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Rift between RBI and Government

Introduction

There has been considerable support on the proposal to establish the Public Debt Management Agency (PDMA) to manage Central government debt, and to shift the regulation of government securities from RBI to SEBI. However, on April 30 2015, the finance minister stated that clauses ***relating to the PDMA, amendments to the RBI Act 1934 and the Government Securities Act 2006*** would be withdrawn from the Finance Bill, 2015. The FM announced that the Union government would now work on a roadmap for the PDMA and unified financial market regulator in consultation with the RBI. However, the inflation targeting has been entrusted to the RBI.

If the RBI that Mr Rajan heads is now opposing the reforms (the idea of PDMA and entrusting the regulation of government securities to SEBI), he is obliged to disclose the RBI's reasons and also explain why he changed his own views. Equally, Mr Jaitley is obliged to explain why he gave in to RBI's opposition, and what the "further consultation" with RBI is expected to yield.

Amidst the above background, the three subjects are of great importance, that we will take separately:

1. The first is debate on taking away the management of the domestic debt of the Govt from the RBI and entrusting it to an independent Public Debt Management Agency (PDMA).
2. The second is moving the regulation of government securities from the RBI to the SEBI.
3. Inflation Targeting and the New Monetary Framework.

Let's now take each one of them now.

Public Debt Management Agency

Consistent Support for PDMA

RBI was among the first to recognise the need for PDMA, proposing it in its ***Annual Report 2000-01***. It was supported by the ***Percy Mistry Committee*** on Making Mumbai an International Financial Centre (2007), the ***Raghuram Rajan Committee*** on Financial Sector Reforms (2008), and the ***Financial Sector Legislative Reforms Commission*** (2011). The Arguments supporting establishment of PDMA are:

1. ***Conflict Of Interest:*** Government borrows to finance its debt. It issues — or authorises the RBI to issue on its behalf — government securities (G-Sec). RBI is the largest *trader of G-Sec*, the *operator of the securities infrastructure* (which consist of an exchange, a depository and a clearing house for G-Sec), the *regulator of the market* for G-Sec, the *regulator of banks* who are the largest purchasers of G-Sec, and *determinator of the interest rates for G-Sec*. So, the present system is riddled with conflicts of interest with RBI acting as a "judge, jury and prosecutor". This makes a case for independent PDMA for debt management.
2. ***Integrated Management of Debt:*** It will also facilitate better planning and management of domestic and foreign market borrowings of the centre.
3. ***Relieve RBI:*** Apart from reducing the operational burden on the RBI, it will help RBI focus on core functions related to monetary policies.
4. ***Strengthen Bond Market***
5. ***Help Promote Investment***
6. ***Globally Accepted:*** Shifting public debt management from RBI to a debt management office is a globally accepted best practice. Most OECD countries have already established dedicated debt management units.

In the Budget for 2007-08, UPA announced the setting up of a ***Middle Office of PDMA*** in the Government. It was set up and, with the help of RBI's experts, began to acquire skills in public debt management. The Finance Bill 2015, till recently, laid out the contours of the PDMA. It envisaged the agency as a body corporate with a separate board, consisting of executive and nominee members appointed by the Central government.

Arguments Against PDMA

However, post the Asian financial crisis, after Bimal Jalan took over as governor of the RBI, the dominant belief shifted against such a separation of powers for several reasons.

1. ***Conflict of Interest Argument Questioned***
    - There are also conflicts of interest between government as owner of banks and issuer of debt. There is no evidence in India to suggest that either debt management or monetary management has been compromised by the RBI.
    - Further, the RBI's endeavours in debt management have resulted in significant improvements in the G-Sec market trading and settlement system, with greater transparency, more efficient price discovery, no settlement risk, lower transaction costs and a level playing field.
    - One question that has to be addressed in the light of this evidence is: If it ain't broke, why fix it?

2. ***Pragmatic Fiscal and Monetary Coordination***
    - In the interest of pragmatic monetary and fiscal coordination, it is prudent to leave debt management to the RBI.
    - Large fiscal deficits meant that the government borrowing programme did impinge on monetary policy, liquidity and the cost of credit for the private sector.
    - Independent management and issuance of government debt could distort the sovereign yield curve in a thin market, jeopardising monetary signalling and its transmission.
    - Foreign exchange market volatility had implications for debt management.

