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Are Central Banks Creating the Next Crisis?

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Introduction

A central bank is the apex bank of the country .The history of central banking dates back to the seventeenth century with the establishment of the Sveriges Riksbank, the central bank of Sweden, in 1668 as a lender for government funds or an issuer of currency and a clearing house. Since then, central banks have continuously evolved to take their modern forms. The underlying objective of all central banking functions of the world has remained to be "for the economic interests of the nation, consistent with government economic policy". In modern context, they are largely responsible for taking various quantitative and qualitative policy decisions that affect the banking system, financial institutions and the economy as a whole. Other functions of the central bank include role as a banker to the banks, advisor and banker to the government, lender of last resort, supervisory function and significant role in economic development of the country. During this journey, they have faced various challenges, including the financial crises such as those of 1857 and breakdown of 2008.

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In the Indian context, the Reserve Bank of India (RBI) is the central bank of the country. It was established on the 1st of April, 1935 under the Reserve bank of India Act 1934 and was later nationalized on the 1st of January, 1949. RBI is fully owned by the government and has a board of managers managing its operations, currently headed by the governor, Mr. Urjit Patel. Mr. Patel is in office since September 2016. RBI is perceived to be an independent body, however, the significant involvement of the government brings me to the first set of arguments of the paper - How autonomous is the central bank of India in reality?

Over the past few decades a number of publications have been made by the RBI and various committees either on developments in the financial sector or concerns regarding the same or providing recommendations for improvement of the financial and banking sector of the country. For instance, the Narasimham committee was formed twice, first in 1991 and second in 1998, to study structural, organizational and functional aspects of banking and suggest changes for improving its efficiency and productivity. In 1998, it also reviewed the progress of the implementations. Similarly, another committee set up in 2011 – the Financial Sector Legislation Reform Committee (FSLRC), led by Justice BN Shrikrishna, for legislative reforms in the financial sector and creation of a Unified Financial Agency. Even though most of the reports brought in valuable recommendations, only a handful of them were actually implemented. This brings me to the second set of arguments of the paper – Is it time to revamp our legislative framework in the financial sector? How is it impacting the growth of NPAs in the country? Should we accept suggestions like the setting up of unified financial agency? To what extent would such measures help?

There is a steep rise in the number of non – performing assets (NPAs) and frauds in the country. These are primarily due to the flaws in the legislative framework and due to governance on the part of the regulators, inclusive of the central bank, and the boards of commercial banks. It is quite evident from the available reports from the financial sector that they are adversely affecting the banking system of the country and leading to an alarming situation. This brings me to the third set of arguments of the paper – How crucial is governance to a bank and what role can a central bank play? Is it done adequately and in the correct manner?

Next to the issue of governance, is the concern regarding protection of data and breach of privacy, especially with linking of Aadhaar to bank accounts in India. It has become a central point of debate in the country. Instances such as the one where the Aadhar CEO challenged the hackers to hack his account through Aadhar and the hackers could do it successfully, point towards the vulnerability of the system. This issue might not be a cause for a crisis directly, but it raises question on the credibility of the system, leading to the loss of trustworthiness, and clearly pointing out to the challenges being faced on the societal front by the central banks.

This is a rising concern which may be a major bigger issue in the future. Finally, coming on to monetary policy front, globally falling interest rates, like what happened back in 2008, have been in spotlight since a few decades. However, the scenario in India is better compared to Japan and various European countries that are operating on negative interest rates and helicopter money. This brings me to my fifth argument of the paper – As commonly discussed, are falling interest rates an indication of an upcoming crisis?

These arguments, when referred to in detail in the upcoming sections, shall clearly point out my stand for the aforementioned question and will putforth some proofs for the same as well. It is imperative to identify the factors that might lead to a crisis of any form in the future. In addition, all efforts should be made to resolve them on priority. It's all the more important because a particular form of crisis doesn't just impact to particular sector but may have a domino effect on the entire economy and the society as a whole. For instance, a financial crisis initially may seem to impact the financial sector by means of crashing of financial institutions or plunging of stock prices or popping of bubbles. However, it may also lead to the loss of trustworthiness and efficiency, complemented by disruption of socio economic fabric and an impact on political, social, environmental, legal and technological structures of the country. This will be elaborated further in the course of the paper.

