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Who should control India's central bank?

The Indian government is challenging the Reserve Bank of India's independence for all the wrong reasons

The Reserve Bank of India (RBI) is locked in a bitter public feud with the administration of Prime Minister Narendra Modi over Modi's attempts to encroach on the central bank's independence. In fact, the government's actions are a serious problem, but not for the reason many people seem to think.

An independent central bank is widely regarded nowadays as a pillar of a modern economy. But the concept of central-bank independence is relatively recent – and deeply flawed. After all, a central bank performs critical functions – controlling an economy's base money supply, setting interest rates, regulating banking activities and credit volume, and acting as lender of last resort – that cannot be carried out independently of fiscal and other economic policies.

Support for central-bank independence rests on two assumptions: that the only objective of monetary policy should be price stability, and that efforts on this front should be insulated from the political pressure faced by governments seeking to meet multiple goals, such as employment gains, financial inclusion, and a stable exchange rate. The upshot, however, is that central banks end up answering to financial markets, rather than to governments that are accountable to the public.

But the Modi government's actions are not intended to link monetary policy to smart fiscal and economic policies, in order to serve the needs of the public more effectively. Instead, they amount to a short-sighted attempt to strengthen the position of the ruling Bharatiya Janata Party (BJP) ahead of upcoming elections.

The Indian economy has problems

The BJP is under severe pressure. Despite rapid GDP growth, the Indian economy is fragile. Formal employment growth is slow or stagnant, the

current-account deficit is rising, and capital flows are volatile. Producers and consumers are confronting a grave liquidity shortage, and, with banks struggling to manage their growing portfolios of non-performing assets, credit flows have been drying up. As a result, investment continues to decline, and many small and medium-size enterprises – the backbone of the economy – are on the brink of collapse.

These problems have been building for more than 15 years, since successive governments began forcing state-run commercial banks to engage in long-term lending that should have been the preserve of development banks (which were eliminated during India's economic liberalisation). Other sorts of crony lending were also encouraged, reflected in the fact that fewer than 5,000 large borrowers accounted for 90 per cent of total non-preforming assets – and more than half of all Indian bank loans – at the end of March. The recent bankruptcy of the major shadow lender IL&FS has exacerbated the credit squeeze.

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Modi's government may not have created these problems, but it has not done anything to resolve them, either, despite its lofty promises to ensure rapid employment growth, root out corruption, and clean up the banking system. Its demonetisation project, which entailed the invalidation of high-value notes, was a disaster, inflicting enormous damage on citizens – especially the 81 per cent of workers who earn their living in the informal sector – without making so much as a dent in corruption. The poorly designed and implemented Goods and Services Tax created further chaos and economic disruption.

With elections looming, Modi's government hopes to stimulate the economy and revive investment with a big public spending spree. But this would require the release of more credit – a condition that the central bank, focussed on cleaning up existing bad debts and forcing banks to act more prudently, has repeatedly disregarded.

Fighting for the public interest

Instead, for the first time in independent India's history, Modi's government invoked Section 7 of the RBI Act, which empowers the government to issue directions to the central bank. Those directions include easing restrictions on lending by 'stressed' banks, amending prudential norms to allow more lending, providing a single-window

facility for loans to small enterprises without due diligence, and relaxing limits on a single company's foreign portfolio holdings of corporate debt. The government also wants to dip directly into the RBI's reserves to finance its own expenditure.

This prompted a sharp response from RBI Deputy Governor Viral Acharya, who publicly declared that, should the government infringe on the RBI's autonomy by 'raiding' its balance sheet, it would face the wrath of financial markets.

Acharya's rejection of the government's demands is all the more surprising, given the RBI's own role in allowing the proliferation of non-performing assets. Even the US Federal Reserve has acknowledged that if the central bank is partly responsible for a crisis, it must be willing to contribute to the resolution, both by letting the government monetise some of its deficit and by expanding its own balance sheet.

As it stands, the government has big business in its corner. Presumably, many large firms with unpaid debts want access to fresh credit, though the list of large corporate 'willful defaulters' submitted to the Modi government four years ago by Patel's predecessor, Raghuram Rajan, remains secret, despite parliamentary requests and Supreme Court directives to release it. We do know that some of India's business heavyweights, such as the Tata and Adani groups, are also hoping to benefit from a plan to forgive power-sector loans.

The standoff between the Modi government and the RBI is not problematic because of the risk of infringing on central-bank independence; it is problematic because the Modi government is not fighting to protect the larger public interest, but rather to revive irresponsible bank lending, protect its cronies, and win votes. And yet, when things go south, it may well be the RBI that is left holding the bag.

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