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# Term Paper of Indian Economic Problem (406)

## "RBI AUTONOMY": A QUESTION OF TRUST

**Umesh Kumar**
**Department of Economics**
**(Assistant Professor)**
**Gargi College**
**University of Delhi**

## #1 ABOUT RBI

In year 1927, that time government set up a commission which was headed by Hilton Young and therefore known as Hilton Young commission. This commission recommended that there is need of central banker in country, then government passed the RBI Bill and Bill received ascent of governor general in 1934, hence RBI act passed in 1935.

The important thing here is its higher-level appointments. Central Board OfDirectors (CBD), there are 20 members in RBI. This number is categorized in two parts 5(includes one Governor and 4 deputygovernors) and 15(10 Experts appointed by government of India and 1 finance secretary and 4 from different RBI zonal office).

Reserve Bank Of India(RBI), is the central bank of India. As other central banks, of the world RBI also performs different function. Since RBI plays multi facet role by executing multiple functions such as issuing currency, managing foreign exchange, working as bank of the government but the most important function of the central bank (RBI) is overseeing monetary policy.

Reserve Bank of India plays a vital role in the economy in promoting growth and parallel controlling inflation rate , these two things can not be carry on simultaneously therefore RBI has to take some tough decisions but with consultancy of government of India. But it is not usual case that both of them get satisfy with the prepared policy of each other. Although, policies are prepared in the interest of general public but instead of that sometimes these policy are unable to fulfill personal goals of these two individual institutions (central government and central bank ).

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When the decision of thesetwo-institution variate in different direction, then conflict occurs, debates take place. Question arises whose decision in optimum and who has to give up in this conflict. It gives birth to the question that “Is our central bank is independent?” or in other words “RBI AUTONOMY: A QUESTION OF TRUST”.

The most importantly RBI’s duty is to maintain a nice flow of money in the market by monetary policy with different tools such repo rate, CRR, SLR etc. In simple words monetary policy is regulating flow of money in the economy throw above-mentioned tools.

But what to do or not to do is not verbally; there is an agreement between government of India and central bank, which is known as Monetary Policy Framework Agreement (MPFA). In this agreement, the target of inflation by which has to be achieved by the RBI is given by the government of India in every five years. In current scenario RBI has been given target to maintain level of inflation between 2% to 6% although target is to achieve a healthy level of inflation of 4% but there 200 basis points can be less or more.

NEED of this agreement is to bring out RBI from dilemma that is, if RBI promotes growth it has to follow loose policy such as lowering interest which leads to credit flow and push GDP up but along with this it also pushes up graph of level of inflation upward by higher consumption. Therefore in order to reducing inflation rate RBI has to pull back money from market by various tools such as by increasing repo rate, CRR rate, SLR rate etc. but it has limiting effect on growth of the country this is dilemma for RBI.

**#2.<u>Why there is CONFLICT between Central government and Central Banker (RBI)</u>?.**

Monetary Policy Committee(MPC): Committee in which minor to major decisions taken by the members of the committee.

OLDER SYSTEM OF MPC : There used to be committee of five person headed by the Governor and under older system weighted power was given to the governor, in other words, decisions of governor would prevail over the decision of remaining members of the committee.

NEW SYSTEM OF MPC :In this system committee has six members in which three are of RBI and remaining three are experts by government of India. The important point is that in this new system governor does not have weighted power rather casting vote, it means in any decision if there is tie between 3-3 members then Governor can produce its own vote for favoring the decision by its own will.

In this respect, many an economists, experts and eminent personality says the inclusion of 3 members in the committee government of India already intervening in the decision making process of RBI and snatching its autonomy.

Now it is important to discuss what are the points of contention between central government and central bank. But it also becomes necessary to understand such friction between these two institutions are not new but it has been happening with the origin of itself.

There are many points of contentions, which are given below.

1. Repo Rates / Interest Rates:This is usual point of friction between government of india and central bank . Government’s objective is to achieve high level of growth so that high GDP in country may high but objective of central bank is to have sustainable growth with a comfortable level of inflation rate. Therefore government

always wish to lower repo rates and to use loose monetary policy whereas central banks wants to use tool only if it is needed to do so.

