ISAS Brief
No. 614 – 7 November 2018

The RBI versus the Government: Much at Stake

Vinod Rai

Summary

The Reserve Bank of India (RBI) and the Indian government seem to have locked horns again. The differences seem to be getting more strident. The RBI clamping down on lax banks and restraining non-banking financial companies and the government appointing its own preferred persons on the RBI Board as well as attempting to whittle the RBI's independence have been the instigating factors. This is not new but needs to be curbed quickly by both agencies sitting together with a constructive mindset.

Importance of Institutions

Institutions are the edifice on which democracy is premised. Good and independent institutions contribute to the vibrancy and robustness of the democratic functioning. Certain institutions take birth from the constitution and others are created by statute. Irrespective of their genesis, the autonomy that they enjoy in their functioning determines the efficacy by which they fulfil their mandate. Regulatory institutions arise out of a statute and are created to permit the government an arm's length functioning such that their expertise and professionalism can be exploited objectively. It is with this objective that central banks have been created in each country. In India, as in most other countries, the central bank – the Reserve Bank of India (RBI) – has been assigned the principal function of regulating the monetary policy. In order to effectively perform this role, it needs to be permitted a certain degree of autonomy and independence, with attendant accountability. The finance ministry manages the fiscal policy.

Differences between the RBI and the Government

It is not the first time that these authorities are on the wrong side of each other. It may not be the last either. In 1935, Sir Osborne Smith resigned over differences with government. Governors Benegal Rama Rau (1957), K K Puri (1977) and R N Malhotra (1985) resigned due to differences with their finance ministers. On the other hand, history records that major differences have also been quietly resolved in the best interest of the country. This time around, the interlocutors on both sides seem to have taken rigid stands from which they cannot be seen to be withdrawing.

What are the differences?

The RBI's tough action on certain banks by putting them under prompt corrective action, thereby curbing their capacity to lend and putting a restraint on non-banking finance companies, seems to make the government feel that liquidity in the market has dried up, thereby restricting credit growth. The perception is that loans to the micro, small and medium enterprises as well as the agriculture sector would not be forthcoming. These, however, are the more obvious differences. There have been more strident differences on an attempt by the government to set up a parallel regulatory agency (the Payment Regulatory Board) to perform financial intermediation, thereby eroding the RBI's remit.

Differences have also emerged on personalities occupying board positions in the RBI. The term of Nachiket Mor, a monetary expert and well-known banker, was truncated to appoint S Gurumurthy, a chartered accountant but who is better known as a Rashtriya Swayamsevak Sangh ideologue. The government is also poised to take a hefty surplus from the RBI's reserves, a move perceived to fund its fiscal deficit.

Governments, across the globe, have had differences with their central banks largely because the former act under shorter time frames under political compulsions. The central banks plan with a longer perspective. The RBI is presently in the midst of managing a difficult monetary environment with institutions such as the Infrastructure Leasing & Financial Services Limited having defaulted on its liabilities. Nevertheless, the government would like to persuade it to give growth a chance, obviously with demonstrated fiscal correctives to ensure that there is no spike in inflation since credit growth is dormant. This critical juncture calls for concerted action where the monetary authority and the fiscal authority have to walk hand in hand. Planting a couple of politicised personnel on the RBI Board is a non-issue. There are enough number of experts and monetary specialists to drown discordant and possibly uninformed opinions. Every previous governor has had to contend with such situations. A most recent example was that of United States' (US) President Donald Trump publicly disagreeing with the Federal Reserve. The US has probably had the most strident disagreements among policymakers. The net result of all the debate, which quite often was in public domain, did lead to some synergistic policy improvements.

Much is at Stake

The country can ill afford a discordant economic policy construct at this juncture. For the government, the elections loom close ahead. For the RBI, the non-performing assets build up and the implosion of financial institutions could cast a shadow on its regulatory capability. Neither can see the quality of its governance being impaled. It is not too late for mature and sedate minds getting together on both sides, setting their differences aside and rising to the occasion to ensure that the economy is on an upward gradient. The RBI has been granted a voice by the government. It speaks and administers on behalf of the government. The government, on the other hand, has a responsibility to its electorate. It cannot belie that trust. Its supremacy has to be preserved. Lesser mortals than those presently at the helm of affairs on both sides have resolved their differences in the past. There is no reason why the present dispensation cannot do it. In fact, posterity will never pardon them if they do not do so.

. . . . .

Mr Vinod Rai is Distinguished Visiting Research Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. He is a former Comptroller and Auditor General of India. He can be contacted at isasvr@nus.edu.sg. The author bears full responsibility for the facts cited and opinions expressed in this paper.