3. ***Doubts over Capability of PDMA vis a vis RBI***

    - As banker, the RBI has been helpful in accommodating the deficit and surplus modes, taking into account the market's absorptive capacity. One is doubtful if an independent body will have the experience to handle cash management of such magnitude.
    - With elevated debt levels, debt management could no longer be viewed as a routine function that could be delegated to a separate, independent body.

4. ***Separation Being Challenged Globally***

    - Globally, the conventional view on separation has been under challenge after the financial crisis. It is being said that central banks should be encouraged to once again take up their earlier roles as managers of national debt.
    - Even in the *UK*, there was serious parliamentary debate on shifting the debt office back to the Bank of England. It was ultimately decided not to unsettle the extant structures. Instead, it was decided that the two should work in close coordination with each other.
    - *Denmark and Iceland* have shifted debt management back to the central bank.

Conclusion

The arrangements for cash management and meeting temporary shortages of liquidity will need to be worked out. Irrespective of how separate the agency is or is not, given the size of the borrowing programme and the stage of development of markets, the ***RBI and the Ministry of finance will need to work in close coordination***.

SEBI As The Regulator Of Government Bonds

- The other idea of entrusting the regulation of govt. securities to SEBI also flowed from the ***conflicts of interest*** that have been referred to earlier.
- SEBI is the regulator of the capital market (equity and corporate debt) and will be, shortly, the regulator of the commodities derivatives market as well. It is therefore logical that the govt securities market should also be placed under SEBI, which will be ***the unified regulator of financial trade*** — an idea supported by the committees mentioned earlier. No one doubts that SEBI has the relevant skills to take on the additional responsibility.
- However, India will not take away the RBI power ***to regulate trade in government bonds*** even as it prepares to remove the central bank's responsibility for managing public debt, says govt.
- For the time being, GoI has withdrawn this proposal from the Finance Bill 2015.

Inflation Targeting (IT) and New Monetary Framework

An important milestone in India's macro-economic management was reached in Feb' 2015 with the RBI and the government agreeing to a **New Monetary Framework** that will pave the way for flexible inflation targeting. The RBI Act will be amended so as to accommodate the new framework. By officially committing to inflation targeting through the signing of a monetary policy agreement between the finance ministry and the RBI, India has joined 28 other countries in explicitly fixing goals for annual increases in the CPI and pinning responsibility on the central bank for achieving them.

These have been on the lines of the recommendations of the ***Urjit Patel Committee***, which had also suggested CPI inflation (rather than WPI) as the reference point. RBI Governor Raghuram Rajan has thrown his weight behind the Patel Committee's recommendations, ensuring the adoption of substantial portions of the report in the agreement.

Rajan had suggested setting up of monetary policy committee following the acrimony between RBI and government on interest rates cuts. He had said ***Parliament should set an inflation target*** for the central bank instead of the present discretion-based targeting of inflation, and ***set up a monetary policy committee*** a la the *US Fed' Fed Open Market Committee*.

Basics of Inflation Targeting(IT)

- ***Definition of IT***: A central banking policy that revolves around meeting preset, publicly displayed targets for the annual rate of inflation. The benchmark used for inflation targeting is typically a price index of a basket of consumer goods, such as the Consumer Price Index (CPI).
- ***Types of IT***: Point Targeting and Range Targeting.
- ***Rationale For IT***
  - Reduce impact of inflationary shocks and the associated costs
  - Targeting a low rate of inflation would lead to a more stable and lower long term rate of interest.
- ***Pre-requisite for IT***:
  - Central bank should not be constrained to finance the government budget.
  - Central bank must have the ability to accurately forecast the inflation, and assess the impact of monetary policy on inflationary expectations
  - A relevant price index is to be selected. Most countries choose CPI for targeting. But countries susceptible to external shocks or supply side shocks may choose core inflation.

