India’s Central Bank Under Attack

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ITHACA – Indian Prime Minister Narendra Modi’s government has launched an all-out political assault on the Reserve Bank of India, and the barrage of criticism is already taking a toll on the institution. This is an alarming development for India, because the RBI’s credibility and effectiveness have contributed substantially to macroeconomic and financial stability, thereby helping to sustain rapid GDP growth in recent years.

One key criticism leveled against the RBI is not unique to India: the central bank, the government claims, is impeding growth by raising interest rates in the name of a misguided fear of excessive inflation and financial instability. US President Donald Trump has leveled similar complaints at the Federal Reserve, claiming that interest-rate hikes are dampening economic growth and the US stock market.

But the threat such attacks pose to the RBI dwarf those faced by the Fed, not least because, unlike the Fed, the RBI has no statutory independence. Making matters worse, the Modi government has, for the first time ever, invoked Section 7 of the RBI Act, which allows it to issue directions directly to the central bank governor on matters of public interest.

The Modi government’s willingness to go to such lengths suggests that more than interest rates are at stake. The government is particularly unhappy with RBI measures to clean up India’s banks, many of which are burdened by a large volume of non-performing assets, and prevent risks from building up in other parts of the financial system. These measures are squeezing state-owned banks’ ability to lend to politically connected clients.

Of course, government ministers can’t come right out and say that. So, instead, the Modi administration – and, in particular, Arun Jaitley, the finance minister – has taken the RBI to task for not preventing the accumulation of non-performing assets in the banking system after the credit spigots were opened to help cope with the global financial crisis.

The government has also accused the RBI of subverting due process by keeping it in the dark about monetary-policy moves. This criticism is disingenuous at best. At worst, it could bring to a grinding halt much-needed banking-sector reforms aimed at, among other things, ensuring productive, rather than politically motivated,

lending. Such an outcome would heighten financial risk and jeopardize the economy’s growth potential.
So far, RBI Governor Urjit Patel has refused to give in to the government’s demands. It helps the RBI’s stature and independence that Patel and his lieutenants, like their predecessors, are experienced at navigating the RBI through economic and political minefields. But if the government continues to attack the RBI on multiple fronts, effective monetary policymaking could become impossible. And if those attacks include forcing Patel out, the blow to the RBI – the only well-respected technocratic institution in India’s mostly dysfunctional bureaucracy – would be severe.

Central-bank independence is often fetishized nowadays. But if a central bank pursues objectives that have no political support, its legitimacy should (and will) suffer. Nonetheless, the loss of operational independence – the ability to act without interference in pursuit of its stated objectives, developed in consultation with political authorities – can also be fatal to a central bank’s credibility.

Consider recent events in Turkey. President Recep Tayyip Erdoğan’s public attacks on the central bank’s independence caused the Turkish lira to plummet. By the time the central bank prevailed over Erdoğan’s dictums and raised interest rates, it was too late; its credibility had been shattered.

Modi’s government has a strong interest in ensuring that the RBI does not suffer a similar fate. After all, the central bank’s credibility has been essential to enable the implementation of policies that have provided the government with room to maneuver in a difficult domestic and external environment.

For one thing, the RBI has prevented the rupee from falling further, thereby averting the risk of a vicious circle of capital outflows and currency depreciation. Moreover, the RBI’s commitment to price stability has translated into low interest rates, keeping the government’s debt-financing costs in check. More broadly, the RBI’s monetary policy and supervisory authority have made it one of the most potent tools for keeping the economy on a stable, high-growth path.

With national elections approaching, India’s government cannot afford to sacrifice these benefits, especially at a time of rising skepticism about its ability to maintain fiscal discipline and implement difficult reforms. Modi and Jaitley need to recognize this and start speaking up for, not against, the RBI.

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