



India

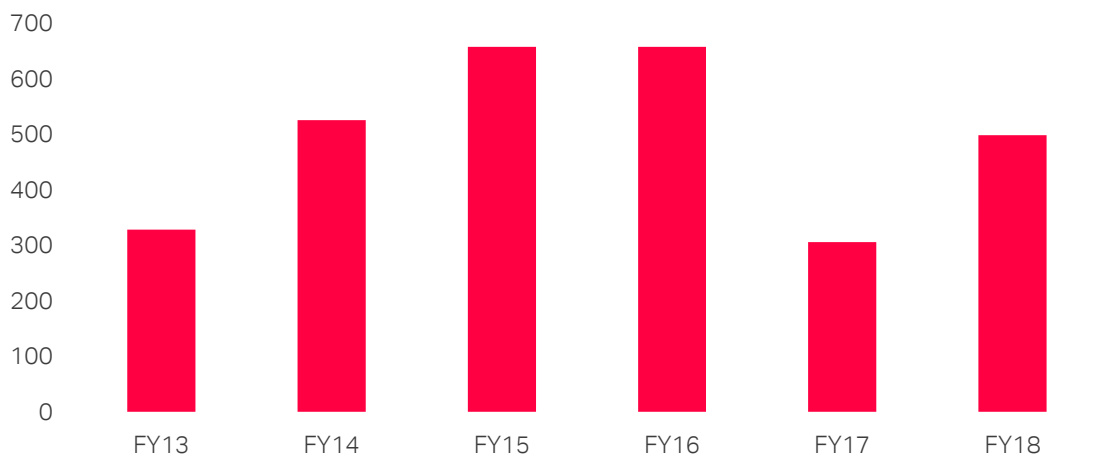
HIT TO CENTRAL BANK CREDIBILITY

Shumita Deveshwar

Reserve Bank of India Governor Urjit Patel resigned on 10 December following weeks of acrimony between the central bank and the government over issues ranging from the use of the RBI's reserves to the handling of commercial banks' non-performing loans.

- **Governor's exit signals irreconcilable differences with the government**
- **Government will push to use RBI reserves and ease financial norms**
- **Credible replacement needed to restore RBI's institutional autonomy**

RBI dividend to the government (Rs bn)



Source: RBI.

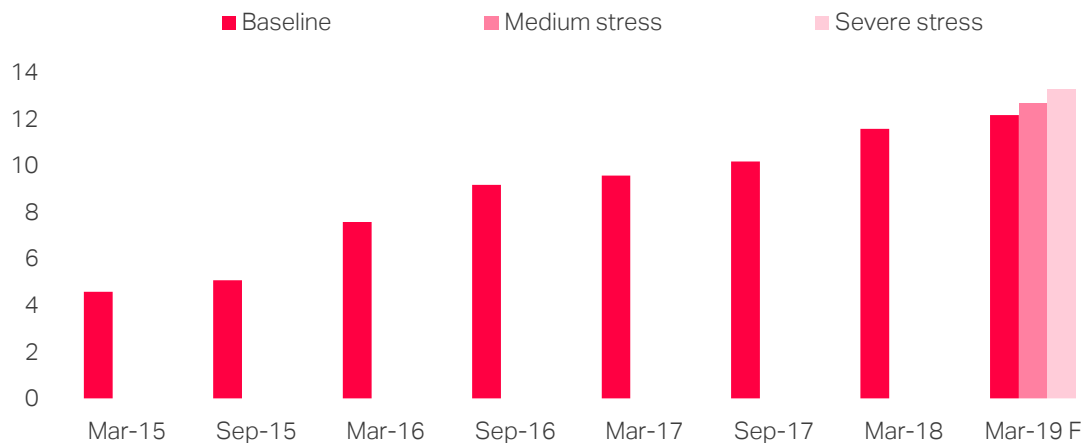
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Resignation follows weeks of acrimony

Following RBI Governor Urjit Patel's resignation, concerns have risen on whether other top officials will also resign, especially Deputy Governor Viral Acharya who had in the first place spoken publicly against government efforts to influence central bank policies (see our 31 October 2018 report [Costs of the RBI-government spat](#)). The central bank clarified late Monday evening that Acharya has not quit, but Patel's exit signals that the differences between the RBI and the government were irreconcilable.

