India's Central Bank and Finance Ministry Must Introspect Before Rushing to Battle*

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The ongoing differences between the Reserve Bank of India (RBI) and the government over the central bank's autonomy, specifically in terms of decision-making, is a classic example of how the weakening of the domestic institutions can potentially destabilise the economy.

As for the role of institutions in an economy, there is a wealth of literature on the two schools of thought on institutions and their role in an economy. In terms of 'old institutional economics' – subscribed to by economists like Commons, Veblen, Hodgeson and Galbraith among others – individuals are considered to be susceptible to (or moulded by) the influence of the prevailing institutions and cultural situations. Thus institutions are considered to be important agencies that influence the behaviour of individual agents in markets with their "informational-cognitive" functions.

As interpreted above, business concerns and strategies are influenced by institutions. They usually influence and exercise a major role on those decisions in market economies. Depending on the business environment and the direction of change in the prevailing institutions, the impact can be facilitating or destabilising.

With markets uncertain, and uncertainty as such subject to grading, institutions may reduce or enhance uncertainty and thereby change the level of confidence. Norms and prescriptions offered by institutions can thus be responsible for the varying responses in the market.

The role of institutions deserves a mention in relation to the current state of the Indian economy and the rift as has come up between the central bank and the official treasury, represented by the Ministry of Finance. These are in the context of the current situation where the financial sector has been facing multiple problems which include the shortage of liquidity and the related drop in credit flows.

The issue, however, is just the tip of an iceberg which has been building up over some time, with the piling up of non-performing assets (NPAs) in both state-run and private banks, the near-collapse of the non-bank financial corporates (NBFCs) including the bankruptcy of the IL&FS and the credit squeeze faced by the MSME concerns, to name a few.

The drop in credit availability is currently viewed with concern by the finance ministry, which seeks a remedy with demands on the RBI to make available additional cash. Demands as above have met with displeasure from the RBI which considers such moves as an infringement on its autonomy.

Large NPAs

Problems in India's financial sector can be related to several aspects of its functioning which include both the changing policies and the failure of governance to tackle the problems has emerged. The Indian 'big-bang', which started with the budget announcements in July 1991, was targeted to gradually remove regulations in most spheres of the economy.

While it is questionable whether the desired goal of de-regulation in achieving market efficiency was actually realised, in the meantime the opportunities as well as interests for speculative transactions generated a distinct sphere of financial activities in markets bearing no links to real activities. Examples of those speculative transactions include the use of futures and other derivatives in markets for equities, real estates, currencies and commodities.

With returns on the financial transactions at levels higher than those in the real sector, corporates, as well as households, prefer speculation rather than real production as the main arena of their activities.

Tendencies as above can be held in part responsible for the large NPAs of banks, which are mostly related to the large corporate borrowers. Citing the financial stability report of the RBI, it was reported that "in March 2018, large borrowers accounted for 54.8 % of gross advances and 85.6% of GNPAs". This goes with the high ratio of NPAs to gross assets at scheduled commercial banks (SCBs) at 22% in March 2018.

NBFC crisis

Problems in India's financial sector also prevail in the non-bank finance corporations (NBFCs). This is despite a large section of those being subject to the prudential regulation and provisioning norms set by the RBI. NBFCs have been borrowing heavily from the financial system in the country, with the SCBs, followed by mutual funds, as major lenders.

The recent crisis at IL&FS, which met with near bankruptcy, and similar situations with the housing finance corporations reflect the seriousness of the issue. A large part of the problem with the NBFCs is related to an asset-liability mismatch incurring short-term liabilities (to SCBs, mutual funds and insurance companies) which can not be met by their long-term assets, consisting of investments on infrastructure, housing and other long-term projects.

A major factor behind the mismatch has been the total absence of development banks in India like IDBI, ICICI, and IFC – all of which transformed into commercial banks.

