Tussle over RBI's Capital Conditions

What is the issue?

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- There have been demands for years for the use of RBI’s internal reserves for fiscal purposes, and for higher dividend payments to the government.
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- But the government's claim that the RBI holds capital much in excess of what is needed is highly contestable.
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What is the complexity here?

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- **Capital** - The likely consequences on the balance sheet have restrained banks from taking monetary policy measures to address deflationary trends.
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- E.g. in late 1990s, the Bank of Japan hesitated to take monetary policy measures to address Japan's acute deflationary situation
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- So determining the adequate quantum of economic capital for a central bank (CB) in the present era of fiat money is not very simple.
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- **Backup** - An appropriate backup against the monetary liabilities for macro-financial stability is the key issue here.
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- Two distinct back-up systems exist - the tax-based system and the reserve-based system.
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- In the tax-based system, the central bank’s balance sheet does not have much relevance.
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- Instead, the present and future tax revenues of the government provide the ultimate support to RBI's monetary liabilities.
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- In the reserve-based system, the central bank’s balance sheet strength and

internal reserves provide the support.
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- An important operational difference here is that the central banks do not undertake quasi-fiscal activities as they have aversion towards credit risk.
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- Most central banks occupy intermediate positions between the two types.
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What is RBI's case in this regard?

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- The RBI is closer to the second type, particularly in its evolution in the post-reform period.
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- The RBI's statute does not permit buying of securities both in India and abroad which are not issued/guaranteed/supported by the sovereign.
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- The RBI began building its forex reserves after the Balance of Payment crisis of 1990-91.
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- So from 1993-94 onwards, its composition of assets has undergone a major structural shift.
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- Now, the foreign assets (including gold) are significantly higher than domestic assets.
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- The former's share in total assets, which was about 50% in 2000, rose to about 80% in 2018.
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- Among other contributory factors, this transformation has certainly been a reason for the decline in structural inflation.
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- From close to double digits in 1990s, it has come down to 4-5% now.
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What is the risk then?

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- The preponderance of foreign assets comes with a price of higher risk with lower return vis-à-vis domestic assets, necessitating higher capital.

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- Further, there exists an extra layer of risk associated with foreign assets.
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- It's because their composition is not entirely a result of the RBI's monetary policy operations.
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- RBI buys US dollars through domestic forex market interventions.
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- But it maintains a roughly 50:50 currency and asset composition in US dollars and in other major currencies in its foreign currency assets (FCA).
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- The RBI does this not as a monetary authority but as a financial institution, with its particular risk-return strategy for portfolio management of foreign currency assets.
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- Nevertheless, the strategy entails higher risk, a key one being the timely valuation change of foreign currency assets.
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- Given all these, the RBI needs to maintain significant capital to cover all the currency, interest and credit risks that it faces.
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How is the contingency fund scenario?

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- The RBI's free reserves comprise its reserve fund, asset development fund and contingency fund (CF).
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- The CF provides the overwhelming bulk and is the first cushion for absorbing general loss.
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- It was almost entirely exhausted in 1993-94 as a result of the exchange rate guarantee.
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- This was provided by the RBI to FCNRA (Foreign Currency Non-Resident (Accounts)) deposits introduced in early 1980s.
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- Largely as a consequence of this, the RBI felt the need to adopt a policy in 1997 to build its CF.
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- So a target of 12% for the ratio of CF to its total assets was set.
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- Subsequently in 2004, a detailed review exercise in this regard was undertaken but its recommendations were not accepted, and the status quo was maintained.
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- The CF was subsequently built up, reaching a high of 10.9% of total assets in 2008-09.
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- But currently, this ratio is much lower than the target and stands at a little over 6%, and shows a declining trend.
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- The declining CF is worrying as it can have adverse implications for macro-financial stability.
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- Notably, the large balance in the currency and gold valuation account provides little comfort as it is available only for absorption of currency and gold valuation losses.
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What is the way forward?

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- The RBI should adopt a policy framework to determine dividend payable to the government each year.
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- This should be done after assessing CF adequacy vis-à-vis an identified set of risks, following a rich methodology.
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- This should be supplemented by an analysis of the RBI's earnings under the following categories:
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i. Seigniorage - the profit made by issuing currency (difference between the face value of coins and their production costs)
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ii. Counterpart of capital - the earnings on investing capital
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iii. Counterpart of other liabilities - the earnings on other liability items
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iv. Currency risk - the valuation change of FCA, which needs to be recognised separately in the books of accounts

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- The earnings of the last three categories should be used to consolidate the CF and also to smooth dividend payments.

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Source: BusinessLine

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