Shaktikanta Das' RBI has a delicate task – balance govt's fiscal targets & its autonomy

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File photo of RBI Governor Shaktikanta Das | Kiyoshi Ota/Bloomberg

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The RBI governor is likely to find a way to transfer the right amount of money to help the government meet its fiscal targets.

At a time when the Narendra Modi government is trying hard to meet deficit targets, it would require clever financial engineering to boost revenue through non-tax sources, like disinvestment or RBI surpluses.

If one were to imagine a combined balance sheet of government, public sector enterprises and the Reserve Bank of India (RBI), what is essentially being done is moving money around from one head to another.

In the coming weeks, RBI governor Shaktikanta Das will likely find a way to transfer the right amount of money to help the government meet its fiscal targets. The objective will be that credit rating agencies do not bring down India's rating either on grounds of fiscal profligacy or on account of loss of RBI autonomy.

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Lessons on fiscal prudence

To his credit, throughout his term as the finance minister, Arun Jaitley has remained focused on meeting the fiscal deficit target. From the first budget of this government presented in July 2014, Jaitley has tried to keep the fiscal deficit to GDP ratio on track. The experience of the exchange rate crisis during the taper talk period in 2013 a year before Jaitley became the finance minister would have served as a good lesson on the importance of fiscal prudence.

Fiscal expansion in 2011-12 had spilled over on to large current account deficits for India's balance of payments. A speech by US Fed Chairman Ben Bernanke led to a depreciation of many emerging economy currencies. Among the worst faring currencies was the Indian rupee as India was labelled as one of the 'Fragile Five' economies. The lesson for the incoming finance minister was that macroeconomic stability could be maintained by keeping the fiscal deficit in check.

There were pressures on the new government for fiscal expansion – for increasing public investment, for recapitalising public sector banks, for launching new welfare schemes and expanding old ones, among other expectations. But, Arun Jaitley resisted them. The objective behind doing so was reflected particularly in the talks he gave to investors abroad. Macroeconomic stability and fiscal prudence were repeatedly emphasised as achievements of this government. Sticking to deficit targets was a way to prevent credit downgrades, foreign investors' outflows and a rupee crash. The same logic applies now just before the 2019 elections.

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New sources of financing

Half-year budget numbers show that tax revenue collections have been lower than in the last two years. The failure to meet revenue targets is pushing the government to find new sources of financing. But this is not new money.

The purchase of one PSU by another cash-rich PSU will raise non-tax revenue for the budget, but as the government owned the cash-rich PSU in any case, this is not new revenue raised by genuine disinvestment. Had we been calculating the "PSBR", or Public Sector Borrowing Requirement, where we would have combined the balance sheets of the government and the enterprises it owns, we would not have seen a change in its overall budgetary position.

The second clever financing is to transfer "reserves" from the RBI to the government. While questions of RBI independence and its credit rating dominate the media, at a deeper level, the RBI's balance sheet is not the balance sheet of an independent entity that has a business or a credit rating other than that of the Government of India. If the arrangement between the RBI and the government had been to always transfer all RBI surpluses to the government, then the size of borrowing in past years and the total debt of the government could have been lower. The best thing to do now would be to use the excess reserves for reducing the stock of central government debt. This would not lead to a monetary expansion and, therefore, would be non-inflationary.

However, if the government's fiscal deficit targets are in trouble, then instead of writing off old debt, the government is likely to show it as non-tax revenue to keep the current deficit in control and to meet deficit targets.

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New governor's strategy

The transfer from RBI has two elements. One is the transfer of this year's surplus. In law, reserves can be created by the RBI board with prior authorisation of the government, which appears unlikely in today's environment.

The second element is transferring a part or whole of the stock of reserves from the contingency reserve and the revaluation reserve. This has been accumulated over many years and should not be transferred in one go. One likely solution is that the RBI and government-proposed committee, possibly headed by a respected economist like Rakesh Mohan who has worked with both, could propose a formula to ensure that the gap in this year's budget deficit is met by a transfer from the RBI.

The most likely strategy of the new governor will be to cleverly navigate the RBI to transfer to the government the right amount of money so that credit rating agencies will not bring down India's credit rating, either on grounds of not meeting fiscal targets or on account of loss of RBI autonomy. This will have to be done in the next four to five weeks.

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