

North block vs RBI: Lost in translation

Macroeconomic policies for growth require coordination between the finance ministry and RBI—a far cry from the present scenario



Finance minister Arun Jaitley (left) and RBI governor Raghuram Rajan. Jaitley has repeatedly asked for lower interest rates, but RBI has turned a deaf ear. Photo: Bloomberg

There is a palpable tension between the finance ministry and the Reserve Bank of India (RBI), reflected in newspaper headlines and visible to discerning citizens. Contending statements and conflicting views surface time after time. On occasions, the two seem to be on collision course until one or the other blinks.

It's not the first time that there are differences of opinion, and it will not be the last. In the past, however, differences that arose were resolved quietly through discussion behind closed doors without open acrimony.

The present situation is a marked departure and a striking contrast. Such differences have never been so many and never so much in the public domain.

The consequences are no surprise. Rumours and gossip are abound. And it is good copy for the media. But it is bad for a harmonious relationship between two institutions that have a critical role in the management of the country's economy. It has surely eroded the dignity of both institutions. The collateral damage extends beyond investor confidence and government credibility to the

economy.

Some examples of critical statements, largely from RBI, are worth citing. In August 2014, RBI governor **Raghuram Rajan** said venal and corrupt politicians make an already dysfunctional system worse. In December, he questioned the notion of Make in India, announced by Prime Minister **Narendra Modi** and adopted by government, arguing that it is not feasible and could be a futile quest.

It is difficult to think of any country where the governor of its central bank would, or could, have made such statements on subjects outside his domain.

It seems that the government's threshold of tolerance in this sphere is much higher than it is elsewhere. Union finance minister **Arun Jaitley** has repeatedly asked for lower interest rates, but RBI has turned a deaf ear.

Needle apart, there are three substantive issues: the creation of an authority to manage public debt, the need for a regulator in the market for government securities, and the composition of the monetary policy committee.

Government expenditure exceeds government income. The gap, or deficit, is met by borrowing. For this purpose, it issues, or authorizes RBI to issue, government securities, which are bought by commercial banks and sold in the domestic capital markets. Ultimately, directly or indirectly, it is citizens who are the lenders. Such government borrowing, accumulated over time, is termed as public debt, which the government owes to its people.

RBI performs multiple functions in this sphere. It issues government securities. It runs the exchange and depository for transactions in government securities. It is the regulator of the commercial banks, which are the largest buyers of government securities. It sets the interest rates on government securities.

Conflicts of interest run through every tier of the present system, constituting a flagrant violation of a principle that has an obvious sanctity. For this reason, since 2000, committee after committee has recommended the creation of an independent authority to manage public debt, in conformity with best practice almost everywhere in the world.

In the budget presented in February, Jaitley announced the establishment, through legislation, of a Public Debt Management Agency (PDMA). This decision, long overdue, was a welcome step. Yet, surprisingly enough, he withdrew this provision of the finance bill in May before it was voted upon by Parliament. The finance minister did not explain why. Newspapers speculated this was attributable to strong pressures mounted by RBI in the political process.

The budget for 2015-16 also announced that the regulation of the market for government securities would be transferred from RBI to Securities and Exchange Board of India (Sebi). This was necessary and desirable for three reasons. There are conflicts of interest if RBI

continues as the regulator. Sebi is already the regulator of the capital market for equity as well as debt, and government securities are debt instruments. It would benefit both buyers and sellers if there was one regulator with consistent rules for transactions in financial assets.

Yet, in May, Jaitley withdrew this provision of the finance bill without any explanation. Once again, it would be reasonable to infer, as speculation suggests, that this too was attributable to pressures exerted by RBI.

The composition of the monetary policy committee (MPC) is the third, so far unresolved, issue. At present, setting of interest rates is the domain of RBI alone de facto at the sole discretion of its governor.

In March 2013, the Financial Sector Legislative Reforms Commission (FSLRC) suggested an MPC of seven members, two from RBI, with five external members, two appointed by the government in consultation with RBI, and three appointed by the government.

