals of the regulator, potentially creating a problem of agency in case the agent's self- goals and other-goals (i.e. principal's goals) happen to conflict. The consistency of self-goals and other-goals of the agent should thus have a determining role in the choices of action by the regulator-principal in terms of designing agency features such as extent of specification of agent's acts, level of discretion allowed, invocation of fiduciary norms, policing mechanisms etc. – that in turn, have a bearing on regulatory efficacy.

Mitnick identified two broad classes of agency relationships, based on formalization of the agency role, as "formal occupational" and "consistent structural" agency (Mitnick, 1974). In the first case, agency is a formally recognized role, as with many of the helping professions (medicine, social work, etc.); the formalization is often reflected in canons of ethics specifying appropriate and inappropriate agency behaviours. In the second case (consistent structural agency), the agent's social role is not a formally recognized role of agency, but he or she acts relatively consistently as agent for a given party. Such consistent structural agency is generally created and maintained through the existence of a particular pattern of interactions. Regulation as agency, would be deemed to belong to the class of consistent structural agencies since regulated entities come into existence for different objectives and not merely to satisfy the goals of their regulators.

Regulation as agency relationships can profitably be understood as control systems. Principals seek to control the behaviour of their agents, and agents, in turn, may seek to control or manage elements in their environments so as to satisfy their principals. Thus models in agency often focus on (and carefully model) the incentive systems that ensure or produce these controls. In order to do this, principals must pay specification costs to identify acts of the agent that would satisfy the principal's preferences, and policing costs in monitoring and enforcing compliance. Agents, too, have compliance costs which include opportunity costs of performing as agent rather than performing in other roles and so the costs of actually acting for the principal may be distributed between the agent and principal. Thus calculation of the net benefits of the agent's actions for the principal by itself may be only part of the consideration necessary to understanding the choice and conduct of agency behaviour. A major task of agency theory is identifying the forms and dynamics of principal-agent interactions and of agent control mechanisms.

In the context of regulation, the problem of the principal translates to one of devising most effective, cost-minimising uses of its arsenal of regulatory tools, for achieving agent behaviour consistent with its regulatory goals or what would be considered the same thing as perfecting the agency relationship. "The utility of identifying regulation as a form of agency relation goes beyond the simple "acting for" notion and extends to the use of such relations as structural building blocks in understanding the functioning of the regulatory system. The standard structures and dynamics of agency reappear in regulation, and the standard problems of agency relations are also problems in regulation." (Mitnick 1979)

Further, this approach to regulation makes it evident that regulators not only seek to create agents in the regulated parties; they are themselves also formally agents of those parties in whose name they regulate, i.e., the public. The public regulatory system itself – comprising the agency, industry or regulated entities, interest groups, legislature, executive, courts, and their interactions-can be seen as a complex of influence attempts in which the creation of stable agency relationships plays a major role.

7. Monetary Policy, Bank Regulation and the Agency Theory

Central Banks the world over are entrusted with the responsibility of conducting monetary policy primarily through the agency of commercial banks. However, unless it operates in an absolute command economy, the central bank tries to *influence* the behaviour of commercial banks through various monetary policy instruments. Thus the very premise of effectiveness of monetary policy is that central banks can *control the behaviour* of commercial banks through operations of various instruments of monetary control (Ray 2008). Ray noted that there was a revival of interest in the role of banks in the transmission of monetary policy as there was an increasing recognition of the credit channel of monetary transmission due to, inter alia, a major development of literature on micro-economic information-asymmetry based credit rationing (Stiglitz and Weiss 1981) and role of banks (Diamond and Dybvig, 1983). The result was 'a new theory of monetary policy' (Stiglitz and Greenwald, 2003) derived from the credit channel. Informational and organisational capital within the banking system is important from monetary policy angle. Credit is heterogeneous by nature i.e. loans were not perfect substitutes and regulatory policy could have an important impact on availability of credit. Ray concluded that regulatory policy and monetary policy needed to be based on a theory of bank behaviour.

In a review of Partha Ray's book, Pulapre Balakrishnan, Senior Fellow, Nehru Memorial Museum and Library noted "With the intrusion of game theory into every branch of the discipline of economics we now see banks as active agents working to neutralise the actions of central banks that would erode their bottom lines. With the financial sector reforms in India and the consequent growing power of our commercial banks this is a real possibility."

