A needless controversy: Did RBI Governor overstep his limit?

T.K. Jayaraman

The 2018-19 Budget, presented to Parliament on January 31 will be debated and put to the vote before the new fiscal year beginning from April 1. Meanwhile, Reserve Bank of India (RBI)'s Monetary Policy Committee (MPC) held its sixth bi-monthly meeting on Feb 6-7 and decided upon the benchmark interest rate for the next two months.

The RBI decision is to maintain the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 6%. Consequently the reverse repo rate under the LAF would remain at 5.75%, and the marginal standing facility (MSF) rate and the Bank Rate at 6.25%. The monetary policy now has a neutral stance (neither hawkish nor dovish, but would be changed hawkish, if inflation accelerates).

It was quietly accepted by everyone, as there were compelling reasons: uncertain inflation outlook (inflation now estimated at 5.1% in Q4, close to the allowable upper limit of 6%, as the target is 4% with plus or minus 2%) is of concern, as international crude oil prices have firmed up since August 2017.

Critics, who usually plead for cut in interest rate by RBI, accepted the MPC decision, just as the way Budget 2018-19 was received without much disagreement. The Forbes (India) magazine reflected the general view when it wrote that the Budget is a balancing exercise "between expectations of masses to deliver achhe din and slipping fiscal deficit." The fiscal deficit is revised to 3.5% of the gross domestic product (GDP) in 2017-18, from a targeted 3.2%. Further, the estimated fiscal deficit for 2018-19 is 3.3%, against the 3% target set under the Fiscal Responsibility and Budget Management Act.

RBI's Economic Assessment

By way of explaining the reasons behind its neutral policy stance, Monetary Policy Statement (MPS) presented a brief analysis of the economy. Noting the economy was on a recovery path it referred to the focus of the Union Budget on the rural and infrastructure sectors and observed that it was "a welcome development, supporting rural incomes and investment, and in turn provide a further push to aggregate demand and economic activity". The MPS of Feb 7 did not make any mention of the Indian stock market crash of Feb 1 or the US stock market crash of Feb 4, as the focus of RBI is real economy. However, it made a guarded remark on the estimated fiscal deficit: "On the downside, the deterioration in public finances risks crowding out of private financing and investment".

That was a tame affair, as it did not produce any fireworks. The disappointed pundits were waiting to be provoked. They got it finally when RBI Governor replied to a question raised in the course of the routine press conference held after the announcement of the monetary policy decision.

The question posed to the Governor was with regard to India's declining investment to GDP ratio (from the peak of 35.6% in 2007 to 26.4% in 2017) and the likely impact of the re-introduction of LTCG tax on stocks. His explanation was that as the capacity utilization (now low at around 72%) and poor credit growth, the ratio has fallen; and if the capacity utilization would reach its full potential and if credit growth improves, the ratio would pick up.

In regard to impact of LTCG tax on investment and growth, the Governor replied that there are four already existing taxes on capital: (i) a corporate tax (ii) a dividend distribution tax (iii) a tax on dividend income above ₹ 10 lakh; (iv) a securities transaction tax; and hence the re-introduction of LTCG tax might have some marginal impact.

Two sides of the same coin

Fiscal and monetary policies affect the economy by impacting investment and growth. Excess fiscal spending over revenues leads to increases in public borrowing, which in turn would push up borrowing costs for private sector, thereby discouraging investment. This is known as "crowding out private investment". If both government and central bank agree and do not want a rise in interest rise, more liquidity has to be pumped in through buying of bonds or printing of money for preventing the increase in interest rate. Thus, every fiscal policy decision has the potential to impact monetary policy as well.

Similarly, every monetary policy decision affects fiscal policy. If the central bank raises the interest rate to fight inflation, government's borrowing costs rise and the tax revenues have to be directed to finance them, leaving less for operating expenditures and cutting the budgeted outlays for capital expenditure.

Thus, fiscal and monetary policies are two sides of the same coin: the health of the economy.

Formulation and implementation of two policies are certainly two independent functions and the concept of autonomy is well understood. Interference is always frowned upon.

Within the four corners of the statute, RBI formulates and implements monetary policy, influencing the rise or reduction in money supply, and consequently the purchasing power of the rupee. RBI can also influence the foreign exchange rate and make prices of imports more expensive or export prices cheaper, thereby impacting every economic aspect of existence of the citizens, affecting their incomes, consumption, savings and investment.

Because of such enormous powers, central banks came to be "more hated than loved". In fact, a former and a long time US Republican Congressman Ron Paul, who was seeking his party nomination for contesting US Presidential election, had on his election manifesto the goal: curbing the powers of the US Federal Reserve (the Fed).

One of his famous quotes on the Fed sums up the general dislike:

"First reason is, it's not authorized in the Constitution, and it's an illegal institution. The second reason, it's an immoral institution, because we have delivered to a secretive body the privilege of creating money out of thin air; if you or I did it, we'd be called counterfeiters, so why have we legalized counterfeiting? But the economic reasons are overwhelming: the Federal Reserve is the creature that destroys value of the dollar".

Improving the image

It is no wonder; over the last two decades, there have been concerted efforts to improve the image of central banks by making them more transparent and less secretive. Improving communication is now recognized as a key element to make central banks more acceptable. Rakesh Mohan, a former Deputy Governor of RBI in his presentation at SAARC

RBI can also influence the foreign exchange rate and make prices of imports more expensive or export prices cheaper, thereby impacting every economic aspect of existence of the citizens, affecting their incomes, consumption, savings and investment.

Governors Symposium on Finance held in 2005 in Mumbai, listed three essential kinds of communication: (i) the content of policy measures; (ii) the reasons behind such policy measures; and (iii) analysis of the economy.

Central bank governors and their deputies and senior officials addressing business conferences and chambers of commerce and industries are now a common thing. Central bank websites have link pages devoted to educating the public on technical terms. Their sections, mainly directed to students have emerged as popular and authentic sources of information.

Of course, there were in recent years instances where one central bank chief took special delight in confusing the public. Alan Greenspan, a former Chairman of the Fed was an expert in obfuscation: the action of making something obscure, unclear, or unintelligible.

In fact, he made it an art. His style of speaking is now referred to as "Greenspan-esque".

In a famous interview with MSNBC, Greenspan boasted that he used it, whenever felt necessary

"to avoid certain questions coming up, which you know you can't answer, you end up with when, say, a congressman asks you a question, and don't want to say, "No comment," or "I won't answer," or something like that. So, I proceed with four or five sentences which get increasingly obscure. The congressman thinks I answered the question and goes onto the next one."

A popular story goes thus: Greenspan once told a congressman during his testimony to the lower house of the US Congress:

Mr. Congressman, I know you think you understand what you thought I said but I'm not sure you realize that what you heard is not what I meant.

Governor Patel's answer was direct and informative. He did not avoid the question; or refuse to answer. Certainly he did not indulge in "Greenspan-esque".

Since the Budget 2018 is in the public domain, the claim that RBI Governor cannot comment on it on the ground it is sub judice does not hold water. ■

— Dr T.K. Jayaraman is an Adjunct Professor, Amrita Business School, Bengaluru Campus, Amrita Vishwa Vidya Peetham.