Indian economy

India central bank's payout to Modi government sparks warnings

Analysts say $25bn transfer should be for long-term projects, not a quick fiscal fix

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Amy Kazmin in New Delhi AUGUST 27, 2019

For those who fear India's central bank has lost too much of its independence to prime minister Narendra Modi, the transfer of $25bn to the government this week was always just a matter of time.

With economic growth faltering and the government's fiscal position parlous, the Reserve Bank of India on Monday seemed to ride to Mr Modi's rescue, agreeing the unprecedented transfer from its balance sheet. The $25bn for the government's coffers, from the RBI's profitable central banking operations, amount to about 1 per cent of gross domestic product.

It was fear of such a transfer that last year sparked a bitter confrontation between Mr Modi's administration and Urjit Patel, then the RBI governor. The feud cost Mr Patel his job and triggered warnings about the loss of the central bank's autonomy and credibility. Many analysts were quick to repeat those warnings after the RBI's decision, authorised by Mr Patel's successor Shaktikanta Das.

"Once they introduce this notion that the central bank is going to assist with budgetary financing, it brings up the obvious question of whether monetary policy will be used more broadly to finance government operations," said Eswar Prasad, a Cornell University economics professor.

But others defended the logic of the payout — and more in future — as a sensible use of capital by one of the world's most robust central banks. The more pertinent question, they suggest, is whether New Delhi puts the revenue to productive use — or uses it as a short-term fix for its finances as tax collections fall short.

"I don't see anything egregious in the transfer — there is no real reason as to why the RBI should be sitting with those kind of reserves," said Jahangir Aziz, chief of emerging markets research at JPMorgan. "The question is, what does the government do with that money? That is a completely different question."

The RBI is one of the world's best-capitalised central banks with capital accounting for 28 per cent of total assets, compared to a global average of 8 per cent. Without any legal obligation to transfer its earnings to its sole shareholder — the government — as many central banks do, the RBI has instead issued small ad hoc dividends, amassing a large capital base as a buffer for any potential economic crisis.

"The impression that is created is that the government is raiding something that belongs to the RBI. But normally, this is something that goes to the government anywhere else in the world," said economist Ila Patnaik, a professor at the National Institute of Public Finance and Policy.

Debate over whether India could use some of the RBI capital more productively goes back at least a decade. But New Delhi's focus on the RBI balance sheet intensified during Mr Modi's first term after Arvind Subramanian, then his chief economic adviser, argued that excess central bank equity be used to recapitalise struggling public sector banks.

Struggling with ambitious spending commitments and disappointing tax collection — New Delhi put pressure on the RBI to surrender its surplus capital with no strings attached, eyeing a potential windfall of up to $50bn.

It's a punchy amount. It's meaningful. But it's not so

Tensions over the issue exploded into public view last October when then deputy RBI governor Viral Acharya warned — with Mr Patel's blessing

large to allow the critics to say that the government is raiding the RBI coffers and destroying its balance sheet entirely

Saurabh Mukherjea, Marcellus Investment Managers

— that New Delhi could "incur the wrath of the financial markets, ignite economic fire" if it undermined the RBI's independence.

Within weeks Mr Patel had resigned and the RBI, under Mr Das, set up a committee to propose a new capital framework, including the appropriate level of reserves.

Economists say the committee's recommendations — which were approved on Monday, paving the way for this week's transfer — have deftly balanced payouts with prudence.

"It's a punchy amount. It's meaningful," says Saurabh Mukherjea, founder of Marcellus Investment Managers. "But it's not so large to allow the critics to say that the government is raiding the RBI coffers and destroying its balance sheet entirely."

The committee, led by former governor Bimal Jalan, recommended the central bank maintain its equity in a range between 5.5 per cent to 6.5 per cent of assets, down from 6.8 per cent previously. That facilitated the transfer of the RBI's entire net income of $17.4bn from last year, and $7.4bn of what was deemed excess capital.

In total, the transfer — which includes $3.9bn paid out as an interim dividend in February — is around 2.5 times higher than the average payout in the last five years.

But it was still far below what New Delhi previously sought. The committee also declined to include the RBI's "revaluation capital" — arising from depreciation of the rupee against its foreign currency holdings — as a distributable capital, liable to transfer.

"A fine balance has been struck," HSBC said in a research note. "The government has got some extra money without eroding RBI credibility, given this is based on well-articulated and sound economic principles."

Attention now turns to how New Delhi intends to use the funds. Many economists believe the government should pay off debt to reduce pressure on the bond market. "The right thing to do is take that windfall gain and reduce your borrowing," said Mr Aziz.

The next best option, many say, would be to use the funds for productive investments. "The optics could be made a little better if this money was earmarked for projects that explicitly improve the long-term productivity of the country," said Mr Prasad.

That, some suggest, could also include putting more money towards recapitalisation of public sector banks beyond the $9.8bn already slated. But some economists said it was far more likely that the funds would simply be used to repair the hole in the government's budget so it can hit its fiscal deficit target of 3.3 per cent of GDP.

"Tax revenues are under significant pressure, and hence this amount will most likely be used to plug revenue shortfall," Edelweiss Securities said in a research note.

Mr Aziz warned that New Delhi should avoid using the funds as a crutch to help it through a difficult year, while avoiding reforms to improve long-term economic prospects.

"This is one more escape route with which the government does not do the difficult things," he said. "All you are doing is kicking the adjustment further down the road. If they do not take the right steps now, they may find it very, very difficult to borrow money in the future."