These observations, point to the fact that it is incumbent on the central bank, as the banking regulator, to develop an understanding of bank behaviour.

That agency theory provides a model that appears to fit quite well for analysing the wide range of bank responses to policy stimuli of the central bank has been advocated by scholars such as Joseph F Sinkey. He identifies a chain of principal-agent relations in the regulatory regimen for commercial banks wherein taxpayers or the public are the overarching principals, the legislature is first the agent of the public and simultaneously the principal to the regulator, which in turn is the agent of the legislature and the principal to the banking industry. He scripts the problems of regulation as

> The U.S. Congress, acting as agent for taxpayer principals, monitors bank regulators (including deposit insurers), who in turn monitor insured depositories. Monitoring and bonding are costly activities. Since regulation acts as a tax, bankers attempt to pass the incidence of it onto their customers. The struggle between regulators and regulatees, which can be described as the "regulatory dialectic", serves to stimulate financial innovation but at the expense of wasting costly resources. (1992)

Transposed to the Indian context, the Reserve Bank as the banking sector regulator acts as the agent of parliament which empowers it with the requisite authority and in turn acts as principal to the banking sector through which it seeks to achieve certain socio-economic goals. In Mitnick's agency theory framework, these regulatory goals of RBI form the other-goals for the banking entities it regulates. Aside from monetary policy, the primary objectives or the regulatory goals of the Reserve Bank are prevention of systemic risk, protection of depositor interests, reduction in asymmetry of information between depositors and banks, enhancing efficiency of the financial system and achieving a broad range of social objectives (RBI 2008b). Self-goals of banks would vary according to factors such as ownership, size and distribution, niche businesses etc. but to make profits would be a self-goal of every bank since without profitability the bank cannot sustain its operations for long. The invocation of the fiduciary norm by RBI in respect of agent obligations (since RBI directions have the backing of coercive law) may not suffice for fulfillment of regulatory goals if the self-goals pursued by banking entities 'conflict' with their other-goals and the regulator might have to rethink its strategies in order to minimize or avoid the conflict between self-goals and other-goals of banking entities.

The next chapter will examine whether there is evidence of any goal conflict within the agency theory framework between the RBI and Indian banks through whom the financial inclusion program is being sought to be implemented in India. In the process, the association between the agency problem and RBI's democratic accountability, as defined in the present study is also examined.

Chapter 5

Democratic Accountability and the Agency Problem

1. Introduction

The first three chapters have dwelt on the meaning of democratic accountability, outlining its contours in what may be called the narrow sense and then making out a case, with reference to the Reserve Bank, for broadening the scope of the term 'democratic accountability'. The next chapter discussed the agency problem in relation to regulation and demonstrated that agency theory can be applied to central bank – bank interactions. This chapter examines the possible connection between the democratic accountability of the central bank and the agency problem. It aims to highlight that democratic accountability of a central bank enjoins it to strive to achieve what is identified as public interest, as agent of the public, but transference of the agency to financial entities, having different interests, could be problematic.

At one level, the connection appears comparatively straightforward. Regulation has been shown to be amenable to a conceptualisation as a series of principal-agent relationships between citizens, legislators, the regulator and the regulated entities. Regulation that falters on the agency problem i.e. the inability to design rules that effectively transfer the regulator-goals to the regulated entities in a manner that induces the latter to adopt the goals as their own, would show up poorly on the accountability yardstick, when accountability is measured in terms of performance. In this sense, greater the agency problem the greater is the likelihood of a regulator falling short of the accountability standards. However, this thesis has proposed a measure of democratic accountability of the central bank that extends beyond the narrow, performance–based definition and hence for the sake of consistency the examination of the link between democratic accountability and the agency problem will assume the broader definition. Also, it will illustratively refer to the Financial Inclusion drive of the Reserve Bank of India.

