India

# COSTS OF THE RBI-GOVERNMENT SPAT

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Deputy Governor Viral Acharya's speech last Friday on central bank independence brought the rift between the government and the RBI glaringly out in the open. As speculation ran rife on whether the government will invoke a provision that allows it to issue directions to the RBI on matters it considers necessary for public interest, the Finance Ministry today de-escalated tensions by saying it respects central bank autonomy.

- The RBI appears to have forced the government to back off, at least for now, with the Finance Ministry finally saying that it respects the RBI's autonomy as it sought to calm jittery investor nerves.
- But Governor Patel's days as the RBI chief seem to be numbered; even if he stays on in his post for now, he will – like his predecessor Raghuram Rajan – not receive an extension to his term that ends in September 2019, especially if the current government is re-elected.
- RBI worries over its independence are not isolated; other institutions have complained of erosion of autonomy while Finance Minister Arun Jaitley has questioned whether "the authority of the elected" is being weakened by "non-accountable institutions".
- A key bone of contention between the RBI and the government is the use of central bank reserves: the government wants the RBI to transfer its surplus reserves (that will help fund the fiscal deficit), but is facing stiff resistance.
- This raises fresh concerns over the government's ability to meet its budget targets amid rising macroeconomic headwinds in a politically crucial year.
- Bank credit growth will suffer: the RBI will stand its ground on tighter lending norms while the government will not cede control, resulting in a standoff.

# Strong support for Acharya at RBI

**The government finally felt compelled to issue a statement today that served to de-escalate tensions with the RBI, saying it respects the RBI's autonomy.** Prior to that, speculation was rife that it could take the unprecedented step of invoking Section 7 of the RBI Act that allows it to issue directions to the central bank on matters it considers necessary for public interest. According to various media reports, the Finance Ministry has come close to doing so in recent months, having written "letters of consultation" under Section 7 without yet directing the bank to follow its orders. The subjects of the letters are reported to have varied from the RBI's handling of weak state-run banks and tough lending norms to the use of central bank reserves.

**Those letters could possibly have been the trigger for RBI Deputy Governor Acharya's 26 October strident speech calling for central bank independence.** Acharya had strong support for his views: a key aspect of his lecture titled "On the importance of independent regulatory institutions – the case of the central bank" was the footnote, where Acharya expressed gratitude to Governor Urjit Patel for suggesting the theme of his speech and acknowledged many of his colleagues at the RBI for their inputs. Acharya also cited a 2013 paper he co-authored with Rajan on government myopia and populism, and thanked former Deputy RBI Governor Rakesh Mohan for his insights. He quoted Mohan extensively in his talk, especially his views on the transfer of RBI's surplus reserves to the government that Mohan has termed a "raid" on the central bank's capital.

**Acharya spent much time in his speech focusing on the dangers of transferring central bank reserves to the government,** using the extreme example of the 2010 Argentine crisis. Acharya pointed out that the then Argentine central bank governor Martin Rebrado quit his post due to the "government's permanent trampling of institutions" following a government decree to transfer US$6.6 billion of the central bank's reserves to the treasury. An ensuing constitutional crisis resulted in a severe widening of the sovereign credit default swap spread, and investors filed a lawsuit in New York claiming that the central bank was no longer autonomous, but under the thumb of the Argentine executive branch.

**The analogy to Argentina was severe in our view, but it makes us suspect that the pressures on the RBI were intense for it to react this way.** The RBI under its current leadership has been far more reticent than under Rajan, whose outspokenness on various issues was criticized by some as being out of the ambit of a central bank governor's role. Acharya's speech has faced criticism too, with some commentators of the opinion that an open fight with the government will damage India's economy.