The NBFCs sought to fill the vacuum left by the development banks by meeting the much-needed demand for long-term finance for infrastructure and housing construction. The consequence of this has been one of chaos and instability in the financial sector, especially since the NBFCs happen to be large borrowers from the financial sector.

RBI, Centre face-off

Questions naturally have arisen as to who should assume responsibility for the current mess. This has lead to demands for remedial action in order to arrest further instabilities, which brings us back to the role that institutions play in such situations and the conflict between the two wings of the official agencies in India headed by the finance ministry and the RBI.

The government, expressing concerns over the fragility prevailing in the financial sector and the related credit stringencies has sought remedies which include: easier norms prescribed by the RBI on credit flows from the SCBs (especially vis a vis small and medium businesses), recapitalisation of the banking system including the NBFCs (the latter by infusing funds from LIC, in charge of household savings over long-term), easing of capital adequacy norms and the like. Not much is offered as official explanations from the finance ministry on the factors that have been responsible for the present debacle in the financial sector. Given that the finance ministry suggestions entail the injection of liquidity, the idea is to make use of resources (primarily reserves and some dividends) at the central bank.

Suggestions, as above, from the finance ministry, have met with sharp disagreements expressed by senior officials as well as the staff members of the RBI.

While pointing at the lack of governance over the financial sector which has led to the current situation fraught with fraudulent transactions, the RBI is opposed to a relaxation of the prudential norms for credit and the idea that the situation demands the use of its official reserves. The latter, as deputy governor Viral Acharya pointed out recently, is considered to be an infringement of the central bank's autonomy.

It remains, as fact, that since 2003, net flows of foreign institutional investment had a substantial effect on changes in the official reserves held at the RBI. One has to recall in this context how those reserves were built up in India, reaching the latest peaks at $400 billion and above. The balance, rising from a paltry sum of $4.38 million in April 1991, reached $107.4 billion and $281.5 billion by April 2004 and April 2014 respectively. Unlike in China where exchange reserves were largely contributed by substantial trade surpluses the country earned, foreign exchange reserves in India have grown mostly with inflows of capital and that too of a short-term variety.

The pattern thus has been one where the level of official reserves has no longer been subject to the goals set by the RBI as national monetary authority. Instead, it has been dependent on the sentiments of the portfolio managers as to when they flock in or desert the Indian capital market. An encroachment of the foreign currency reserves in the interest of meeting the shortfall in domestic credit naturally may call for "wrath of the market" in the long or even the medium-run.

What then comes out as the current message from institutions in India to the public?

The differences between the two wings indicate the need for introspection as well as responses on part of the contending authorities. This requires the finance ministry to look back at the stages which brought in the current mess in the financial sector and try to implement remedies which rectify a recurrence of the irregularities and fraudulent practices as have been allowed in the past. Short-term remedial measures to infuse liquidity in the system which include the stalling of the prompt corrective action (PCA) framework, the sanctions to the SCBs to bypass safe prudential limits to lending by using the deposit money at stock may only work as stop-gap remedies that actually bring in further rounds of crisis of a more serious order.

To the extent the finance ministry has already hinted that in addition to relaxing the regulatory norms, the RBI should transfer additional liquidity as dividends and even make use of forex reserves, there have been sharp reactions from the central bank. As rightly held, such reserves, much of which relies on short-term FII inflows in past, cannot be depleted to supplement flows of domestic credit.

But the RBI, the other wing of the financial sector, also needs to introspect on the past, including its compliance during demonetisation which had a disruptive and contractionary influence on the economy. Also, no matter what anyone says, the central bank cannot be held immune to the mis-governance at various banks, which have come out in the open in recent times.

Conflicts between different wings of official institutions as in India at present reflect the need for an agreed solution, based on an honest attempt to identify the lapses in financial governance, with suggested remedies that do not encroach on each other's responsibilities as well as rights.

This is the only way to ensure that institutions can have an effective role in providing a stable order for the financial sector as well as the domestic economy.

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