The Modi Government's Spat with the RBI*

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The Modi government's spat with the Reserve Bank of India, like its sudden resurrection of the Ram temple project, indicates the desperation it feels at its dwindling electoral appeal. Having dealt a huge blow to the small-scale sector through its measures like demonetization and the GST, having aggravated through its inaction the impact on the Indian economy of the world capitalist crisis, and of Trump's protectionism that has followed, it is now quite desperate to salvage some support for itself as the Lok Sabha elections approach. Since mere grandiose announcements such as Ayushman Bharat or doubling agricultural incomes can no longer fool people, it is frantically looking for some additional financial resources with which it can launch some schemes that can carry greater credibility.

It had hoped that demonetization would give it a resource windfall via the non-return of disabled currency, but that hope was belied. At the same time, being desperate to attract financial flows for managing the current account deficit on the balance of payments, it cannot afford to offend globalized finance, either through a greatly increased fiscal deficit, or through any bold taxation measures. Within the neo-liberal straitjacket which it has cheerfully donned, it cannot, therefore, get the resources it wants in the usual ways, i.e. through taxation or borrowing. It is frantically looking for unorthodox ways of laying its hands on some funds, but here the RBI's stodginess comes in the way. That accounts for its latest spat with the RBI.

This spat has to do with its wanting to get hold of a part of the capital reserves of the RBI. (These have to be distinguished from the foreign exchange reserves with the RBI which are the usual focus of discussion). While the economic effects of doing so would be absolutely no different from an increase in the fiscal deficit, i.e. no different from a situation where the government would have sold some new securities to the RBI against currency which it could obtain in return and use for its new projects, it has the "advantage" that it would not be counted as fiscal deficit, and hence is expected not to annoy globalized finance.

This is because the RBI's reserves would be obtained by the government in several ways none of which entails larger borrowing. One way could be an increase in the transfer of RBI's surplus to the government. Since the central government is the sole owner of the RBI, the profits of the RBI, minus what is added to its equity and reserves, is transferred every year to the government budget as its income. The RBI in turn makes a profit because it pays virtually zero interest rate on its liabilities, which consist predominantly of currency, while it earns a positive interest rate on its assets (including government securities).

When Raghuram Rajan was the Governor of the RBI, it transferred virtually its entire surplus to the government budget, but after his exit the transfers have been less than the surplus earned. Running down its reserves could bring about the opposite situation, i.e. transfers to the government budget would exceed the surplus in that particular year, which will not constitute government borrowing, i.e. fiscal deficit.

Alternatively, the RBI could reduce its reserves by using them for recapitalizing the public sector banks on behalf of the government, for which then no provisions need be made from the budget; and that in turn would release funds for other expenditures by the government.

The RBI however is reluctant to run down its reserves because it feels that doing so would increase its risks. International comparisons suggest that there are many countries where central banks have much lower ratios of reserves to assets than in India, while there are others where the ratios are higher. The real point, however, is not whether the reserves are "too high", or which of the two, the government or the RBI, is "right" on this issue. The point is that this entire debate has arisen as a fall-out of neo-liberalism, of the contradictions that inevitably arise in a neo-liberal economy between the compulsion on the part of the government to please international finance and its need to win elections. Expenditures have to be stepped up for the latter, while international finance disapproves of such stepping up.

The RBI of course articulates the position of international finance, but to blame it for standing in the way of larger government spending, is like blaming the local SHO for the actions of a repressive regime. True, the RBI is not supposed to serve international finance in the way that the SHO is supposed to serve a regime of which he or she is a part; but it is foolish to believe that international finance will be taken in by the government's ruse, and approve of its spending more through running down the RBI's reserves just because it does not entail a larger fiscal deficit in accounting terms. The opposition of international finance in short is to State activism in enlarging welfare or social expenditure (it wants such social sectors to be left to private capitalists), not to fiscal deficits in some accounting sense.

No government has been as obedient to the dictates of finance as the Modi government; and with impending elections it not only wants to have the cake and eat it too, but believes that it can manage to do so by hiding behind some accounting practices. The RBI, concerned about the reactions of the "market" (a euphemism for finance) is its first stumbling block; but even if the RBI falls in line with the government's plans, the basic opposition of finance would not disappear.

In fact the removal of fiscal policy from its role as an instrument for intervention in the economy is a hall-mark of a neo-liberal regime. Such a regime exposes the economy to cross-border financial flows, because of which retaining the "confidence of the investors" (a euphemism for keeping global speculators happy) becomes an overriding concern for the government, for otherwise there would be an outflow causing a financial crisis. This means that higher taxes on the capitalists, or on the rich in general, are eschewed, and the fiscal deficit is kept within strict limits (for which there is even an FRBM legislation). And imposing higher taxes on the poor, through indirect taxation that largely falls on them, neither serves the electoral purpose nor can be used to stimulate the level of activity in the economy (for larger government expenditure financed by larger indirect taxation hardly increases overall aggregate demand).

Reviving the fiscal instrument under a neo-liberal regime is therefore not possible, and blaming the RBI for articulating this is pointless, for it is a structural feature of the regime itself, not the invidiousness of a person called Urjit Patel, a favourite till yesterday.

A significant feature of a neo-liberal regime, arising from this, is excessive reliance on interest rate policy. Interest rates are supposed to achieve several different goals simultaneously; and this is a logical impossibility. The Dutch economist Jan Tinbergen had pointed out a simple obvious fact a long time ago, namely that the number of policy instruments in the hands of a government must be at least as many as the number of objectives it is supposed to achieve. The neo-liberal regime leaves only one policy instrument, namely interest policy, to achieve at least three stated objectives: a satisfactory level of economic activity, a rate of inflation that is within limits, and a balance of payments that can be managed without causing excessive exchange rate depreciation for that would bring in its train a whole plethora of woes. (It may be thought that exchange rate policy itself can be used to manage the balance of payments, but this never works in practice, since the effect of exchange rate on exports and imports takes a very long time to manifest itself and meanwhile there can be a run on the currency which can ruin an economy). It is obviously impossible for one instrument, namely monetary policy (which is basically centred around interest rate policy) to achieve all these objectives.

The Modi government's spat with the RBI is rooted in this structural characteristic of neo-liberalism. The apparent conflict between the RBI's desire for "autonomy" (so that it can become a gendarme of international finance), and the Modi government's desire to spend more while remaining within a neo-liberal regime, is a false discourse. The removing the gendarme would not mean removing the regime. The real need is to step out of the neo-liberal regime itself.

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