# Questions on institutional credibility

**Finance Minister Jaitley has not reacted directly to Acharya's speech but the following day, he questioned whether "the authority of the elected" is being weakened** and a "power shift in favour of non-accountables [institutions]" being created. His comments were meant for a wider set of institutions, not just the RBI. There has in fact been increasing concern about government interference in other institutions as well, most recently with the removal earlier this month of the head of the Central Bureau of Investigation (India's top law enforcement agency) and in the judiciary. Four senior Supreme Court judges had in January 2018 held an unprecedented press conference where they questioned the inner workings of the apex court.

**The government's appointment of S. Gurumurthy as a director on the board of the RBI in August was also controversial as he has strong political leanings,** and is affiliated with the right-wing Rashtriya Swayamsevak Sangh (that in turn is linked to Prime Minister Narendra Modi's Bharatiya Janata Party). Given his strong support of Modi and the November 2016 demonetization drive, his appointment is viewed as being political. He had also in the recent past posted tweets heavily criticising the RBI's policies on cleaning up banks' balance-sheets.

**Gurumurthy took to Twitter again on 29 October, declining a media report that he put pressure on the RBI to ease credit to small firms and relax lending norms.** He said that of the five issues discussed at the October RBI board meeting, there was disagreement only on one – although he did not specify what that was. (On a separate but relevant issue, the Delhi High Court on 30 October initiated contempt proceedings against Gurumurthy for retweeting a blog alleging bias and impropriety in a judge's decision to release a rights activist from house arrest. Gurumurthy had earlier tweeted that the judiciary was in a "sorry state".)

# Key challenges to RBI's autonomy

**Acharya's speech had sought to reassert the RBI's independence, and he issued a warning,** saying that "governments that do not respect central bank independence will sooner or later incur the wrath of financial markets, ignite economic fire, and come to rue the day they undermined an important regulatory institution". The RBI has been increasingly assertive since early 2017, following doubts cast on its credibility after the government's demonetization drive, as we had pointed out in our earlier research.

**The RBI Deputy Governor cited three key issues as challenges towards maintaining the RBI's independence:** regulation of public sector banks, the use of the RBI's reserves and the central bank's regulatory scope. He said that the RBI's effective independence on these issues will secure greater financial and macroeconomic stability and be a "true inclusive reform" for India's economic future. We briefly analyse below the progress on each issue:

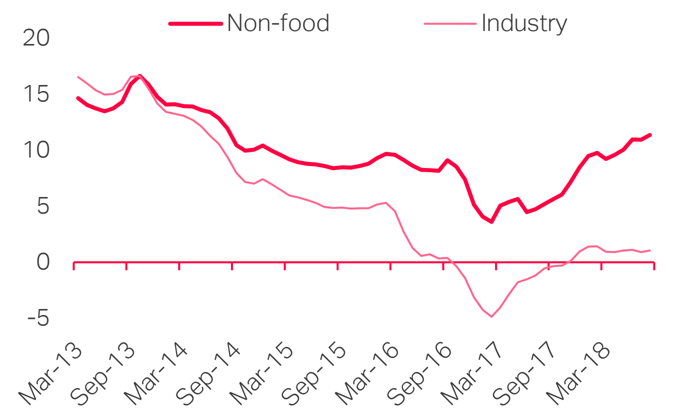
- **Public sector banks**: The RBI has been asking for greater regulatory powers over state-run banks, especially since the massive US$2 billion fraud by the second-largest state bank Punjab National Bank, earlier this year. The government blamed the RBI for failing to detect the fraud, but Governor Patel countered that dual regulation of state banks by the Finance Ministry and the central bank, as well as weaker market discipline mechanisms for state banks had a role to play.

  Acharya made a reference to a March 2018 speech by Patel in which the Governor had called for making bank regulatory powers ownership neutral. But the government is reluctant to cede managerial control, as is evident from the no-go on its privatization programme and the sale of one state-run bank to another (bank or insurance company, as was the case with IDBI Bank's sale to Life Insurance Corp.).

  The government is also calling for easier regulatory control over poorly performing public sector banks to help improve their credit growth. The RBI has put 11 state banks under its Prompt Corrective Action (PCA) framework that limits a bank's operations in order to de-risk a bank's asset size and stabilize its health. However, some of the banks' losses widened after being put under the PCA, while lending to corporates has been muted and recovery of stressed assets from the bankruptcy resolution process has been slow.