The RBI and the government have been at loggerheads for many weeks now over various issues. They range from the use of the central bank's reserves (the government apparently wants greater access to reserves to help fund its fiscal deficit) to the handling of banks' non-performing loans (with the government arguing that the stringent rules have hurt credit growth). The government has also been asking the RBI to provide more liquidity support to help non-bank finance companies as well as small- and medium-sized firms, but the central bank has seemed wary of risking longer-term financial stability for a short-term push to economic growth. Banks' non-performing assets (NPAs) are expected to continue rising in the current fiscal year, having increased sharply since the RBI forced banks to proactively declare their stressed assets as bad loans (see chart below).

Gross NPAs (%)



Source: RBI.

Deputy Governor Acharya in his October speech had warned that using RBI reserves to fund the fiscal deficit would erode confidence in the government's fiscal consolidation plans, and the central bank itself would stand to lose credibility in the event of a capital shortage. The RBI has been paying hefty dividends to the government, having transferred Rs500 bn of its surplus reserves in FY18 after a gap in FY17 due to the large costs it incurred in managing the November 2016 currency notes ban. The government has denied that it needs the RBI's reserves to help meet its FY19 fiscal deficit target of 3.3% of GDP, but it is widely expected to miss its aim of narrowing the budget gap from 3.5% in the previous year. And as we have pointed out in our previous research, the overall fiscal deficit that includes the budgets of the states is large (see our 21 June 2018 report [Welfare tilt hits fiscal credibility](#)).

Patel's replacement key for rebuilding credibility

Although some investors have criticised the RBI's tough stance with regard to banks, the Governor's resignation will still worry them as it damages the institutional credibility of the central bank. The rebuilding of trust in the RBI's autonomy will depend on whether the remaining top leadership of the central bank stays intact as well as on who the government chooses to replace Patel. A government bureaucrat, for instance, will do little to help shore up the RBI's credibility whereas an eminent, independent economist with no political links will be an ideal candidate. Just a day before Patel's departure, IMF Chief Economist Maurice Obstfeld said that the RBI's emphasis on financial stability is correct, and "it is important for the government to heed that".

We believe that the new RBI Governor will likely be sworn in with a pre-agreed agenda, given the high levels of acrimony between the government and the last two central bank heads. Patel replaced former Governor Raghuram Rajan, whose outspokenness and open disagreements with the Finance Ministry cost him an extension to his tenure (with all his predecessors in recent history getting a two-year extension to their three-year terms). Just two months after Patel took office in September 2016, Prime Minister Narendra Modi announced the shock currency notes ban that took 86% of the notes in circulation out of the system overnight. Rajan had opposed the idea of demonetization while in office. The negative fallout of the cash ban led not only to an economic growth slowdown, but the RBI employees union complained about the Finance Ministry's alleged interference in central bank functioning. Patel – a far more reticent personality than Rajan – started to gradually state his differences with the government from early 2017 onwards.

The RBI's board has been overactive of late, and following a nine-hour long meeting in mid-November, the central bank issued a rare press release in which it detailed various steps decided by the board, including the constitution of an expert committee to examine the RBI's Economic Capital Framework (which in effect means the use of the bank's reserves). Economic Affairs Secretary Subhash Chandra Garg, who also serves on the RBI board, subsequently said that the government will insist on more interim dividends from the central bank, and he also said that the government wants to discuss changes to the RBI's governance structure to enable greater supervision at the next board meeting, which is scheduled for 14 December.

Conclusion

Patel's departure comes just days before that board meeting, and also a day ahead of the results of key state elections – the last major round of polls before Modi's re-election bid in April-May 2019. The state election campaign was a tough fight between Modi's Bharatiya Janata Party and the main opposition Congress party, and as we found during our visit to the states of Madhya Pradesh and Rajasthan in late November, voters appear disenchanted from the still frustratingly slow pace of economic progress (see our 29 November 2018 report [On the road: Polls signal swing against Modi's BJP](#)). Modi is under pressure to ramp up economic growth, and the RBI's autonomy and credibility may just be a consequent casualty.

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