2. Financial Inclusion and Democratic Accountability of RBI

It was outlined in the last chapter how the efficacy of monetary policy is dependent on the way banks respond as agents, through whom monetary policy impulses are sought to be transmitted. In the sphere of banking regulation too – another salient function of RBI – banks in India have been used as conduits or agents for socio-economic changes. It would appear as a result, that the prognoses of agency theory would be of relevance to the central bank. Historically speaking, one of the most important events in the financial evolution in India was bank nationalisation in 1969, bringing in a significant shift of the financial topography of the country. While there was substantial increase in banking facilities between 1951 and 1967, with the population per branch office declining from 1,36,000 in 1951 to about 75,000 in 1967, the perceived fault lay in the fact that expansion of branches was mostly in urban areas, and rural and semi-urban areas continued to go un-served. Consequently, a number of economic activities, in sectors ranging from agriculture to small-scale industrial units and the self-employed, did not have proper access to banking facilities. This led to the widespread political perception that, left to itself, the private sector was not sufficiently cognisant of its larger responsibilities towards society. Private banks were seen as being excessively concerned with profit alone, which made them unwilling to diversify their loan portfolios across different scales of operation of economic units, as this would raise transaction costs and reduce profits (RBI 2005).

From an agency theory framework, nationalisation is easily rationalised as a way of aligning the larger interests of the community in the role of ultimate principal with the self-interest of commercial banks in their role as agents, which were almost exclusively private prior to nationalisation. Since late 1960s, both the government and the Reserve Bank have been concerned with the non-availability of banking facilities to the under-privileged and weaker sections of society and have accordingly taken several initiatives over time such as bank nationalisation, directed lending by prescribing priority sector targets, concessional interest rate schemes, the Service Area and Lead Bank Scheme. The broad approach during the 1970s and '80s was oriented towards credit requirements of specific sectors / segments of society. The recent approach, since 2005, subsumed under the term 'financial inclusion', focuses on the individual / household level and aims at delivery of banking and payments services at an affordable cost to the entire population, inclusive of the vast sections of the disadvantaged and low-income groups, without discrimination. (RBI 2008b)

The extent of exclusion at the time that the agenda came into focus, around the year 2005, was enormous. According to a survey conducted in 2003, India had the highest number of households (145 million) excluded from banking. 50% of the population did not have bank account. Only 34% of the population engaged in formal banking. Only 17% of population had any credit exposure. Only 30000 villages had a commercial bank branch of the total 6 lakh villages. Only 10% had life insurance cover and just 9.6% had any non-life insurance (Chakraborty 2013). Thus, despite the efforts for increasing banking outreach after nationalisation, large swathes of India's population were deprived of mainstream banking facilities. Regulatory intervention was deemed necessary to address the problem of market failure in providing financial services to the rural, low income segment of the population as the market for formal, regulated financial services to the poor was largely missing. A missing market implies that there is some obstruction to an efficient free market which would enable a Pareto efficient distribution of resources but for various reasons this market doesn't exist. This obstruction could involve poor information, high transaction costs or the inability to price all social costs / benefits e.g. through externalities. 'A market for a particular commodity will fail to exist when private calculations show that there is no profit in its existence. No price is quoted and no transactions can take place. Such markets are closed. Market failure arises when private calculations dictate a closed market, but a social calculation shows that a gain is possible through exchange. Government action can make profitable the establishment of a market when there is market failure' (Heller 1997).

The new Indian government took the view in 2004-05 that growth had to be more egalitarian and inclusive to be sustainable and that financial inclusion was an important component of the inclusive growth agenda. Empirical evidence also suggested that improved access to finance was not only pro-growth but also pro poor, reducing income inequality and poverty. For e.g., a broad cross country sample study[7] observed that the income of the poorest quintile grows faster than the average per capita GDP in countries with better developed financial intermediaries. Moreover, for poor households, credit is not the only, or in many cases the priority, financial service they need. Good savings and payment (domestic as well as international) services and insurance may rank higher (World Bank 2008). The Reserve Bank first articulated the term 'financial inclusion' in its Monetary Policy statement of 2005-06 by noting the extent of financial exclusion:

> ... there are legitimate concerns in regard to the banking practices that tend to exclude rather than attract vast sections of population, in particular pensioners, self-employed and those employed in unorganised sector. While commercial considerations are no doubt important, the banks have been bestowed with several privileges, especially of seeking public deposits on a highly leveraged basis, and consequently they should be obliged to provide banking services to all segments of the population, on equitable basis. Against this background, (1) RBI will implement policies to encourage banks which provide extensive services while disincentivising

[7] Finance, Inequality and Poverty: Cross-Country Evidence Thorsten Beck, Asli Demirgüç-Kunt, and Ross Levine, World Bank Policy Research Working Paper 3338, June 2004

those which are not responsive to the banking needs of the community, including the underprivileged. (2) The nature, scope and cost of services will be monitored to assess whether there is any denial, implicit or explicit, of basic banking services to the common person. (3) Banks are urged to review their existing practices to align them with the objective of financial inclusion.