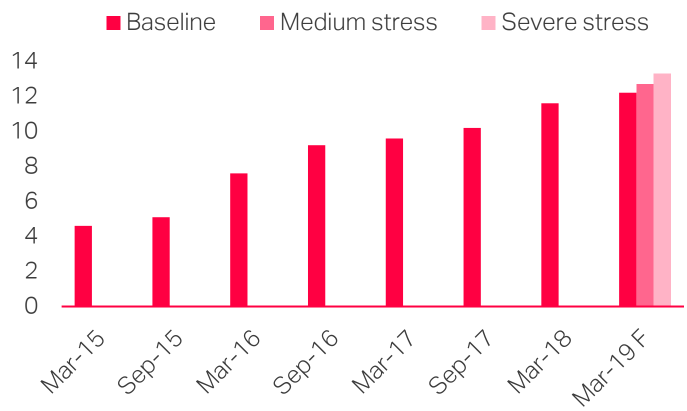
  Another flashpoint on the banking sector is the RBI's so-called February 12 circular that asks banks to take all large accounts over Rs20 bn for insolvency proceedings if a resolution plan is not agreed upon within 180 days, and forces lenders to declare a borrower delinquent if payments are overdue by even one day. The government and businesses have argued that these restrictions are too tough, and the banks meanwhile continue to struggle. The RBI believes this will make the recognition of stressed assets more efficient and transparent, thereby averting in the future a repetition of the current credit crunch owing to the large amounts of bad debt on banks' books. As the chart on the right below shows, non-performing assets (NPAs) are forecast to rise further to at least 12.2% by March 2019 from 11.6% of total advances at the end of FY18.

**Bank credit growth (3mma, % yoy)**




Source: Bloomberg.

**Gross NPAs (%)**




Source: RBI.

- **RBI's reserves**: The Deputy Governor cited an August 2018 media report that said Finance Ministry estimates show that the RBI has Rs3.6 trillion excess capital to share with the government. It had said that government officials feel the central bank is being extremely conservative in its assessment of capital buffers to meet market risks.

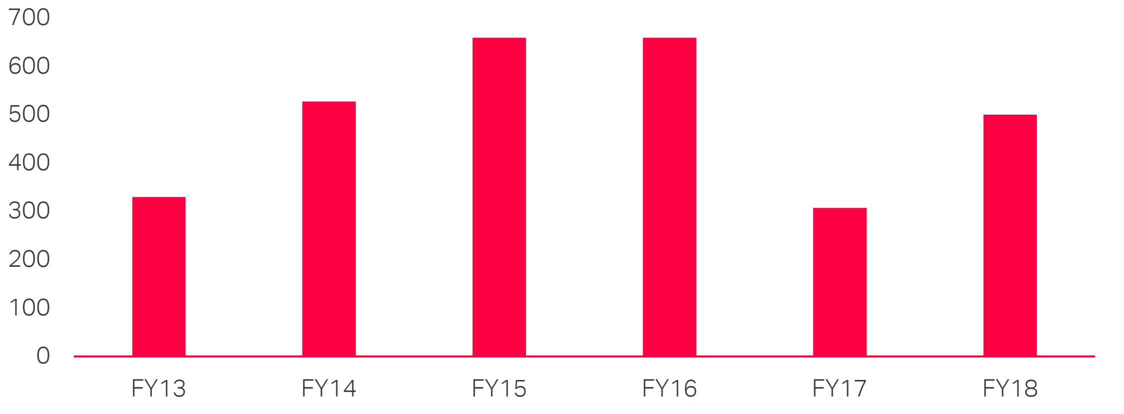
  Acharya called this a "thorny issue" and extensively quoted an article by former Deputy Governor Mohan that denounced the use of the reserves for reasons including longer-term fiscal consequences (the same as issuing new government bonds to fund spending), an erosion in confidence in the government's fiscal consolidation plans, and the central bank itself losing credibility in the event of a capital shortage.