Arguments

- **Governance Perspective**

How autonomous is the central bank of India in reality?

The Reserve Bank of India is deemed to be an autonomous body, independent of any external influence. However, the reality seems to be quite different. According to a paper by N. Nergiz Dincer and Barry Eichengreen from TED University, Ankara, and University of California Berkeley, which was published in 2014 in the *International Journal of Central Banking,* it was found that the RBI is the least independent among 89 central banks they had looked at in their study. In the course of their study, they took four major factors into consideration:

- government intervention in appointing the central bank's head
- government intervention in making policy decisions
- price stability being the sole or primary goal of monetary policy
- limits on ability of the government to borrow from the central bank

On account of these factors, RBI's autonomy was questionable. This clearly proves that the autonomy of the RBI has been in doubts even at the global level even in the past. The policies and working of the RBI are highly influenced by the Central government and ministry of finance. Right from the recruitment and selection of the top brass to making policy decisions, each step depends on the decisions from the

central government. Even the Reserve bank of India Act 1934 gives the government the power to direct the central bank. Taking a closer look at the four parameters set in the course of study stated above, we would observe the following, which shall in turn justify RBI's ranking as the least independent central bank.

Talking about government intervention *in appointing the central bank's head,* the government has a significant say in recruitment of the governor as well as four deputy governors of the central bank. Past experiences have proved that the governors brought in are generally at the discretion of the government. The chosen ones are usually those who would comply with the agenda set by the government in their policies and facilitate implementation without cross opinions. For instance, the exit of the former governor of RBI, Raghuram Rajan, paved way for the new governor, perceived to be a pro-government economist and execution of major economic events in the recent times such as demonetization confirm the same. When initially proposed in 2016, demonetization was opposed by the RBI citing the fact that its short-term economic costs shall outweigh its long term benefits. The repercussions were also talked about by Rajan in his book "I do what I do". According to section 26(2) of the RBI Act, with the advisory of the central board, i.e. the governor and the deputy governors, demonetization is allowed and the central government can declare any denomination as not a legal tender any more. Thus, with the help of the current governor, it was made possible without any objection. Secondly, a decade ago, in 2008, Duvvari Subbarao, a top bureaucrat of the UPA Government, was appointed as the RBI governor instead of Reddy's deputy Rakesh Mohan, who was the preferred candidate. Mr. Subbarao was a person who would work in alignment with the wishes of the central government, being a part of it, formerly. Moreover, the power of RBI governor to decide upon interest rates has been curtailed by vesting it with Monetary Policy Committee where out of a total of six members, three are appointed by the Government of India.

Often, laxity is seen on the part of the government when recruitment of top RBI officials is to be done. Delays in appointments by the central government, further impacts the efficiency and working of the bank. Thus, the government has a major say in the recruitment, selection and functioning of the top RBI officials due to its ownership rights, thereby, questioning the independence of the RBI.

Talking about government intervention in making policy decisions, the government tends to have a major role in the decision-making process of the RBI. For instance, when we speak of the maintenance of a certain levels of interest rates, the opinion of the RBI and the government seem to be conflicting due to their varied objectives. The RBI and its economists frame policies with a long term vision after analyzing the current scenario of the economy. On the other hand, the ministers of the government, who often have very miniscule exposure to the economic measures,

mould the RBI policies for vested interests and populist measures owing to their myopic vision. The government targets exponential GDP growth to boost the positive image of the economy in the global market, and stresses upon lower interest rates which would increase the spending in the economy by increasing the purchasing power of the citizens, thus, making them happy and satisfied. There might be a possibility that there is already unused potential in the economy which must be used first rather than increase spending. This is where the RBI policies take a hit. Moreover, the ministers also fail to understand that any policy measure that is implemented takes time to be fully effective. This is popularly known as 'lag effect of any policy decision or measure'. The *lag effect* for any monetary policy is around 1-2 years. The ministry of finance tends to fiddle with the economic measures and causes more harm to the economy than benefit. No doubt, the fiscal and monetary needs have to go hand in hand, but excess leads to volatility. Thus, justifying the third point of study, *price stability being the sole or primary goal of monetary policy*, which clearly is not the case in the Indian context. The monetary policy is tweaked largely based on need rather than the economic conditions of the country. For example, when we talk about currency depreciation, no intervention has been to correct it.