2. NBFC Liquidity issue:NBFC stands for Non Banking Financial Companies, Government of India critically against the handling of liquidity crises in the NBFC by RBI. Government of India says that RBI should do more and introduce special window to increase liquidity in NBFC because in coming months and years there is huge redemption in the short run which lead shortage in liquidity in the market and hence it would affect performance of NBFC. But upon it, RBI's stands are that it is already conducted open market operations and SBI has announced to purchase assets from NBFC. RBI will do more but present situation does not required actions. Therefore two here also two institution are opposite to each other and hence the friction take place.
3. FOREIGN EXCHANGE RESERVE ISSUE: Another point of friction between government of India and RBI is depletion in forex reserves. Although, there are many internal and external factors to depletion in forex reserves but Government of India says that RBI is not introducing and implementing sufficient reforms to stabilize forex reserve. It says in few months back it was around 426 billion USD, which is now 394 billion USD and declining, but RBI stand is that. Upon that RBI's stand is that there is need to correct the value of rupee in foreign exchange market and hence it allows the adjustment in forex reserves itself.
4. ISSUE OF NPA: NPA stands for Non Performing Assets, in this context government of India says that in the year 2008 to 2014, RBI was inactive and inaccurate in making its policy, it allowed huge amount of credit in the market which led to huge amount of NPA in current years. This argument is also true to a certain extent but not entirely because of demand of hour at that time was to had inflow in the market the reason for that was global financial crises but government's issue is also that RBI didn't take sufficient measures after such situation, it means RBI had to pull back money from market. RBI's stand is that it took actions by introducing IBC 2016, 5:25, PCA etc. and preparing policies to handle the situation.
5. REGULATION OF PSBs: PSBs stands for Public Sectors Banks.This is very hot at which debates are taken as the NEERAV MODI SCAM happened government of India criticize RBI not to be proactive in find out this scam before it came in public domain. But here RBI's grievance is that it has not sufficient power to regulate PSBs as It has to regulate private banks. It says that most of business activities are performed in PSBs not in private banks and the removal and appointing power is in the hands of government of India. Therefore, It is difficult to regulate PSBs. In case of private it is easy, best example is removal of YES BANK CEO. But in case of PSBs RBI is forlorn
6. PAYMENT REGUALTATOR ISSUE: Few months ago, Government of India issue a draft in which it proposes to have a new and separate Payment Regulator. Upon that RBI says that payment regulation is the sub system of its system so there is no need to be a separate payment regulator but if it is necessary so the new payment regulator should be within RBI and headed by Governor itself.

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7. ISSUE OF PCA: PCA stands for Prompt Corrective Action, which sticking point regulation. RBI uses RBI over a period of time host many measures to decline in the NPA in which PCA is most effective tool. PCA is the methodology in which performance of a bank is decided on the bases of four important parameters which are CAR/CRAR, NIPPA (Assetsquality),Profitability and Leverage.

**PCA matrix – areas and risk thresholds**

| Area | Risk threshold 1 | Risk threshold 2 | Risk threshold 3 |
|---|---|---|---|
| Capital (Breach of either CRAR or CET 1 ratio) | up to 250 bps below Indicator <10.25% but >=7.75% upto 162.50 bps below Indicator <6.75% but >= 5.125% | more than 250 bps but not exceeding 400 bps below Indicator <7.75% but >=6.25% more than 162.50 bps below but not exceeding 312.50 bps below Indicator <5.125% but >=3.625% | In excess of 312.50 bps below Indicator <3.625% |
| Asset Quality (Net non-performing advances ratio) | >=6.0% but <9.0% | >=9.0% but < 12.0% | >=12.0% |
| Profitability return on assets | Negative ROA for two consecutive years | Negative ROA for three consecutive years | Negative ROA for four consecutive years |
| Leverag Tier 1 Leverage ratio | <=4.0% but > = 3.5% (leverage is over 25 times the Tier 1 capital) | < 3.5% (leverage is over 28.6 times the Tier 1 capital) | |

**RISK THRESHOLDS AND CORRECTIVE ACTIONS**

| RISK THRESHOLD 1 | RISK THRESHOLD 2 | RISK THRESHOLD 3 |
|---|---|---|
| RESTRICTION ON DIVIDEND / DISTRIBUTION/REMITTANCE OF PROFITS<br>MORE CAPITAL TO BE BROUGHT IN BY OWNER / PROMOTERS IN CASE OF FOREIGN BANKS<br>DISCRETIONARY ACTIONS BY REGULATOR | IN ADDITION OF ACTIONS UNDER RISK THRESHOLD 1,<br>RESTRICTIONS ON BRANCH EXPANSION - DOMESTIC / OR OVERSEAS<br>HIGHER PROVISIONS AS PART OF COVERAGE REGIME<br>DISCRETIONARY ACTIONS BY REGULATOR | RESTRICTIONS ON DIVIDEND<br>RESTRICTIONS ON BRANCH EXPANSION.<br>RESTRICTIONS ON MANAGEMENT COMPENSATION AND DIRECTOR'S FEES.<br>DISCRETIONARY ACTIONS BY REGULATOR |

As above two charts makes it clear that if any bank comes under PCA category according to threshold stages given actions to be taken for example DENA BANK was considered as PCA category RBI asked it not to open new branches without consulting RBI . But the point of friction again here is between central bank and central government. Government says PCA should be taken but bring some flexibility and relax in rigid guidelines and wants to follow Basel 3 international standard. But RBI wants its implementation strictly.

