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INDEPENDENCE AND ACCOUNTABILITY: ON RBI

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

Far from achieving a desirable ‘monetary-fiscal coordination’ in India today, the Reserve Bank of India (RBI) and the government give the impression that they are not on the same page even as far as an understanding of their roles is concerned. This may be seen in statements by them on websites, Twitter and in the old-fashioned mode of the public lecture given by the Finance Minister and a Deputy Governor of the RBI, respectively. The RBI suggests that its independence is being violated while the government rationalises its intervention in terms of its concern for the economy. How do we make sense of these positions?

Even at the time when the idea of central bank independence began to germinate some two decades ago, this was understood to mean a ‘functional’ independence. That is, the bank would be unconstrained by the government in its functioning, which includes both the instruments it uses and how it uses them. However, its autonomy was not to extend to ‘goal’ independence. What the goals of the central bank should be were to be chosen by the government without reference to the bank. The main issue here was whether the bank should focus on inflation alone or also on the level of employment. Within a decade of this debate, it had been conceded that the focus would be exclusively on the former, and monetary policy came to be identified with ‘inflation targeting’.

Wilful on defaulters? : on RBI

Two points may be mentioned in this context. First, the discourse was solely among interlocutors from Western democracies, ensuring the issues were those related to their economies. Second, even as the major central banks of the world shifted to inflation targeting, in yet another example of American exceptionalism, the U.S. did not revise the goals of the Federal Reserve. It was to continue focus on maximising employment while keeping prices stable, a sensible recognition of a possible trade-off between these goals. In India where for close to a quarter century political parties of all hues appear to suggest ‘what is good for America is the best for India’, this has been missed. In 2015 the RBI was by law, in line with a “modern monetary policy”, expected to target inflation. It was to remain the banking regulator though.

Once we are aware of how central bank independence was first sought to be understood and of the agreement between the RBI and the Government of India in 2015, it is not difficult to separate the grain from the husk in the public spat between the two playing out in the media. The issues of contention happen to be the corrective action to be taken for stressed banks, the prudential norms to be adopted by financial institutions, the easing of liquidity and the sharing of the surplus generated by the RBI. Here, barring the last, all others are in the RBI’s bailiwick so to speak. On the other hand, on the sharing of the surplus, it is understood that the Government of India legally is the owner of the surplus generated by the country’s public institutions. Even under this architecture, though, all care must be taken to ensure that the central bank’s reserves are of a level commensurate with the extent of the financial sector and the potential degree of systemic risk from its malfunctioning, which can vary. So, we can’t go just by formulae here.

Tussle for power: what's the RBI-government stand-off?

Apart from the issue of sharing the surplus, the RBI should be left alone by the government to decide on the right course of action. This derives not so much from a notion of central bank independence as it does from the point of view of a credible governance policy. The Government of India would have chosen the Governor, participated in the choice of his deputies

and had a say in the appointment of even the independent members of the central board of the RBI. In addition, the board has representatives of the government on it. It should now be left to this body to decide on the precise corrective action for banks with high NPAs, the desirable state of liquidity and the prudential norms to be observed by banks. The RBI is the banking regulator after all, and for the government to attempt to direct it would constitute micro-management.

Stepping away from legal niceties, there is reason to believe that some of the actions being sought to be imposed on the RBI today could jeopardise the stability of the economy. While acting as the lender of last resort can be stabilising, under no circumstances would it be advisable to lower prudential norms in the presence of stressed banks. The government's concern for the health of the medium and small enterprises is well-founded. After all, they were among the most affected sections following the demonetisation of 2016. If, in the spirit of contriteness as it were, the government wants to reach out to them, the right course would be to provide interest rate subvention, rather than to force the RBI to tweak its lending norms. There is a severe lack of judgment in loan melas promising online sanction in less than an hour. There is the suggestion in this of the political business cycle, a government trying to nudge the economy prior to an election. The resistance of the RBI top brass to this desperate action is understandable.

Whatever may be the misfeasance of the government in its recent dealings with the RBI, however, it would yet be acceptable to review its own performance in the sphere in which it has an untrammelled independence, namely monetary policy. Under this arrangement it has control over the interest rate. Over 2013-2018 there has been a 5 percentage point swing in the real interest rate in India, moving from a negative to a positive level, making it among the highest in the world, much higher than that of China. This is clearly the consequence of an exclusive policy focus on inflation from even before inflation targeting was formally adopted by Parliament in India. It may well have contributed to slow industrial and export growth, due to a real appreciation of the rupee, and a rise in NPAs even after their existence had been recognised. If this is the monetary policy that central bank independence brings with it, we might just be a little sceptical of the value of the independence itself.

There is a certain populism inherent in privileging inflation control to justify extraordinarily high interest rates. While it would be bad economics to tolerate high inflation, the absence of inflation by itself only benefits those in employment, it does not assure jobs to the unemployed. Thus a monetary policy that ignores the impact of its actions on unemployment is not credible. Interestingly, the government and the RBI have always been on the same page as far as inflation targeting is concerned. The populist message that inflation erodes the income of the poor conceals the possibility that in the implementation such a policy could hold back job creation by restricting investment. The rising current account deficit, the slow growth of employment and the disappointing performance of manufacturing, the sector most closely affected by high interest rates, should prompt us to review how monetary policy is conducted in India. In the past, the RBI had a 'multiple indicators approach' which paid attention to inflation, growth and the current account. This may not have borne the precision conveyed by 'inflation targeting' but it did answer to Keynes's dictum, "It is better to be vaguely right than to be precisely wrong."

Pulapre Balakrishnan teaches economics at Ashoka University, Sonipat, Haryana

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