The RBI continuously changes the repo rates and takes measures as per the requirements arising due to political compulsions. These changes are done to bring inflation to the desired levels and to increase the demand and fuel economic growth. However, at times the repo rate is decreased and eventually the credit creation by commercial banks increases. This leads to inflation and to economic divide, black marketing and decreased real income of the citizens. The quality of life and standards of living of the law abiding citizens are therefore compromised. The government also directs and puts the foot down in non-monetary matters such as foreign investment rules in the banks. This further strains the efficiency and effectiveness of the banking system.

The same has also been talked about by former RBI governor Subbarao in his book "*Who moved my interest rates?"* as a concern, supported by personal experiences. Even in an interview in 2016, Raghuram Rajan, the then RBI governor, spoke about how essential it was for the RBI to be independent if the economy was to grow as per the plan and wishes. These points provide enough evidence against the independence of the RBI. This not only poses a concern, but also points to the danger looming for the economy. Further, the credibility of the bank and its image in the world forum is questioned.

In a nut shell, high Government interference and puppet central banks turn out to be a fatal combination to run any country andare instrumental in creating the next crisis for the country. If we talk about the *limits on ability of the government to borrow from the central bank,* there is no such limit up to which the government can borrow from the central bank. However, the general notion is that the more the government

spends, the more money supply increases in the economy. Yet, the independence of the RBI comes under question. Is it time to revamp our legislative framework in the financial sector? How is it impacting the growth of NPAs in the country? Should we accept suggestions like the setting up of unified financial agency, will that help? In the 21st century, the financial sector is continuously evolving with the new financial products and services coming in rapidly. There is a plethora of newer opportunities and equal number of challenges. The major challenges include

- Employee and Technology management
- Asset quality
- Capital Adequacy
- Un-hedged forex exposure
- Balance sheet management.

These challenges weren't present when the laws governing them were framed. Hence some of the laws are outdated in the modern context. As pointed out by financial sector legislative reforms commission (FSLRC), led by Justice BN Shrikrishna, the regulators in the country are sector based, be it RBI, SEBI, IRDA, FMC or PFRDA and there are products which entered late into the market and do not form the part of any of the regulators. Another related problem is that of overlapping of issues. The same concern falls into the purview of two or more regulators, who work independently of each other. As a result of differential views, either there is compromised justice or inefficiency in judgment. The committee has suggested of creating a unified financial agency which shall not be a unified financial regulator but shall comprise of seven agencies, which are mentioned below.

- Reserve Bank of India (RBI)
- Unified financial agency
- Financial sector appellate Tribunal (FSAT)
- Resolution Corporation
- Financial redressal agency
- Public Debt Management Agency
- Financial Stability and development council

The primary focus of the council's report was consumer protection by means of providing regulation, execution and justice through a single window, thereby, replacing the bulk of laws and regulations governing the financial sector in India and adapting to its dynamism. Even though these regulations were seen beneficial for the sector, they faced stiff opposition as they were perceived to be leading to dilution of power of the regulators. The government and the RBI have failed to implement them in totality, with the exception of the monetary policy committee (MPC) for monetary policy decisions and a unified regulator of international financial services centre (IFSC) at the GIFT City.

Right kind of governance is a major concern not just at the country's level, but also at the global level. Even after the global breakdown of 2008, a number of questions were raised against central banks of the United States and the European Union related to their negligence of the deteriorating asset quality of the commercial banks and extremely low level of interest rates, resulting in the housing bubble and thereafter, the breakdown. A number of major financial players were shut down, such as the Lehman Brothers and other suffered huge losses. Later corrective actions were taken in terms of reinforcement of G20 principles and increased financial stability. However, such milestones are yet to be achieved in the Indian financial system and the progress towards achieving these has been slow.

We witnessed the Kingfisher Airlines scam in 2012. However, no significant modifications in the financial legislature were made. It was only in the year 2016, that the banking and insolvency code was passed in order to speed up the process of realization of value of distress assets. Most of the distress assets lose value by the time a legal order is passed and only the scrap value can be realized, which creates major dents in the banking system. In fact, a World Bank report stated that out of $1 invested in India, only 26 cents could be recovered in the times of distress and on an average it took 4.5 years in India to realize the value of distress assets, which is twice the time taken by China and other developed countries.

