On taking Sides in the RBI-government Stand-off *

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Unlike in the worlds of business and politics, there is little scope for gossip in the world of economics. So, when multiple signals suggested that that there was a stand-off between the government and the Reserve Bank of India (RBI), the media made the most of it, with a multitude of stories reporting and explaining the nature of the spat and its implications. Given the formal economic arguments that must enter those discussions, there is much that the lay reader cannot process to assess which of the two institutions is right in this controversy. However, the thrust of the reportage has been that, the reason the two institutions are at cross purposes, on issues varying from banking regulation to control over the payments system and rights over the central bank's surpluses, the government is trespassing into what is a sacred space reserved for technocrat central bankers and undermining the independence of the central bank. That is not all correct.

There is cause for confusion here. The government after all has a major say in the appointment of the central bank's governor, its deputy governors and its boards. Though it is true that once appointed it is difficult to dislodge these officials from their positions, their terms of three years or less are short. How independence can be ensured in such circumstances is unclear. Moreover, the idea of central bank independence did not emerge solely from the central bank but was one of the tenets of the policy of financial liberalization and 'reform' that successive governments have adopted since the early 1990s. The decision to do away with the practice of unilateral "monetization" of the government's budget deficit, by borrowing from the central bank against the issue short term treasury bills, was one step in giving the RBI and its monetary policy initiatives a degree of independence. Since then many further steps in that direction have been adopted, including the agreement between the RBI and the government on constituting a monetary policy committee that would independently and by majority decide on the monetary stance and change in policy interest rates to be periodically adopted by the central bank. Thus, the degree and nature of 'independence' of the central bank has been decided in consultation with and acceded to by the government rather than being won by the former.

All this occurred not just because of the government's own commitment to reform, but because this stance on the role of the central bank is the preferred policy choice of international finance, the presence and role of which in the economy has increased hugely. If the doors to cross-border flows of finance are opened, and government policy is influenced either by a desperate need to attract capital inflows or to prevent the outflow of foreign capital that has already entered the country, then the macroeconomic policy choices made are in keeping with the preferences of global finance. So, once the capital account is liberalized, governments eager to please international finance make a strenuous effort to display their commitment to monetary and financial reform of a particular kind, in which central bank adherence to a set of pre-specified monetary policy objectives and practices, is a basic tenet. Thus, the central bank must be independent of the government to adopt such a monetary policy framework, but its independence cannot extend to choosing an alternative monetary policy regime.

World over, such ‘independence’ is associated with adherence to a conservative monetary policy focused on inflation control, even if that is achieved at the expense of growth. Inflation that erodes the real return on financial assets and undermines the real value of financial assets is anathema to finance capital. So, since fiscal deficits are seen as potentially inflationary, fiscal conservatism is the preferred stance of finance. And monetary policy, finance holds, must be focused on targeting relatively low inflation. But this is the view of finance and not of an ‘independent’ central bank. There is no overriding consensus on what objectives should govern central bank practices and what those practices should be. But finance capital and its advocates have argued for a kind of central bank independence in which one kind of policy frame is the only one acceptable. “Reformist” governments committed to pleasing finance have accepted this recommendation. And, so has the government of India.

There is one fundamental flaw in this case for central bank independence in developing countries. That stems from the fact that the movements of globalized finance, which is the source of the view that the central bank should be independent, can themselves undermine that independence. Thus, for example, if liberalized rules on cross-border flows result in an increase in the volume of capital inflows from abroad, a consequence is a strengthening of the domestic currency, which raises the dollar prices of exports from the country concerned and undermines their competitiveness. So, the central bank has to intervene in currency markets to buy up foreign currency and prevent appreciation of the domestic currency, resulting in an increase in its foreign currency asset holding. This increase on the assets side of the central bank’s balance sheet is matched by an increase in its liabilities, which is nothing but an increase in money supply. Note here that the volume of money supply is not being determined directly by the central bank but by the decisions of foreign players that influence the volume of inflows of capital from abroad. All the central bank can do is try to to neutralize the effects of such inflows by “sterilizing” them, or by reducing the volume of other assets it holds, through sale of its holdings of government securities for example. To the extent that it cannot fully sterilize the flow, money supply increases. In sum the central bank may, by arrangement, be relatively independent of government interference with much policy autonomy, but it is not truly independent in a world of liberalized capital flows. In which case the legitimacy of the independence claim is clearly in question and can be violated when needed.

However, in normal times, the arrangement between the government and the RBI, which grants the latter some independence, does not create too much of a problem. But the times currently are not normal. Capital is flowing out of India because international interest rates are rising. Banks are saddled with large non-performing assets, which is forcing them to hold back on credit provision. Non-bank financial companies are imploding, led by IL&FS. The result is a liquidity and credit crunch that hurts small and medium businesses. Meanwhile, an election approaches, with the economy still to get over the adverse shocks delivered by demonetisation and the introduction of the GST. From the point of view of the BJP and the government, increased expenditures on sops and schemes are called for to woo the voter, but this is hardly the moment to rile finance with a larger fiscal deficit. The government finds itself trapped by the failures of its own neoliberal policies.

