Monetary Policy and the Dilemma of Self-Respect in India

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Abstract

The case deals with the famous conflict between the ministry of finance and the governor of RBI regarding formation of monetary policies in Indian context. Although such conflicts have been occurring for quite a long period of time but it became quite an issue during August-September, 2016 when a famous economist, despite working immensely well as a governor, was not renewed for another tenure. The root cause of such a decision was though to be his conflict with the finance ministry as well as with the Prime Minister. We have made an attempt to explain the behavioural attitude of both the parties and looked to capture their behaviour by the help of a game theoretic approach.

Key Words: Monetary Policy, Game theory, Self-respect

The Case: Introduction

We can have multiple uses of game theory and at the same time throw some light on the debate between Ministry of Finance or even Prime-Minister with the Governor of Reserve Bank of India. The long-standing debate between the role of RBI's governor and Ministry of Finance regarding formulation of effective monetary policy in India is a well-known phenomenon. RBI, if not every time, had well qualified, well renowned economists as its Governor. All the governors played their parts in the formulation of effective monetary policies that has taken the nation ahead. It is to be remembered that the post of RBI's governor is for a period of three years. But there are multiple

examples of Governors who have served for more than three years or even less than that. India also got good economists as its finance minister, especially in the post-liberalization era. But, intervention of ministry of finance started to be heard of every time regarding the formation of monetary policies but such facts never took the shape of any big issue till 2016.1

A famous economist took charge of the RBI's governor in September 2013. This person, being a well renowned economist worldwide, earned immense popularity by correctly predicting the Economic Recession of 2008-2009 and held other prestigious positions in world famous institutes. India, on the other hand, after three decades of multi-party coalition governments, formed its first single party government in 2014 with the Prime Minister, being projected as a 'Hero' by the ruling party and viewed by millions of people, was supposed to solve all sorts of problems the nation was going through, including the economic ones.

The Governor, during tough times, served really well and helped the Indian economy to perform exceptionally well in so many monetary and social aspects, since monetary policies do bear deep impact on all the economic activities. But, again the problem of intervention started to come from the Ministry of Finance and even from Prime Minister's office as they tried to impose their policies on RBI. On the other hand, the government initiated many social projects related to monetary aspects that tasted success on ground reality. So, government wished to enjoy its advantages as policies by the Prime Ministers whereas the RBI believed it was the outcome their effective monetary policies that had brought prosperity and stability in economy. Such controversies regarding the successes of various social as well as monetary policies, every now and then, started to appear in the news. Every now and then,

1 Since this is a real case, names of the protagonists are not used.

it was heard that the Governor denied to accept Government's recommendations or partially accepted it and maintained his dominance in the formulation of policies. Even on few cases, the Governor had criticized Government's policies and workings.

As the time went on, the tenure of the RBI Governor neared its end, demand came up from parts of the society to extend it, for his excellence service and his eligibility as the best suited person for

that post at that time. Another part of the society was of the view that there was no need to extend his tenure, as any other Governor would serve equally well like him under the guidance of Ministry of Finance and the Prime Minister himself. So, a battle of trustworthiness versus self-respect had developed gradually but surely. Both thought they knew the economy well which was right and both thought they could serve it better than the other.

On 26th June, 2016, the Governor announced that he does not want to serve another tenure as the Governor, that is, after finishing the first one in September, 2016, nor the Government asked him to do so, though there were appeals from different parts of the society on behalf of his continuation. Ultimately, the Governor served only one tenure and quitted in September, 2016.

A huge part of population was shocked and perplexed as the Government did not offer him a second tenure. Many were shocked that the Governor did not join hands with the government and did not succumb to the demands of the government for the sake of such a prestigious position. We may apply game theory to find a surprising answer of this jostling between the two as well as understand various aspects of the usefulness of this tool. We know that both the persons were at two poles regarding few decisions and were proud of themselves as well as stubborn, in nature. So, let us begin by considering the pay-off matrix of monetary policy before the Governor was not retained.

Faced with "command" from the Finance Ministry and Prime Minister's office to implement their recommendations in the monetary policy, the Governor could do either one of the two things – concede to the Government or not give way. Similarly, the Government had two options to deal with the obdurate, headstrong Governor – either not renew his tenure or keep him.

For the sake of keeping the game simple, we rank the preferences of the possible outcomes from worst to best and assign the respective pay-offs the numbers of 1 to 4. The Governor had made it clear that he had no intention of accepting government's recommendations in

monetary policies, unless he believed it was good enough for the nation. So, the worst outcome for him was to concede but then not be retained, so this outcome would have a payoff of 1 for him. The second worst outcome was to concede and be retained for another tenure but then his self-respect would have been pounded and the independence of the Reserve Bank would have been

compromised. The third worst outcome was not to concede and also not be retained. Though he might lose his position, he might still maintain his integrity and coming years could prove his stances were much better. Governor's strongest preference would have been not to concede as well as be retained for another tenure. This outcome would have a pay-off of 4 for him. This would mean he had defeated the Finance Ministry and the Prime Minister in the two-way gamesmanship. Meanwhile, the worst outcome for the Prime Minister would be for the Governor to defy his commands but be retained as the Central Bank Governor. This outcome would have the pay-off of 1. The second worst option for the Governor to go for a negotiation but for the PM not to retain him, in order to avoid any future problem. The third worst scenario for the P.M. was not to retain him for his insubordination. P.M.'s highest preference would be for the Governor to fully agree with his demands so that he would not have to get rid of him and retain him for another tenure. This would have the pay-off of 4.

Questions

1) Describe the type of Game that is involved in the above situation.

2) Draw a game tree of the situation with appropriate payoffs.

3) By using the Backward induction method, analyze the game tree and discuss the results observed.

4) Is there any Nash Equilibrium in this game? Find out, if any.

5) Which strategy would have benefitted the nation most?

References

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