In a way, this stand contrasted with the broad approach to banking adopted by the RBI since the 1991 crisis when under the structural adjustment policies (SAPs) a slew of financial sector reforms had been undertaken as per the roadmap provided by the Narasimhan Committee Report–I to enhance the economy's productivity in the long run and set it on a higher growth path. In the area of banking, the Committee emphasised moving towards "a vibrant and competitive financial system to sustain the on-going reforms in the structural aspects of the real economy" (1991). 'It argued for phased reduction of directed credit lending programmes, revoking branch licensing policy and deregulating the interest rate regime. Future branch expansion was to depend on need, business potential and financial viability of location... In a nutshell, the committee called for a new institutional structure that was market driven and based on profitability. This approach was relatively new compared to the 'social banking' approach followed till the end of eighties' (Mehrotra et al. 2009). Thus, there was recognition ab initio, that financial inclusion could be at odds with commercial considerations for banks but was nonetheless, their social obligation.

At a recent India - OECD - World Bank Conference on Financial Education, Governor Dr.D Subbarao, candidly admitted to such an obligation on behalf of RBI. To his own question as to why is the Reserve Bank - a central bank, in the forefront on a quintessentially development issue like financial literacy, he responded

> The Reserve Bank is in the forefront of financial inclusion and financial literacy campaigns because we believe that a banking regulator, particularly in a large developing economy like India, has a unique advantage and opportunity as also a *distinct obligation* to further these goals (2013).

The financial inclusion drive of RBI flagged off in the Annual Credit Policy statement of 2005 and the inclusive growth agenda of the Government that came to power in 2004, are roughly contemporaneous. By this time, RBI had gained a fair degree of independence in the conduct of its monetary policy. That RBI embraced the inclusion agenda of the government whole-heartedly, is indicative of its democratic accountability, which is evident when it is understood that the driving force behind all forms of accountability, is the democratic imperative for public organizations to respond to demands from elected politicians and the wider public. Indeed, it is accepted that if officials can be made compliant to their political superiors or responsive to public requirements then the main objective of accountability will have been achieved. The reverse causality is equally true: the nature of democratic accountability of the RBI was responsible for propelling the Bank to the forefront of the financial inclusion and literacy campaigns, since these were high on the agenda of the democratically elected government and also easily seen to benefit the people at large.

3. The Agency Problem

In a general sense, the agency problem for a banking regulator could be explained thus: the regulator authorises his 'agents' to enter the banking-services space subject to a certain understanding of what kind of conduct it would not condone, given its objectives as regulator of the financial sector. For example, it would deem as unacceptable conduct leading to systemic risk, risk of loss of depositor's money, loss of public trust in the banking system and flouting policy prescriptions of the regulator. These restrictions are 'costly' for the agent and against his propensity for profit maximisation. It is therefore, possible that the interests of the regulatory authority and the banking entity are not totally convergent giving rise to the principal-agent problem.

With respect to financial inclusion, the RBI in its capacity as regulator and principal of the banking sector had to endeavour to transfer its normative obligation to achieve financial inclusion - to banks, acting as its agents in a manner that would not be at odds with the agents' self-goals. And while, the regulator has the coercive authority or recourse to the fiduciary norm (in the language of Mitnick's agency theory) to insist on compliance to its directions issued in pursuance of its goals, unless these directions are in alignment with the own-goals of banks and ownership thereof assumed by banks, there would be moral hazard or an incentive on the part of agents to 'window-dress' their actions to simulate compliance.

