

What you need to know about the RBI vs Centre standoff

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Money trail: The RBI's contingency fund has come down from 12 per cent to 6 per cent - PTI

What is the RBI's war chest? Why does the bank require it? An explainer on the standoff between the government and the central bank

Days after it was reported that the government was seeking ₹3.6 lakh crore from the Reserve Bank of India (RBI) came the rebuttal. The discussion, said the secretary (economic affairs) Subhash Chandra Garg, was only over a proposal to fix an appropriate “economic” capital framework for the central bank.

The reports, on the other hand, had suggested that the government wanted to reset the current framework, if necessary through recourse to a section never before used in the RBI's 83-year history, to free up ₹3,60,000,00 — approximately 2.1 per cent of last year's GDP — for transfer to the government.

The framework governs the risk capital the RBI maintains for absorbing the losses in its various money and forex market operations. While this is not the first time a review is being proposed, such a move by a government that has barely months left in its tenure, ahead of a general election, may be without precedent. The timing has raised questions over the motivation behind the government's move to dip into the RBI's war chest.

What is this war chest? How does it get created? And why does the RBI require it?

Income accrues to the RBI from interest on its holdings of government securities, its overnight lending to commercial banks and the returns on its foreign currency assets. Under the expenditures head, its main outgo tends to be towards the cost of printing currency, agency commission paid to commercial banks to act on its behalf for government transactions, and the cost of employing over 17,000 staff.

Out of the surplus, the RBI makes allocations to various statutory reserve funds. The controversy pertains to the policy for determining how much the RBI must maintain as statutory reserves.

“The first reserve fund is meant mainly to absorb losses from its operations in money, securities and forex markets, and to absorb shocks arising out of variations in exchange rates and gold prices,” explains former RBI governor D Subbarao in his memoir *Who Moved My Interest Rate?*

The second reserve fund is for meeting the RBI's internal capital expenditure and investments in its subsidiaries and associated institutions.

The surplus after allocations to the reserves as per predefined formulae is transferred every year to the government.

As on June 30, 2018, the RBI had accumulated ₹6.91 lakh crore in its currency and gold revaluation reserve, and ₹2.32 lakh crore in its contingency reserve.

“For a cash-strapped government, the surplus transfer from the Reserve Bank, typically of the order of 0.5 per cent of GDP, is a significant source of revenue,” writes Dr Subbarao, who was a finance secretary before his appointment as RBI governor. If as finance secretary he pushed the RBI to raise the payment to the government, as governor he resisted the same pressure.

Every year, in the “weeks before the budget, it is common practice for the finance ministry to shore up revenues by pressuring public sector enterprises to raise dividend payments. The Reserve Bank too comes under pressure to scale down its allocations to the reserve funds so as to leave a higher surplus for transfer to the government.”

A settlement is reached every year with “both sides showing flexibility” to find common ground. “...even as this issue is contentious, it has never turned acrimonious,” he writes.

The standard argument the government makes, as it has in the current stand-off too, is that the RBI is far too conservative in estimating its contingent liabilities and is building reserves in excess of reasonable requirements. The RBI’s usual response is that it puts away no more than is required by minimum levels of prudence.

Over time, many technical committees have examined the question of how much reserves the RBI ideally needs. Central banks can almost always discharge their financial obligations by simply creating new money if necessary, but large exposures and sustained losses can weaken their ability to conduct policy effectively.

The norms in place currently for maintaining reserves were evolved over a period of time, through deliberations between successive governments and the RBI, and were guided by the recommendations from various committees. The RBI’s contingency fund, for instance, has been reduced from 12 per cent of RBI’s assets to 6 per cent over the past 10 years. The RBI is working on a framework that will systematically assess its risk-buffer requirements to determine the transferable surpluses every year.

Former governor Raghuram Rajan, guided by a committee that said the accumulated reserves had exceeded the needed buffer, transferred the surpluses in totality to the Centre, without keeping any for the reserves. Following demonetisation, however, the costs incurred for printing new notes had pared down the surpluses and, in turn, the RBI’s dividend to the government, which upset its fiscal deficit calculations.

What would happen if a consensus is not reached on the quantum of reserves needed, and the RBI is made to part with a portion of its “excess” capital buffer? It would diminish the central bank’s capacity for absorbing losses on account of its interventions under the monetary policy or rupee exchange rate management in the securities, money and forex markets; losses on account of revaluation of its foreign assets and gold; and losses on account of systemic risks, internal frauds and unforeseen contingencies.

Former RBI governor YV Reddy notes in his memoir *Advice and Dissent: My Life in Public Service* the RBI has “to be endowed with sufficient capital”. It cannot “afford to run into losses and depend on infusion of capital from the government, without losing its independence”.

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