Central banks need 'capital' infusion

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"The RBI must function independently and not be a slave to outdated ideas."

The central bank of a country sits at the pinnacle of its financial system and is mandated with ensuring its stability. From time to time central banks are directly or indirectly involved in shoring up stressed commercial banks with capital infusion. So it may appear odd to suggest that occasionally even the central bank may need some of its own medicine. After all central banks make a surplus from their operations, and indeed pay a dividend to their governments. The puzzle is resolved, however, when we recognise that capital is not only funds but also ideas.

Time to reflect on role

In the context, one of the ideas is related to the role of the central bank in the economy. That this issue is being brought up more than half a century after a central bank was instituted in India need not be interpreted as some weakness in the original conception. An economic arrangement once made cannot be treated as settled for all time to come. This also holds true for central banks, often considered venerable beyond querying. It's time to reflect on the role of the central bank in India as we hear of impending changes in the higher echelons of the Reserve Bank of India (RBI). The media coverage has focused on differences among some of its functionaries and the government of India but this is besides the point as there has been complete agreement between them on the role of monetary policy. Moreover for about five years now, the government and the RBI have, as though in concert, implemented a deflationary macroeconomic policy via fiscal contraction and monetary tightening, respectively. One of Prime Minister Narendra Modi's finance ministers claimed credit for the government for having ushered in a period of macroeconomic stability. What this achieved for the economy is a different matter.

A combination of low inflation and small budget deficits was among the prescriptions of the Washington Consensus that reigned for about a decade and a half from the 1990s. With the implosion of the former Soviet Union and the folding up of its east European satellites, this consensus had, via the clout of the U.S., placed a straitjacket on policy makers in the so-called emerging markets, like India. In that moment of triumph it had been thought that the business cycle, or the oscillating trend in market economies, had been permanently tamed. However, as is so often the case in the life of economies, the cunning of history can derail progress with nary a warning. This arrived in the form of the global financial crisis in 2008, which originating in the U.S. soon spread across the world including India. Growth slowed and unemployment rose. The Obama Administration did not hesitate to intervene drastically, strongly supported by the Federal Reserve Bank. The fiscal deficit rose three-fold and the money supply ballooned. Interestingly, inflation did not rise.

A rethink in macroeconomics

The global financial crisis has led to a substantial re-thinking of macroeconomics. The main revisions are that monetary policy defined by inflation targeting can no longer be treated as the centrepiece of macroeconomic policy, that fiscal policy should be used to stabilise the economy when needed and that financial regulation is a must. The limitation of inflation targeting was understood when the 'great moderation', an extended period of low inflation in the west, ended in the financial crisis. It is this that has led to the view that light regulation of the financial sector, as advised by the then Governor of the Federal Reserve Alan Greenspan, can be a recipe for disaster. Finally, it has come to be recognised that assertions of the impotence of fiscal policy may be exaggerated. There could be times when the private sector is held back by the state of the economy. In a recession this would delay recovery. Now fiscal expansion would be necessary. Apart from theoretical demonstration of the stabilising potential of fiscal policy the belief that the explosion of the U.S. fiscal deficit following the crisis actually saved the day has very likely contributed to the rethinking. The general consensus now is that there should be no going back to the pre-crisis practices of narrow inflation targeting, inflexible fiscal policy, and kid gloves for the financial sector.

Lessons to learn

It is hoped that the Reserve Bank of India and the economic policy-making establishment will take into account the evolving understanding of macroeconomics globally. It is unfortunate that policymaking in India has been stuck in the past. This would not have mattered if the consequences were benign. The government has taken credit for attainment of macroeconomic stability, defined by low inflation, even as unemployment has been rising since 2011. A continuously declining fiscal deficit has not restrained the RBI leadership from paying hawk-eyed attention to it, constantly lecturing the elected government of the perils of even the slightest deviation from the path of fiscal consolidation, when strictly it is not its business to do so. It should instead focus on putting its own house in order. Two instances of a failure to do so may be mentioned. Ever since we have had de facto inflation targeting in India, from around 2013, the real policy rate has risen very substantially. This has been accompanied by declining borrowing in the formal sector likely affecting investment. Inflation has come down but it was already trending downward, possibly due to the slowing growth. Subsequent inflation reduction has been assisted by the declining price of oil. Evidence of the role of inflation targeting in reducing inflation in India is weak, as summarised in the study 'The dynamics of inflation in India' (Working Paper 485, Centre for Development Studies, Thiruvananthapuram, May 2019) by M. Parameswaran and myself. Ironically, we have had in India the replay of a scene from the global financial crisis where a central bank focusing on inflation loses sight of brewing financial instability. The crisis at IL&FS, with a group company defaulting on its payment obligations jeopardising the interests of hundreds of investors, banks and mutual funds is only a specific case in point. The larger story is of the steady rise in the non-performing assets (NPAs) of banks even as inflation was abating.

