ISAS Brief
No. 636 – 22 January 2019

Ferment at the Reserve Bank of India: Resetting the Relationship with the Government

Duvvuri Subbarao

Summary

A public spat between the Reserve Bank of India (RBI) and the Government of India that festered for over four months towards end 2018 culminated in the resignation of Governor Urjit Patel and the swift appointment of veteran civil servant Shaktikanta Das as his successor. Reportedly, the root cause of the differences was the RBI's reluctance to accommodate the government's plea for a softer regulatory and monetary policy stance that would have aided economic activity. Even as the dispute has gone to the background, there are continuing concerns about the extent to which the RBI's prized autonomy has been eroded. Among the many challenges for Governor Das will be to remove misperceptions in this regard.

Background

The Reserve Bank of India (RBI) made front-page news for much of the last four months of 2018 because of an acrimonious spat with the government on a host of policy issues. The friction culminated in the resignation of Governor Urjit Patel on 10 December 2018 and the swift appointment of veteran civil servant Shaktikanta Das as his successor the very next day. Although Patel mentioned that he was quitting for personal reasons, the widely held view is that he resigned in protest against the government's attempts to direct RBI policy in ways that infringed on its autonomy.

Government-RBI Differences

What can be gathered by piecing together media reports is that the differences between the government and the RBI centred on the latter's policies that restricted the flow of credit for economic activity, including housing, construction and the small and medium industry sector. Heading into an election in less than six months, the government feared that a slowdown in economic activity would hurt its electoral prospects and wanted the RBI to be more accommodating.

In addition, the government, strapped for budgetary resources, wanted the RBI to pay a higher dividend instead of holding back such a large chunk of its surplus for reserve build up.

Government-Central Bank Differences Not New

Tensions between governments and central banks are neither unique to India nor are they new.

The most recent dispute between the government and the RBI, however, stands out as a departure from the past. In the past, the differences between the government and the RBI were sorted out by finance ministers and governors through background discussions and compromise, whereas this time round, the differences played out in the public domain over an extended period, bringing both parties to cliff edge brinkmanship. Also, whereas the friction earlier was largely apolitical, in this round, it became politicised with opposition leaders joining issues; the dispute also figured in the parliament.

Rationale for Central Bank Autonomy

Guarding an economy's monetary and financial stability requires the adoption of a policy stance that takes a long-term view even if decisions guided by that view might inflict some pain in the short-term. Democratically-elected governments, driven by electoral compulsions, are tempted to compromise long-term sustainability for short-term political gains. For example, a government looking for short-term growth gains, might drive down interest rates so low that it sets off runaway inflation or print so much money that it becomes worthless. Hence, the need for an apolitical central bank, autonomous of the government and free from short term pressures, to ensure long-term monetary and financial stability.

It is well recognised though that the autonomy of a central bank cannot be absolute. After all, a central bank is led by unelected technocrats whereas it is the elected government that is accountable for the outcomes of economic management. Experience from across several countries and over time has shown that the best way to manage this tension is for the government to set the mandate for the central bank in terms of inflation, growth and employment targets but leave the latter free to deliver on that mandate. In other words, central banks enjoy only instrument autonomy but not goal autonomy.

Dramatic Events Leading to Patel's Resignation

Events unfolded quite dramatically over the last few months – a board meeting of the RBI in October 2018 which reportedly featured sharp exchanges between the RBI management and some external directors, including government representatives, a strongly worded speech by Deputy Governor Viral Acharya shortly thereafter, where he warned that "governments rue the day they step on the toes of central banks", an unusual press statement by the government, evidently in a bid to calm agitated markets, affirming its belief in central bank autonomy, and some provocative tweets relating to market conditions by senior officials of the government.

Although Patel's resignation was being speculated upon for several weeks, when it did come, it caused surprise. The public understanding was that in a follow up board meeting in November 2018, the government and the RBI reached a workable agreement on resolving the differences. Evidently, that was not the case. What must have pushed Patel to the brink were reports that the government was contemplating invoking a never before used provision in law to issue ‘directives’ to the RBI in ‘public interest’. Patel must have decided to quit rather than face the humiliation of implementing a directive against his better judgement.

Challenge for the Incoming Governor

The incoming governor, Shaktikanta Das, has a well-deserved reputation for competence and professionalism. Nevertheless, because he is a former civil servant, there is speculation that he would be malleable to government influence and will, in the process, compromise the RBI’s hard earned autonomy. One of his many challenges will be to counter this view by acting in the larger public interest regardless of short-term compulsions and, importantly, be seen to be doing so – a formidable task under any circumstances, but particularly so during the election season.

Governor Das will be judged by how quickly he is able to push the RBI from the front-page back to the business page where it belongs.

. . . . .

Dr Duvvuri Subbarao is Distinguished Visiting Research Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore (NUS). He is a former Governor of the Reserve Bank of India. He can be contacted at subbarao@gmail.com. The author bears full responsibility for the facts cited and opinions expressed in this paper.