8. FEBRUARY 12 CIRCULAR:It is also a sticking point of both institutions that is earlier if a company takes a loan and failed to pay it then bank has to try to recover it by internal mechanism for which it has given 180 days and then it went for IBC (NCLT). But as new circular issue by RBI it is suggested to withdraw internal mechanism and if borrower fails to pay even a single day, banks would start recover process and then send it to IBC (NCLT).

**# 3.Views of different governors and eminent personalities in the matter of independency of central bank or its autonomy and its impact on economy.**

Important points of VIRAL V. ACHARYA'S speech

1. "A government's horizon of decision-making is rendered short, like the duration of a T20 match (to use a cricketing analogy), by several considerations. There are always upcoming elections of some sort – national, state, mid-term, etc. As elections approach, delivering on proclaimed manifestos of the past acquires urgency; where manifestos cannot be delivered upon, populist alternatives need to be arranged with immediate measures .

2. "In contrast, a central bank plays a Test match, trying to win each session but importantly also survive it so as to have a chance to win the next session, and so on. In particular, the central bank is not directly subject to political time pressures and the induced neglect of the future; by virtue of being nominated rather than elected, central bankers have horizons of decision-making that tend to be longer than that of governments, spanning election cycles or war periods."

3. "Sweeping bank loan losses under the rug by compromising supervisory and regulatory standards can create a façade of financial stability in the short run, but inevitably cause the fragile deck of cards to fall in a heap at some point in future, likely with a greater taxpayer bill and loss of potential output."

4. "While not always the case, often the required interventions for stable growth are structural reforms by the government with upfront fiscal outlay; however, these may compromise populist expenditures or require displeasing incumbents. As a result, it might seem as an expedient solution to the government to ask/task/mandate/direct the central bank to pursue strategies that generate short-term gains but effectively create tail risks for the economy."

5. "When important parts of financial intermediation are kept outside the purview of the central bank, systemic risks can build up in "shadow banking" with private gains in good times to a small set of players but at substantive costs to future generations in the form of unchecked financial fragility.

6. "Unfortunately, not all politicians are thoughtful. Not all have the patience to wait for long-term gains. Not all are pleased when appointees refuse to bow to their wishes. And not all are respectful of inherited institutions and conventions, be they central bank independence or, more broadly, the division of powers."

7. "While the jury will remain out for some time on the economic impact of the flexible inflation-targeting framework, it is incontrovertible that the MPC has given monetary policy an independent institutional foundation. The government deserves much credit for its far-sightedness in legislating the required changes to strengthen this aspect of central bank's independence and distancing itself in the process from monetary decision-making (other than through the appointment of external members on ..

8. "One important limitation is that the Reserve Bank is statutorily limited in undertaking the full scope of actions against public sector banks (PSBs) – such as asset divestiture, replacement of management and Board, license revocation, and resolution actions such as mergers or sales — all of which it can and does deploy effectively in case of private banks."

9. "Having adequate reserves to bear any losses that arise from central bank operations and having appropriate rules to allocate profits (including rules that govern the accumulation of capital and reserves) is considered an important part of central bank's independence from the government (see, for example, Moser-Boehm, 2006). A thorny ongoing issue on this front has been that of the rules for surplus transfer from the Reserve Bank to the government."

10. "A final issue is one of regulatory scope, the most recent case in point being the recommendation to bypass the central bank's powers over payment and settlement systems by appointing a separate payments regulator (also covered by Rakesh Mohan in his series, ibid). The Reserve Bank has published its dissent note against this recommendation on October 19, 2018."

## RAGHURAM G. RAJAN'S VIEWS ON INDEPENDENCE OF CENTRAL BANK

Raghuram G. Rajan in his "I DO WHAT I DO" says that there is danger in keeping the position ill-defined, because of constant efforts, bureaucracy is to whittle down its power. Successive government and finance minister misunderstand role of the RBI.

The RBI governor is the technocrat of nation's risk management and not simply any other bureaucrat.

He also made it clear responsibility of The RBI, to fulfill desire rate of inflation in defined framework but if unable to achieve its desired rate of inflation it has to face question from every aspect of nation and answerable to its citizens. Therefore , it is needed to free RBI to move its wings to handle the situation.

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## CONCLUSION

With the beginning to the end of this paper it easy to understand that The RBI, is not just an institution as any other, but It is the nation's RISK MANAGER, so it is essential to make it independent to a sufficient extent so that it can regulate nation's health and wealth. Contentions between Central government and Central Bank, not just put blemish of internal unrest situation nut arises question upon RBI's credibility as result there is down market which make country's condition worse to worst.

Therefore it becomes to mandatory for both institutions to keep discussion with right decisions in public interest and any central government should not misunderstand role of The RBI and its Governor in nation. So that country can be able itself of high growth and comfortable level of inflation in the country.

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THANKING YOU…