The approach adopted by the Reserve Bank to promote financial inclusion was to mandate a series of actions and promulgate enabling provisions for scheduled commercial banks to increase their banking services outreach to the poorer sections and to the unbanked areas in the country. Some of the key regulations were as follows:

In November 2005, RBI asked banks to offer no-frills savings account which requires no (or negligible) balance and is associated with restricted facilities leading to lower costs both for the bank and the individual. Banks were required to provide all the material related to opening accounts, disclosures etc. in the regional languages. KYC procedures for opening accounts were simplified for no frills accounts. Banks have been asked to consider introducing *General-purpose Credit Card (GCC)* facility up to Rs. 25,000/- at their rural and semi urban branches without insistence on security. Next, banks were permitted in January 2006, to use other rural organizations like NGOs, self-help groups, microfinance institutions etc. for furthering the cause of financial inclusion. RBI encouraged the use of Bank Correspondents (BCs) and Information and Communications (IC) technologies to overcome the last mile problem for coverage of all villages with population of more than two thousand. Banks were directed to prepare Financial Inclusion Plans setting self-targets that were to be integrated with their overall business plans. Branch licencing was relaxed with the caveat that a certain percentage of total branches opened had to be in rural areas. Banks were also mandated to partake in financial education campaigns.

It can be surmised that the reason why RBI went ahead with the bank led approach to Financial Inclusion is that it is able to wield considerable control over the predominant segment of the banking services industry in the country i.e. the scheduled commercial banks (SCBs) comprising the public sector banks (PSBs, with the central government as majority share-holder), private banks and foreign banks. The remaining components, the RRBs and cooperative banks, taken together contribute only a small fraction of total bank assets and are partially controlled by state governments (see table below).

Consolidated Balance Sheet size by category of banks as on 31 March, 2012

(Rs in billion)

Scheduled Commercial Banks	Regional Rural Banks	Urban Cooperative Banks	All Rural Cooperatives	LABs
82,995	2,425	3,033	5,822	14

(Source : Report on Trend and Progress of Banking in India 2012-13)

While the RRBs, cooperative banks already have a regional, rural, small-borrower orientation, the SCBs are large, all-India entities, operating with the profit making imperative. Although about 72% of SCB assets are held by nationalised banks, in recent years there has been a partial reversal of the process with the once-nationalised banks being publicly listed but the government retaining the controlling share with at least 51% of the total stock. Foreign Institutional Investors (FIIs), who move around funds globally in search of profits, are permitted to invest in stocks of PSBs up to a ceiling. The limit is 20% of the paid up capital in the case of PSBs including the SBI. (At present, around 10% of SBI stock is held by FIIs). PSBs are thus commercial entities that have to compete for banking business and are not expected normally to be a burden on the government exchequer.

That financial inclusion might not be a profitable proposition immediately and there was a cost involved in this massive exercise of extending financial services to hitherto excluded segments of population, was recognised by Reserve Bank. The expectation was that such costs may come down over a period of time with the resultant business expansion. The Rangarajan Committee on Financial Inclusion noted that extending outreach on a scale envisaged under National Rural Financial Inclusion Plan would be possible only by leveraging technology to open up channels beyond branch network. Adoption of appropriate information and communication technology (ICT) would enable the branches to go where the customer is present instead of the other way round. The Business Facilitator/Business Correspondent (BF/BC) models riding on appropriate technology could deliver this outreach and should form the core of the strategy for extending financial inclusion.

Yet it must be noted that while ICT – BC combination can extend bank reach and reduce costs with scaling up of business, it adds another layer of agency (over and above that between central bank and commercial banks) with its own inherent costs and problems of designing suitable contract between the principal (i.e. bank) and the agent (i.e. BC). Over and above the cost of setting up agent chains, there are costs of monitoring of the relationship ('policing costs' in the terminology used by Barry Mitnick's agency theory) since any self–seeking or deviant behaviour by the agent could derail the efforts at inclusion, expose the bank to reputational risk that could prove debilitating to further progress. These considerations also entail costs of specification and ring-fencing. It may be added here that there is recognition in policy circles that the appropriate business model involving Business Correspondents has yet to evolve in India.

Further, given the enormous diversity of situations facing the poor, financial inclusion can be achieved only by understanding the needs of the customer and thereafter customising products for transactions, remittances, savings, loans and insurance. The need of a localized approach would require banks to rethink their policy on having uniform products for the entire country (Thorat 2006). Banks are expected to innovate 'with strategies and business models which are beyond the realm of conventional thinking'. For a large bank, this means that it cannot reap the benefit of its size or scale of operations by standardising and automating. Customisation of services adds to its costs.