In January 2014, an RBI committee suggested an MPC with five members: three from RBI and two appointed by RBI. In July, the draft Indian Financial Code (IFC) circulated by the finance ministry suggested an MPC with seven members, three from RBI and four external members appointed by the government. RBI governor is proposed as the chairman in each alternative.

There are conflicting views on the MPC's composition, which have inevitably spilled over into the media and the political process. Strangely enough, there is no ownership of any proposal as both the finance ministry and RBI are now in a denial mode emphasizing that they are in consultation.

The significance of the MPC is being exaggerated. It is centre-stage for those who believe that the management of inflation, through the use of interest rates, should be the responsibility of RBI alone, for which it must have autonomy.

The underlying macroeconomics is flawed. Experience elsewhere shows that inflation targeting does not assure outcomes. Indeed, it cannot if inflation is driven by real factors, such as supply-demand imbalances, rather than monetary factors, such as excess liquidity.

Even so, interest rates are an important price, and a signal, in a market economy. This decision must not be a prerogative of one person alone. Hence, the constitution of an MPC with a balanced membership is essential. The draft IFC proposes seven members, made up of three internal members from RBI, including the governor as chairman, and four external members appointed by the finance ministry.

The external members must be independent individuals, with domain expertise in macroeconomics, in no way connected with either the ministry or RBI. This is a perfectly logical composition that is consistent with existing practice in countries such as the US, Australia, Norway, Sweden, Korea and Thailand. MPC decisions, everywhere, are based on consensus through persuasion and put to vote only as a last resort.

The original stance of the ministry on the creation of a PDMA and Sebi as the regulator of the market for government securities, carving out two roles presently performed by RBI, is absolutely correct. Several committees, including one chaired by Rajan before he was appointed governor, recommended exactly the same. The unexplained withdrawal of these two provisions of the Finance Bill suggests that the ministry lacks courage of its conviction.

Similarly, its approach on the MPC is broadly correct and it must ensure a balanced composition. RBI is simply engaged in a turf battle to preserve its jurisdiction. The narrative about autonomy or independence is false. In an ironical reversal of roles, it appears that RBI is more political than the finance ministry in this jostling for space. This debate must also be situated in its wider context about macro-management of the economy. Fiscal policy and monetary policy are two instruments of macro-policies, which must not be dichotomized. The idea that RBI should manage inflation through monetary policy and the finance ministry should manage growth through fiscal policy is completely wrong. Indeed, the two instruments should not be separated from each other or implemented in isolation. The reasons are not rocket science.

Each instrument affects both objectives of restraining inflation and fostering growth. Larger fiscal deficits might fuel inflation while smaller fiscal deficits might dampen inflation. High interest rates might stifle investment and dampen growth while lower interest rates might stimulate investment and promote growth. If high interest rates are juxtaposed with strong exchange rates, which is what RBI is doing, then this is bound to stifle exports and dampen growth further.

Similarly, the use of each instrument can reduce space for use of the other instrument. Monetary policy has significant fiscal consequences in India because public debt is large as a proportion of gross domestic product (66%) and interest payments on these debts are large as a proportion of government expenditure (25%); even modest increases in interest rates exercise a strong influence on fiscal flexibility.

By contrast, the monetary consequences of fiscal policy are no longer significant because fiscal deficits are met by domestic market borrowing, but there is no borrowing from RBI to bridge the gap that could lead to monetary expansion.

Thus, if monetary policy is vested in RBI alone and fiscal policy is the responsibility of the finance ministry, three sets of problems will arise. First, each would ignore the interactive consequences, explained above, for the other. Second, the essential coordination between the fiscal and monetary aspects of macro-policies will fall between stools. Third, the distribution of the burden of adjustment will be an outcome of bargaining, as RBI will press for fiscal adjustment and ministry will press for monetary adjustment.

Clearly, macroeconomic policies for development, which manage inflation, promote growth and create employment, require partnership and

coordination between the finance ministry and RBI. Even if it seems a far cry in the present milieu, this needs sagacity and wisdom on the part of those concerned. In such turf battles, there are no winners.

The losers are not only the institutions themselves, but also the economy and the people.

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