

# ISAS Insights

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## Ten Challenges for the New RBI Governor

*The new Governor of the Reserve Bank of India, Urjit Patel, has assumed office in relatively calmer times. Of his two immediate predecessors, Duvvuri Subbarao headed into the global financial crisis within less than two weeks of assuming office in 2008, and Raghuram Rajan came in the midst of a rupee crisis in 2013. Now, growth is on the uptrend, inflation is largely on target, fiscal consolidation is on track and the political situation is stable. Nevertheless, there is no dearth of challenges for Patel.*

Duvvuri Subbarao<sup>1</sup>

Urjit Patel, incumbent deputy governor, took over as the twenty-fourth governor of the Reserve Bank of India (RBI) on September 4, 2016. His appointment to succeed Raghuram Rajan to the top job at the RBI has been widely hailed for the policy continuity it will bring. Patel has impressive academic credentials, wide experience in private and public sectors and a reputation as an intelligent policy economist. His biggest asset by far is that he chaired the committee which recommended fundamental changes to India's monetary policy framework which have since been statutorily enshrined.

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During the process of selection of the new governor, which lasted nearly two months and when the government played its cards close to its chest, there was speculation that the government will choose someone with known sympathies for growth concerns who will therefore reverse the tight policy regime that Governor Rajan had run. By opting for Patel who, it is believed, shares Rajan's policy proclivities, the government earned brownie points for not compromising the long term sustainability of the economy for short term compulsions.

Unlike his two immediate predecessors – Subbarao, who headed into the global financial crisis within less than two weeks of assuming office in 2008, and Rajan, who came in the midst of a rupee crisis in 2013 – Patel steps into the top job at the RBI in relatively calmer times. Growth is on the uptrend, inflation is largely on target, fiscal consolidation is on track and the political situation is stable. Nevertheless, there is no dearth of challenges for him. This paper discusses ten potentially top challenges for the new governor.

Let us start with inflation control, the bread and butter job of any central bank. The new inflation targeting framework enjoins the Reserve Bank to deliver on 4% inflation. Admittedly, the framework allows a generous tolerance band of  $\pm 2\%$  around this central number, implying that inflation anywhere in the range of 2 to 6 per cent will be within target. Nevertheless, the market has a tendency to ignore this band, and Patel's credibility will be on the line if he strays far away from 4%.

Achieving 4% inflation is going to be a daunting challenge given the supply side drivers of India's inflation over which monetary policy does not have much influence. Also, several factors which kept inflation subdued during the Rajan years – low oil and commodity prices, dampened rural wage growth and low export demand - may reverse course pressuring inflation. Even as these compulsions will compel Patel to run a tight policy, there will be pressure on him to slash rates, especially as the government enters its fourth year in office and will be under pressure to spur growth as it approaches the next election. How Patel manages this classic growth-inflation tension will be a test of his leadership skills.

A related challenge in the monetary policy arena, and second in the list of challenges, will be institutionalizing decision making under the soon to be established Monetary Policy Committee (MPC). Even discerning analysts fear that a shift in decision making on monetary policy from the governor as an individual to a committee, half of whose six members will be nominated by the government, will entail a risk to the autonomy of the central bank. The concern is that government appointed nominees will compromise their professional judgement and push for the softer interest regime typically desired by the government even if that threatens inflation. This concern is perhaps exaggerated, and both the government and the yet to be constituted MPC deserve the benefit of the doubt. How Governor Patel institutionalizes the MPC process to ensure that decision making remains objective, and is widely perceived to be objective, will be crucial in preserving the policy credibility of the RBI. The protocol and conventions he establishes for the MPC functioning will also determine Patel's legacy.

Beyond monetary policy, Patel's biggest challenge, and the third on this list, will be to bring the task of bank balance sheet clean up initiated by his predecessor to a logical closure. The first step of this task, pressuring banks to recognize all bad loans beyond reasonable doubt, is nearing completion. The second step will be to ensure that banks are recapitalized to make up for these losses. Much of this burden of recapitalization will be on public sector banks and therefore on the government. A resource-constrained government with an onerous commitment to fiscal responsibility will be tempted to resort to some clever financial engineering to shore up bank capital. Should that be the case, Patel will have to speak up to ensure that the recapitalization is credible and robust even if it might force the government to take some politically risky, even unpopular, decisions.