Moreover, the very nature of financial exclusion means that the target group for inclusion is poor and generally lacking in education and awareness. It would take a certain amount of hand-holding of target groups to overcome their initial apprehensions and generate trust in the mainstream financial institutions. In this matter, not only are the *locally based* institutions better placed 'to enjoy greater acceptability amongst the rural poor and have flexibility in operations providing a level of comfort to their clientele' (Rangarajan 2008) but they will, in all likelihood, have a better knowledge and understanding of local conditions and issues specific to the rural poor. The intimate knowledge of the prospective clientele is especially important from the point of view of credit dispensation. The nature of credit markets is different from standard markets for commodities. Exchange is not contemporaneous. Credit received in the present by an individual or firm is exchanged for a promise of repayment in the future and there may be no objective way to determine the likelihood that the promise will be kept unless the creditor has familiarity with the specific borrower and his circumstances. Mehrotra et al explain how information deficit could foreclose the credit option :

> Since, the *expected return* to the bank depends on the probability of repayment, so from the bank's perspective it would like to identify borrowers who are more likely to repay. For identifying the good borrowers, banks use a variety of screening devices, including the interest rate. Those who are willing to pay high interest rate may, on an average, be more risky. They are willing to take higher risks to gain higher returns if successful, but such high returns are generally associated with a higher probability of failure, making it less likely that the loans will be repaid. As the interest rate rises, the average riskiness of those who borrow increases, as well as the possibility of reducing the banks' profits.

With information being imperfect and costly to gather, the banks may face adverse selection and moral hazard problems, making them reluctant to lend. It is not surprising therefore that the Rangarajan Committee Report on Financial Inclusion, strongly recommended harnessing those institutions that had a distinct local character such as RRBs, MFIs and cooperatives. The report said of RRBs

> RRBs, post-merger, represent a powerful instrument for financial inclusion. Their outreach vis-à-vis other scheduled commercial banks particularly in regions and across population groups facing the brunt of financial exclusion is impressive. RRBs account for 37% of total rural offices of all scheduled commercial banks and 91% of their workforce is posted in rural and semi-urban areas. They account for 31% of deposit accounts and 37% of loan accounts in rural areas... RRBs are, thus, the best suited vehicles to widen and deepen the process of financial inclusion (2008).

In regard to Micro Finance Institutions

Micro Finance Institutions (MFIs) could play a significant role in facilitating inclusion, as they are uniquely positioned in reaching out to the rural poor. Many of them operate in a limited geographical area, have a greater understanding of the issues specific to the rural poor, enjoy greater acceptability amongst the rural poor and have flexibility in operations providing a level of comfort to their clientele (ibid).

On the need to revitalise the rural cooperative structure

In terms of number of agricultural credit accounts, the Short Term Cooperative Credit System (STCCS) has 50% more accounts than the commercial banks and RRBs put together. On an average, there is one PACS for every 6 villages; these societies have a total membership of more than 120 million rural people making it one of the largest rural financial systems in the world... A financially sound cooperative structure can do wonders for financial inclusion given its extensive outreach (ibid).

From the perspective of agency theory, these three types of institutions are not acting as agents as far as financial inclusion is concerned. They are already regionally, rurally dispersed and their core clientele is the small borrower and the small saver and as such financial inclusion is within the realm of their 'self-goals'. With a little more support and planning these organisations can be inculcated with the expertise, attitude and interest to provide various financial services which the poor may need including savings, remittances, credit and insurance. By using local manpower resources and information, these organisations bring a sense of ownership and responsibility towards financial inclusion which would then not be deemed to be an 'other-goal' or an imposed task but the 'bread and butter' for these organisations. Thereby huge agency costs involved in efforts to promote inclusion via contracted intermediaries by remotely located institutions with limited manoeuvrability could be avoided.

4. An Assessment

Some factors which make it difficult for SCBs to extend their services to all economic and geographic segments of the population are: the insufficiency of their branch network and their need to employ agents to reach the target customer, inability to reap economies of scale given the requirement for customisation and the informational disadvantage vis-a-vis local actors. It is these factors that are at the root of the agency problem as they cause conflict with the fundamental commercial motive of these banks. Looking at regulation through the prism of the agency problem, does not negate the importance of regulatory objectives such as financial inclusion, but could bring to the table some standard mechanisms to deal with the problem such as incentivising banks in place of relying on command style of regulations. It could also focus on alternative means to achieve the objectives that pose lesser conflicts. For e.g., the Raghuram Rajan Committee Report seemed to think likewise when it pitched for a paradigm shift 'to alter the emphasis from the large-bank-led, public-sector-dominated, mandate-ridden, branch-expansion-focused strategy for inclusion' (2009). It recommended for more entry to private well-governed deposit-taking small-finance banks, offsetting their higher risk by certain regulatory means even though the Committee recognized that small banks have not distinguished themselves in India in the past. Alternatively, the Boston Consulting Group had proposed that Indian banks be allowed to explore the subsidiary route to drive down distribution costs in their financial inclusion drive (Brij Raj 2011). Also, commercial banks could provide support to what would be essentially local initiatives such as SHGs, MFIs, Cooperatives. These suggest that it is possible to address the problem, by suitable policy measures.