Features of New Monetary Framework

- Under inflation targeting, the ***RBI will target a fixed rate of CPI inflation*** — below 6 % by Jan' 2016, and 4 % from the next year (2016-17) with a band of plus/minus 2 %. The latter translates into between 2 and 6 %.
- At the core of the new inflation agreement is the **Monetary Policy Commitee,** which will have the RBI Governor and the Deputy Governor in-charge of Monetary Policy, but also a government nominee and a number of independent experts, who will form the majority. The Monetary Policy Committee will determine the stance of Monetary Policy. It is its creation and likely composition that has evoked a fair amount of controversy.
- The RBI will publish the **operating targets as well as an operating procedure** through which the target will be reached.
- The central bank will also prepare **a document every six months** explaining the sources of inflation and the forecast for the next six months.

Views Supporting Government Move In Favour of IT

1. **Growth Needs:** It has also been claimed that in the pursuit of price stability, the objective of meeting the growth needs of an increasingly complex economy will not be forsaken.
2. **Cushion Against Inflationary Shocks**
3. **Enhanced Investment:** Targeting inflation will lead to stable rate of interest, and hence is good for investment climate.
4. **Greater Accountability:** The central bank will be more accountable now if it fails to meet the pre-set inflation targets. It will have to explain in writing to the govt. if inflation goes above or below the pre-set levels.

Views Criticising Government Move In Favour of IT

There have been influential detractors, including former governors of the RBI.

1. **Pure Monetary Approach To Inflation:** In their view, inflation in India is largely driven by food and fuel prices over which Monetary Policy has very little impact. The limitations of a pure monetary approach to inflation suggest that along with the inflation mandate, the central bank should have the responsibility of growth and inflation. The U.S. Federal Reserve is committed to both price stability and employment.
2. **One Sided:** Others point out that the agreement is one-sided: while the RBI binds itself to an inflation target, there is no corresponding commitment from the government to maintain fiscal discipline.

3. **Role and Composition Of Monetary Policy Committee:** The Central bank sources have said the two sides are at odds over the size of the committee, its composition and whether the central bank chief would have veto power.
4. **Limited Success In Developing Economies:** Studies covering a number of countries have made the point that inflation targeting works best in developed economies, and has had very limited success in the few developing countries where it has been tried. This is because:

    - There is also a poor appreciation of the **transmission mechanism** in India. Banks react asymmetrically and frame their interest rate policy in line with their own internal procedures. It is not at all surprising that a rate cut does not translate into lower rates on loans to borrowers.
    - Unlike in other countries, India's CPI has very *high weightage for food and non-alcoholic beverages* (FNB) — 45.86 % in the new 2012-base combined index. The FNB contribution to the CPI is lower even for Ghana (43.48), Thailand (33.48), Brazil (24.6) and South Africa (17.5), not to speak of New Zealand (18.84), Canada (16.4) or the UK (11.2). It follows from this that CPI inflation is significantly tied to food inflation. Given the latter's high weightage in the CPI, the success of inflation targeting in India is predicated on what happens to food prices. In that, external factors —*sliding global oil and farm commodity prices* — too play a significant role. Now, we don't know when these external factors may turn unfavourable, and push up CPI inflation all over. Does it make sense at all, then, to target inflation — that too at the retail end — while blaming the RBI for overshooting?

5. ***Inherent Danger Of Creating An Anti-Farmer Policy:*** While inflation targeting has some rationale in advanced economies, where food's contribution to the CPI and consumption expenditures is barely 20 %, and agricultural markets are far more organised, there is an inherent danger of it creating an anti-farmer policy bias in a country like India. Can one make rational projections of food inflation here? Considering the sheer unpredictability of such an exercise, wouldn't the rigid commitment to CPI inflation targets naturally predispose policymakers towards *freezing minimum support prices, imposing restrictions on farm exports on the slightest pretext and opening up to duty-free imports with or without the WTO*?

Conclusion

The dominant objective of monetary policy is the maintenance of price stability. And the Inflation targeting gives precision to the concept of price stability. Rising prices ***adversely affect savings*** while making speculative investments more attractive. These apart, there is a crucial social dimension, particularly in developing countries. Inflation adversely affects those who have no hedges against it, and this includes ***all poorer sections*** of the community. This is indeed a very strong argument in favour of the maintenance of price stability in emerging economies.

However, seeing the history of limited success of inflation targeting in developing countries (as discussed earlier), the govt and the RBI should refrain from framing ***a growth inhibiting and anti-farmer policy*** that targets just inflation at any costs. That will be detrimental to the idea of enacting a new monetary policy.

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