In the event, the government has turned to its ‘independent’ central bank for help. Reduce interest rates, it says, to kick-start the economy a bit. But the RBI, hiding behind the monetary policy committee, is not willing to oblige the government, going only part of the way in small and slow steps. The government wants the central bank to relax the curbs it has placed on loss making banks burdened with bad assets, so that they can extend credit and implement the Prime Minister's desire to rain credit on the small sector. The RBI says that it cannot approve and facilitate such 'populist' policies. The government wants the RBI to relax regulatory guidelines so that liquidity can flow more freely from the banking system into the economy and facilitate production and investment, but the RBI say there is no problem on the liquidity front. The government wants the RBI to transfer Rs. 3.6 lakh crore out of its Rs.9.59 lakh crore reserve to the budget, so that government expenditures can soar without violating fiscal deficit targets. The RBI says that would be disastrous since the reserves it holds are strategic in nature. Finally, the government wants to handle the regulation of a range of favoured private and new-fangled payments companies and banks, but the RBI rightly wants to retain that turf as the sole regulator of the payments system. In essence, an RBI that went along meekly with the government decision to demonetize high valued notes, despite some objections it had, has now turned adamant and is using the 'independence' fig leaf to refuse to tow the government's line. It is almost as if it feels that behind all the sweet talk on independence from the government it has been humiliated enough, and cannot take any more.

At one level the RBI's position is not all defensible, and the government has a point. Put simply, while the central bank is not politically accountable to anybody by virtue of its leadership being unelected, the government is. This could result in situations where the government would prefer adoption of policies that are not in keeping with the tenets of reform as prescribed by the community of finance. That seems to be the case now. But the central bank whose independence the government acceded to is not willing to go along. This may not be for the right reasons. A typical example of this is the preference of the RBI, committed to inflation targeting, for high interest rates, in keeping with the notion that a tight monetary policy is needed to keep inflation expectations in control. Besides the fact that the relationship between interest rates and inflation is empirically weak at best, this does adversely affect demand and growth and favours rentier income earners rather than those looking to invest in productive activity.

Moreover, the RBI cannot wash its hands of the problems facing the banking system, saying that being publicly owned they are state and not central bank-controlled. With financial liberalization of the kind adopted in India resulting in a near wipe out of development banking institutions, and bond markets being inadequate as channels for financing long term investments, the task of filling the gap for long term finance fell on the banks. In normal circumstances banks would not fund long term, because of the maturity mismatches between the sources of their capital (mainly short term deposits) and such long term commitments. Moreover, long term commitments are far more illiquid than the liquidity expectations of those who provide banks with their capital. But with the Indian commercial banking system being largely publicly owned and with an implicit promise of sovereign guarantees on bank lending, the banks, post-liberalisation, were made the principal source for long term finance, leading to huge maturity, liquidity and risk mismatches. The result has been what should be expected: a sharp rise in non-performing assets in the books of the banks, that is now posing the threat of insolvency. While it is true that government policy was primarily responsible for this outcome, the central bank as regulator of the banking system is also culpable. Neither did it object to the government's policies, nor did it intervene to prevent excessive maturity and liquidity mismatches. So, it too is responsible and has a role to play in redressing the problem. However, the central bank has suddenly turned independent here as well, prescribing harder rules for recognition of bad assets and calling for unassisted bank action, under the 'prompt corrective action'or PCA framework, to correct for the problem. This action, coming after the onset of a crisis, is only worsening matters and leading to credit curbs and a liquidity crunch, with adverse effects on growth and the performance of small and medium businesses. A politically accountable government cannot accept that outcome, at least in election year, since it penalizes even those who are not loan defaulters or responsible for designing the policies that went wrong.

While the Modi government has combined neoliberalism with the pursuit of the most bizarre economic policies to drive itself into the mess it finds itself in, that does not justify a central bank committed robot-like to targeting inflation and claiming that it is responsible for little else. No case can be convincingly made that the central bank's independence must in principle be protected at the expense of all else. In fact, rather than the current "dispute", the real problem is that there is too much "in principle" agreement on the issue of central bank independence between the government and the central bank.

That being said central banks as institutions have an important role to play in regulating and monitoring the banking system and managing the payments and settlements system, besides aligning monetary policy to socially acceptable goals such as output and employment growth, rather than mere inflation targeting. In those areas they are one among the institutions that provide the checks and balances to ensure that narrow interests and objectives do not hijack policy. It is here that the government has crossed the red line in recent times, influenced in part by the mess its policies have created and substantially by the need to win voter support in the impending elections. This clearly is an area where the RBIs willingness to stand up to the government's demands needs appreciation. But these gestures should not be treated as a spat in which the RBI is free of blame and only the government is remiss. The central bank too needs to shed its biased neoliberal perspective and admit to responsibility for its past acts of commission and omission that have also contributed to the current mess in the economy.

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