An important rationale of public sector banking and the kind of bank regulation that is aimed at development of weaker sections, backward areas, small borrowers etc. is to meet certain social objectives. Questions have been raised in the past whether we need to rely on the banking sector or are there other policy instruments (Singh 2002). In the context of alternative instruments for example, it has been pointed out that even capitalist countries like the USA have a much higher tax-GDP ratio than India and in many European countries this ratio is even higher than in the US. A direct method of meeting the social objectives could be to increase taxes and use the proceeds to promote socially desirable activities. One reason among others, for the reliance on the banking sector to be the instrument of socio-economic change is the democratic accountability of the central bank that makes the institution sensitive/responsive to the developmental needs of the society. It harnesses the resources of what are basically commercial entities, over which it can enforce its writ, for satisfying social objectives, in the process creating the conditions for the agency problem. Democratic accountability of RBI, in a sense, forces its hands. However, it must be added here, democratic accountability only potentially aggravates the agency problem for it is possible to ingrain in policy, features designed to ameliorate the problem by reducing areas of conflicting interest. The first step however would be to recognise the problem as such. It is also possible to turn around the argument a little and insist that for the sake of democratic accountability, the RBI must consider all issues that interfere with the 'success' of its socially-useful regulations and that include the agency problem.

Conclusion

While accountability has acquired many connotations in recent times, the core meaning of accountability remains a relation between an actor and a forum wherein the actor has an obligation to explain and to justify his or her conduct, the forum can pose questions and pass judgement, and the actor may face consequences. Democratic accountability refers to the relation where the forum to which a public actor is answerable is the citizenry at large, in whose name all authority is exercised in a democracy. From practical considerations, democratic accountability manifests as the obligation to be answerable to a democratically legitimised institution such as the parliament or the executive government. Given the various typologies of accountability, it is recognised that different accountability mechanisms are appropriate in different circumstances depending on an organisation's structure and nature of functions.

Central banks, being important public institutions whose actions have wide ramifications must adhere to the dictates of democratic accountability. While this requirement is found unexceptionable, the problem arises in defining and measuring democratic accountability of central banks. The academic literature on the subject is strongly influenced by issues relating to *independence* of central banks. Overall, the broad approach to evaluating democratic accountability of central banks found in the literature is to examine the legal framework regarding the precision of monetary policy objectives, transparency practices and final responsibility for monetary policy. It is notable that democratic accountability is discussed almost entirely in terms of the monetary policy function of the central bank although central banks, especially in the developing world, are entrusted with a number of other functions for which also, they are liable to be held accountable. There are moreover, difficulties in designing accountability mechanisms for central banks on account of certain special features of the monetary policy goals which are that inflation is not entirely in the control of central banks (especially in developing countries) and there are long gestation periods for policy actions to affect macro-economic outcomes. With 'uncertainties' thrown in, the result is that it is difficult to establish an exact correspondence between action and outcome making evaluation of central bank performance complicated. Recognising these complexities, many countries have chosen to rely less on formal ex post accountability mechanisms and more on an obligation for decision-makers to be transparent about the basis for their actions. Further, as monetary policy instruments are avowedly blunt instruments having economy-wide implications, central bankers must in principle, take ownership of the impact of their actions.

On these grounds there is a case for broadening the concept of democratic accountability of central banks.

When the Reserve Bank of India is considered against the Amtenbrink criteria, it shows up the central bank law for what it is viz. a law to enable the government to control the institution, not make it accountable. This is undoubtedly because the RBI Act is a pre-independence Act enacted by the colonial government which did not intend to slacken its hold on monetary administration and the Act was not amended in any significant way since. While the legal provisions generally used in the literature to assess democratic accountability and encapsulated by the Amtenbrink criteria, indicate an accountability deficit on certain counts, this study contends that one of the main pillars of the Amtenbrink framework i.e. the single objective for monetary policy, is not appropriate for India. This renders the rest of the Amtenbrink accountability-framework untenable as a measure of democratic accountability of the Reserve Bank.