A popular reading is that recently the RBI has had to face some pressure exerted by the government's nominees. This may well have been the case. But what we need is not just a central bank that is left to function independently, but also one that is not a slave to some defunct school of thought. It has many mandated functions, among them ensuring an adequate supply of clean currency notes in denominations sought after by the ordinary Indian.

Reserve Bank of India

Establishment

- The Reserve Bank of India was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934.
- The Central Office of the Reserve Bank was initially established in Calcutta but was permanently moved to Mumbai in 1937. The Central Office is where the Governor sits and where policies are formulated.
- Though originally privately owned, since nationalisation in 1949, the Reserve Bank is fully owned by the Government of India.

Preamble

- The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank as:
- "to regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage; to have a modern monetary policy framework to meet the challenge of an increasingly complex economy, to maintain price stability while keeping in mind the objective of growth."

Central Board

- The Reserve Bank's affairs are governed by a central board of directors. The board is appointed by the Government of India in keeping with the Reserve Bank of India Act.
- Appointed/nominated for a period of four years

Constitution:

Official Directors

- Full-time : Governor and not more than four Deputy Governors

Non-Official Directors

- Nominated by Government: ten Directors from various fields and two government Official
- Others: four Directors - one each from four local boards

main work

- To control the issuance of bank notes, to keep monetary reserves in view of monetary stability in India and generally operate currency and debt system in the interest of the country.
- Formulation, implementation and monitoring of monetary policy.
- Regulation and supervision of financial system

Manages foreign Exchange

- Issues and exchanges or destroys currency and coins not fit for circulation.
- Banker to the Government: performs merchant banking function for the central and the state governments; also acts as their banker.

Autonomy of the Reserve Bank

- **Under Section 7 (1):-** The Central Government may from time to time give such directions to the Bank as it may, after consultation with the Governor of the Bank, consider necessary in the public interest.
- **Under Section 7 (2):-** Subject to any such directions, the general superintendence and direction of the affairs and business of the Bank shall be entrusted to a Central Board of Directors which may exercise all powers and do all acts and things which may be exercised or done by the Bank.
- **Under Section 7 (3):-** Save as otherwise provided in regulations made by the Central Board, the Governor and in his absence the Deputy Governor nominated by him in this behalf, shall also have powers of general superintendence and direction of the affairs and the business of the Bank, and may exercise all powers and do all acts and things which may be exercised or done by the Bank.

What is monetary policy committee?

- The Monetary Policy Committee (MPC), constituted under Section 45ZB by the Central Government, determines the policy interest rate necessary to achieve the inflation target.
- Earlier this work was done by the Governor of the Reserve Bank.
- The monetary policy department of the Reserve Bank helps this committee in monetary policy formulation and contributes to the decision making process on the policy repo rate from the views of all stakeholders of the economy and the analytical work of the Reserve Bank.

Expected Questions (Prelims Exams)

1.Which of the following are main functions of Reserve Bank of India?

1. Regulating the exchange of currency
2. Forming monetary and fiscal polices
3. Management of foreign currency

Select the correct code-

(a) Only 1 (b) 1 and 2

(c) 1 and 3 (d) 2 and 3

Expected Questions (Mains Exams)

Q. The role of Central Banks becomes important in the emerging challenges in global economy in present times. The Central Bank of India is facing which institutional and operational problems? What effective steps should be taken for its resolution. Suggest. (250 Words)