  The RBI spelt out its dividend policy in its August 2018 annual report, which said that it will stagger the distribution of its surplus reserves. It said that as the RBI's reserves have historically witnessed a cyclical trend due to volatility in market forces, and as it needs to maintain a very large open forex position to achieve its public policy objectives, it needs the reserves to reduce the impact of cyclicality. It added that the same approach for surplus distribution cannot be applied across central banks due to the varied economic and political environment under which they operate.

  The government believes that the RBI's profits ultimately belong to the government, and given that India's central bank is one of the most well-capitalised in the world, it has enough cash to spare. The Finance Ministry has made a case for using RBI reserves to help recapitalize state-run banks, but former RBI Governor Rajan had resisted the idea, saying that it would amount to the RBI as banking regulator getting into the business of owning banks with the attendant "conflicts of interest".

  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 currency notes ban (see chart below). Prior to that, the RBI under Rajan had transferred Rs658 billion to the government over two consecutive years. But clearly the government wants more (Rs500 bn from the RBI in FY18 constituted only 3% of government revenue in the last fiscal year).

**RBI dividend to the government (Rs bn)**




Sources: RBI, Bloomberg.

- **Regulatory scope**: Earlier in October, the RBI had released a dissent note against a government committee's recommendation to appoint a separate payments regulator. The central bank had said that there is "no case" for a separate regulator, and such a regulator amounts to bypassing the RBI's powers.

To be sure, the speech was not an unrestrained admonishment of government action. Acharya credited the current government for its far-sightedness in legislating the formation of a Monetary Policy Committee and thereby distancing itself from decisions on monetary policy. He also noted that the RBI's relatively new inflation-targeting mandate also safeguards against use of monetary operations to fund the fiscal deficit as well as leaves exchange rate management to the central bank. Furthermore, he acknowledged that the erstwhile repressive levels of the Statutory Liquidity Ratio and the Cash Reserve Ratio, which ensured substantial amounts of bank deposits were channelled to the government, have steadily reduced and continue to be rationalised.

# Conclusion: A bumpy road ahead

**The current government is worried about the sluggish economic recovery, and with no quick fix to these problems, it will keep the pressure on the RBI to ease its policies.** The RBI's clear threats forced the government to back down, for now, and as the markets started to react to a possible erosion of central bank credibility, the Finance Ministry finally said that it respects central bank autonomy. Jaitley's criticism of the RBI's delayed reaction to the mounting bad loans just a day prior had seemed to worsen the standoff with the central bank, but clearly at this juncture, the government thought it would be hazardous to attack the current RBI leadership without causing an adverse fallout, such as the departure of central bank officials. The RBI leadership had strong backing from within its ranks, former central bankers and the RBI's employees association, which on 29 October issued a statement saying that "undermining the central bank is a recipe for disaster and government must desist (from) it".

**The RBI's top leadership has made it evident that it will stand its ground on the three issues it has specifically mentioned** – the state-run banks, the use of its reserves and its regulatory scope. Acharya's speech clearly suggests that the RBI was frustrated with government interference. Noting the need for central bank independence from the "over-arching reach of the state", he said that although the RBI and the government have clashed several times in the past as well "governments have in the end had the wisdom to support it [the RBI]". That was a signal to the Finance Ministry to back off.

**It will be important to keep an eye on the developments at the RBI in the coming weeks and months as its relationship with the government remains contentious.** India also has a long road ahead towards reforming its banking sector. Both Patel and Acharya have in their speeches quoted the 2017 Financial Sector Assessment Programme of India by the IMF and the World Bank, which stated that the RBI's powers to supervise and regulate public sector banks are constrained. The banks' balance sheet clean-up process as well as the fledgling bankruptcy process will be long-drawn, and the banking sector will be a key reform area to monitor even after the 2019 elections.

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