DAILY POST
JOURNALISM OF HOPE

From Chandigarh

November 3, 2018

The Rift and Drift

T.K. Jayaraman and A.K.Mohapatra

The American humorist, Will Rogers once quipped, "The wheel, the fire and central banking are the three great inventions since the beginning of time". No doubt, that was an exaggeration as humorists do indulge in, to drive their point home. They were the creations of the 20th century.Pamela Woodall, the editor of *The Economist* of London, observed in her introduction to the special issue: "A survey of the World Economy" called the central banks as the "navigators of the economies in the world".

In a democracy, differences between government and central bank are not unusual. The government is responsible for fiscal policy (raising revenues through taxes as well as public borrowing and expenditures), and the monetary authority is responsible for controlling money supply and facilitating flow of financial resources to economic agents through using instruments such as changes in interest rate, affecting borrowing cost; and targeting inflation.

Sorting out differences

The differences are not unusual for the simple reason that governments are replaceable in a democracy where periodical elections (ranging from three years in Australia and New Zealand, four years in the USA to five years in India) give limited time to the victorious party (or parties in case of coalition) to hold power for implementing their manifesto. They are in an understandable hurry. Their view is myopic. On the other hand, central banks have a long term view of the economy, as their heads have a longer tenure. The elected governments often pursue policies with eyes on the next election. The decisions, though popular and vote winning, may have negative impacts in the long run.

However, the declared long term goals of governments and central banks are not different: economic growth and rise in per capita real incomes; and price stability, for stabilizing domestic purchasing power of money; and external purchasing power of the currency, which is the exchange rate. As policies of elected governments are often formulated with a view to retain power, the central banks' long term objectives may tend to differ. It is the divergence in their perspectives that give rise to differences.

The rift

The current rift, between Reserve Bank of India (RBI) and Government of India (GOI), will give lessons on governance. Although the RBI top brass has superior technical qualifications, they may not have experience in public administration. In public administration, decisions are always reached by resolving conflicts and of course compromises, and reconciling differences in interests. Once the storm is blown over, both sides will have to sit down and draw lessons for the future for better governance.

The rift was provoked by Deputy Governor Viral Acharya in a blunt speech, when he delivered the AD Shroff Memorial Lecture on October 26, 2018. He said:

> "Governments that do not respect central bank's independence will sooner or later incur the wrath of financial markets, ignite economic fire and come to rue the day they undermined an important regulatory institution".

The differences between RBI and GOI, which are fairly well known thanks to an agile Press, center around:

- RBI's firm stand on bringing weak banks under PCA
- bad debts to power sector
- drying up of credit to medium and small business enterprises
- liquidity crisis faced by the non-bank financial companies
- increased sharing of RBI profits

Need for Consultation

It is not clear before the Deputy Governor's speech there were any ongoing consultations between GOI and RBI. Consultations and interactions are key avenues to solve differences, which affect the nation's interests. Both GOI and RBI have had differences in the past. An interesting point of information has emerged in the last two days from the twitters including those from former finance ministers, the governments in the past never resorted to powers given under Section 7 of RBI Act, which enables GOI

> "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. 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".

Section 7, if ever invoked and directives given to RBI, would make it clear that autonomy of RBI is just a myth. The so called feeling of independence on RBI was created all along these years because no directive was issued.

One may have the weapon in one's armoury but its non-use itself gives the owner full strength, physical and moral. As it takes two to tango, both GOI and RBI have been the winners all along.

The string of success has been broken. Was the Deputy Governor's AD Shroff Memorial Lecture, as they call it "the last straw from the camel's back?"

Could it have been avoided? **T**here were many flash points all along, as listed above. In retrospect, both parties would have recognized by now that there should have been more consultation or interaction between GOI and RBI before Deputy Governor's October 26 address. It appears there has been reluctance to sit down and talk. Consultation is not surrender. Interaction is not abdication of the so called autonomy of RBI or "sovereignty" in economic policy making. The interests at stake are national. Consultation and interaction result not only help striking a golden mean but also facilitate and ensure smooth governance.

The drift

Since January this year, the rupee has been allowed to drift. It has been depreciating. No doubt mandate before RBI is price stability and not managing the exchange rate, the fall has been steady and alarming. Combined with rise in oil price in dollars, the pain of the double whammy has been immense. The current account deficit is expected to hit 3% of GDP and retail inflation would reach 4%, the RBI target rate. Thanks to coordination between central banks and governments, the other Asian economies have been handling the crisis better. They are actively trying to stabilize exchange rate by both raising interest rates and effective intervention in foreign exchange markets, by selling dollars and purchasing domestic currencies. RBI's stand is managing exchange rate is not their concern; and as price stability is the only goal; any intervention is limited to reducing volatility.

The Indian rupee is the worst performer amongst all Asian currencies. Only when rupee fell to the record low of Rs 74.50 on Oct 8, RBI actively intervened. It was too late. The foreign exchange reserves have fallen from the record high of $426 billion to less than $400 billion without much success. Any recovery in rupee exchange rate, since then and before the rift came into open, was more due to fall in oil price. After the rift between RBI and GOI was widely known on Oct 31, investors turned nervous and the rupee plunged to the day's low of 74.14.

If GOI and RBI do not come to the table, the rift would worsen and the rupee drift would continue.

Dr T K Jayaraman is a Visiting Adjunct Professor to Amrita School of Business and Dr Amiya Mohapatra is an Associate Professor, Fortune Institute of Business Studies, New Delhi