India's huge need for infrastructure investment – of the order of two trillion US dollars over the next five years – is well known. Finding financing of this order has been a mind boggling challenge. Infrastructure projects are long gestation and are typically financed by the bond markets. In India though, in the absence of a deep and liquid commercial bond market, the burden of financing infrastructure has fallen on banks. There is a limit to how much banks can stretch to meet this demand given that their liabilities – deposits – are short term while financing infrastructure, which is long term, entails an asset liability mismatch. There is also a limit to how much of regulatory forbearance RBI can

allow the banks to facilitate infrastructure financing without compromising bank safety. The obvious solution is to develop a deep and liquid bond market which has so far eluded India.

Among the last policy decisions of outgoing Governor Rajan has been to bar banks from lending to corporates with more than Rs. 260 billion (USD 4 billion) of debt on their balance sheets starting Fiscal Year 18. The hope and expectation behind this regulatory tightening is to force large corporates to access the bond market and thereby give it depth. Pursuing this decision will pose complex dilemmas on several fronts. First, can Patel stay firm with this decision in the face of potentially large credit demand that will come from telecom companies to pay for the spectrum they will get under the proposed auctions or from bid winners of the large smart city and freight corridor projects? Second, will there be demand for these bonds or is there a risk of the costs getting unviably high for the corporate bond issuers? Third, will RBI turn into a market maker by accepting these bonds for repo purposes? How will it affect financial stability? Developing a robust, deep and liquid bond market can be expected to be a continuing challenge during Patel's three year term.

Given that the government's fiscal profligacy has historically been a major driver of India's inflation, one of the critical responsibilities of RBI governors has been to point this out unequivocally in order to pressure the government into fiscal correction. That the present government has shown admirable commitment to fiscal consolidation is a comfort for many reasons, and specifically from the Reserve Bank's perspective, for the relief it will bring to combating inflation. There is always a risk though that the government may stray from this commitment out of electoral compulsions or resort to some off balance sheet financing. Governor Patel will have to continue the tradition of speaking out forcefully against such loose practices. That will be the fifth on the list of his challenges.

The sixth challenge for Patel will be to minimize the impact of spill over from advanced economy policies on India's macroeconomic management. This battle has to be fought on two fronts. On one side, Patel will have to persist with Rajan's strong and firm stand in international fora that advanced economy central banks must show much greater

sensitivity to the spill over impact of their policies. On the other side, he will have to ensure that policy spill overs will not jeopardize India's price and financial stability. Admittedly, the global situation, notwithstanding the current grim outlook, is much less uncertain today than it was during the Subbarao years and even during the Rajan years. But the governor can ill afford to take such risks off his radar.

Seventh, even as he is guarding the spill over front, Patel will have to pursue capital account liberalization which is critical for India to attract both foreign equity and debt investments of the type and in the volume it needs. In pursuing this, Patel will no doubt confront the 'impossible trinity' – the futility of simultaneously targeting a fixed exchange rate, monetary policy independence and an open capital account. Several emerging economies, notably in Latin America, had come to grief because of flawed timing and sequencing of external sector reforms. In negotiating the way forward, Patel will have to pursue the tradition of *festina lente* – which is Latin for making haste slowly, and this requires a mix of surefootedness and calculated caution.

Among the many legacies of Governor Rajan will be his diversification of India's banking structure consistent with the requirements of an emerging, growth hungry economy. Moving away from the monolithic structure of universal banks, Rajan has issued licences to small finance banks to meet the needs of small depositors and small borrowers and payment banks to harness technological advances to further financial inclusion. RBI is reportedly also contemplating other specialist banks such as wholesale banks and investment banks. These are works in progress and Patel's challenge will be to take this initiative forward, taking corrective action on the go, based on lessons of experience. In particular, he will have to calibrate regulation and supervision of these niche institutions to ensure stability while at the same time not stifling innovation.

We are witnessing many disruptive innovations in the financial sector, many of them triggered by advances in computer and communication technologies. These disruptions can be a force for the good; they can improve efficiency and deepen financial inclusion. But technology is a double edged sword. An emerging big threat to financial stability is cybercrime. This is not yet much understood by regulators and central banks. A new and

potent challenge for Governor Patel – the ninth on this list - will be to keep abreast of developments on this front and keep the Reserve Bank ahead of cyber criminals.

Finally, a common and constant challenge for central bank governors is communication. Post crisis, central banks have realized that effective communication can enhance policy effectiveness by managing market expectations. At the same time, even some veteran and highly regarded governors have been guilty of communication missteps. As a deputy governor in Governor Rajan's team, Patel kept a low profile. But as governor now, he will have to be more communicative – speaking up and speaking out as the occasion demands. There is of course no one-size-fits-all role model for central bank communication. Urjit Patel will have to tailor his communication stance consistent with his personality and comparative advantage. For Patel, this tenth challenge on the list could well turn out to be the most formidable.

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