Transparency, specification of its monetary policy objective(s) according to emerging situations, and explanation of the rationale behind policy actions are the most important aspects of RBI's current accountability framework. At present, RBI's transparency practices far exceed that mandated by formal disclosure requirements. The Reserve Bank recognises the informal channels of accountability and the vital role of financial markets in this regard. It has made its communications policy a critical component of its overall policy that allows it to influence expectations of inflation and interest rates, to enhance policy effectiveness. At the same time communication serves to 'demystify' the working of the Bank across the entire spectrum of its mandate.

However, given the special conditions that attach to central bank operations, the multifarious roles of the Reserve Bank, the structure of the economy, the state of development and the inevitable role of the government, there arises a rationale for extending the meaning of democratic accountability beyond traditional boundaries to refer to the degree of responsiveness, dialogue and engagement of the RBI with its ultimate constituency i.e. the general public and its representative forums. It may not be wrong to contend that the developmental orientation of the Bank does not stem from the RBI Act 1934 but from the degree of democratic accountability of the Bank whereby the economic objectives of the elected government, which must be considered as the repository of popular will in a democracy, get subsumed within RBI policies. In terms of this broader definition of democratic accountability, the Reserve Bank fares quite well. The critical test in this area is perhaps the extent of institutional trust it enjoys and in the words of Narendra Jadhav 'the degree of credibility that the Reserve Bank has earned over time. is in itself likely to be an effective instrument of monetary policy in meeting the challenges of the future.'

The second part of the dissertation introduces the Agency Theory in the backdrop of the concept of regulation as an exercise in modifying individual / collective behaviour according to some accepted norm. It was demonstrated how bank regulation in particular, could be viewed as an agency problem wherein the central bank as regulator acts as the principal to banking entities under its jurisdiction – who act as its agents.

In this context, the regulations in respect of financial inclusion – which ranks high on the priorities of RBI – are examined. This study finds instances of goal conflict within the agency theory framework between the RBI and the scheduled commercial banks through whom the financial inclusion program is sought to be mostly implemented. The bank-led BF/BC model of inclusion is subject to the agency problem as the scheduled commercial banks are large, all-India entities, operating with the profit making objective while it is recognised that financial inclusion might not be a profitable proposition, at least immediately, and that there is a large cost involved in this massive exercise of extending financial services to hitherto excluded segments of population. It is contended that with the BC-led strategy, costs might not come down even in the long run. On top of normal operational costs, the model adds considerable agency costs by way of monitoring, specification and ring-fencing costs for the banks that use intermediaries. Factors which make it difficult for SCBs to extend their services to all economic and geographic segments of the population and are thus at the root of the agency problem are: the insufficiency of their branch network and their need to employ intermediaries to reach the target customer, inability to reap economies of scale given the requirement for customisation and the informational disadvantage vis-a-vis local actors. By looking at the problem through the prism of the agency theory, it is possible to consider alternative styles of regulation such as incentivising banks or considering alternative actors who face lesser conflicts of interest.

The relationship between the agency problem as embodied in the regulations aimed at financial inclusion and RBI's democratic accountability is that the latter obliges the Bank to synchronise its efforts with that of the government on a program seen to hold immense potential to benefit the economy and society. While the main entities under RBI's tutelage are the scheduled commercial banks and constitute the mediators through whom RBI seeks to implement socially-desirable goals, it becomes susceptible to the agency problem since the mediators in question might find it inherently difficult to align the regulatory goals with their self-goals. In this sense, democratic accountability could aggravate the agency problem which anyway exists to some degree between all regulators and regulatees since all compliance is costly. However, if the agency problem is recognised, it can be 'watered down' by suitable (re)design of regulations. It follows from what has been stated so far that on account of the character of its democratic accountability, RBI could get into an agency trap by pushing banks into taking actions for which they are not very suitable. But at same time it must be recognised that the very same character of democratic accountability would demand that RBI's regulations are designed to minimise the agency problem so that the objectives of the regulations are actually fulfilled and not derailed by agency.

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