Such procedural and legislature related delays pave way for more fraudulent activities in the country which indirectly create a hole in the pocket of the depositor who has kept his money with the fraud affected bank. In some cases, the central banks fail to see the commercial banks selling their bad liabilities to recover costs. Many a times, RBI is seen as the Lender of Last resort who would manage to avoid shutting down of the bank and repay the depositor's money. However, the fact is that the money used by RBI from its reserves, ultimately belongs to the tax payers and will eventually affect them directly or indirectly. There are examples when the manipulation of balance sheet is noticed only after the scam. To protect the bank from shutting down operations, the central bank often plays a key role. The central bank lends money to them, to carry out operations after a scam, but that too affects the balance sheet of the bank. Talking about PSU Banks, the government doesn't provide enough funds for their smooth operations.E.g.in FY 2015-16, government paid Rs. 8000 crore to the banks which was just 50% of the sector's total requirement. When seen from a broader angle, it is a complete loss which cannot be recovered under any circumstance.

Due to ineffective implementation, several fraudulent cases and NPAs have come into light. To prevent the re-occurrence, in 2018, a new bill named "Fugitive Economic Offenders Bill 2018" was brought in, but by then the damage had already been done. Major scams such as the Nirav Modi scam in the PNB bank worth

approximately Rs. 11400 Crore, that shook the banking system of India, were enough to question the credibility. The point being put forth is that “prevention and precaution is better than cure”, especially when the cure comes at a huge cost and 1.3 billion citizens of the India are made to suffer. If corrective actions and steps towards right governance in the financial institutions of the country had been taken beforehand by the central banks, along with the ministry of finance, then such loss of wealth from commercial banks, mainly PSUs, would not have occurred. Due to these incidents the banking system not only loses their credibility and trustworthiness among the masses, and investors, but also sows seeds for a future crisis looming on the economy. When people lose trust and start withdrawing extensively, the banking system stands nowhere because the principle that all depositors shall not withdraw at the same time gets affected. Similar scenario happened in Greece in 2015, where the bubble busted due to rapid withdrawal and loss of confidence in the system. The economy ultimately suffered and is still in the process of recovery.

One of the major roles and responsibilities of the central bank is to be a custodian for the financial institutions, monitoring the structure and functioning of other financial institutions. Here, the systems in the central bank are found to be lax and wanting. At times, the central banks allow the license or permission to major financial institutes to open sister or ancillary concerns. This leads to the creation of fake demand as the firms keep financing themselves and rotate the money to give better impressions to investors. Occasionally RBI also fails to effectively monitor the Urban Co-operative Banks (UCBs) and Non-Bank Finance Companies (NBFCs). We come across failure of a number of UCBs, and RBI fails to protect unsuspecting depositors from the clutches of the unscrupulous NBFCs.

From the societal viewpoint, the central bank at times fails to prevent money laundering activities in the banking system, and the banking channels are misused for financing terrorism, inflow of narcotics and anti-national activities, which adversely impact the society. Though few of the major concerns have been mentioned above, there are a lot many arising out of poor governance. Thus, until and unless, the central banks grow more vigilant and improve the regulation, execution of laws and provision of adequate justice, they are only inviting more trouble for the banking system and thereby leading to a future crisis, which might not just be financial but also have a social and socio-economic impact. How crucial is governance to a bank and what role can a central bank play? Is it done adequately and in the correct manner?

Looking at the present Indian financial context, governance at the levels of both the RBI and commercial banks is equally important and any kind of compromise, might lead to serious breakdowns. The central bank can implement stricter policies and disclosure norms related to inspection and monitoring of financial institutions. It can also have a continuous check over the manipulations or faulty disclosures in the

balance sheets of various financial institutions. If any kind of asset where the recovery seems to be doubtful is found, there must be an inquiry conducted on an immediate basis and it should be verified if the bank has enough funds to repay its depositors.

A major chunk of problems in the financial sector is due to lack of knowledge and awareness. At the level of citizens, it must ensure not just financial inclusion, but also financial awareness about products, services and institutions. The awareness should be spread to each citizen, even to the poor and illiterate strata of the society. Taking such measures will not only ensure proper governance, but also, avoid future crisis. At present, steps are being taken but they are not adequate and not reaching to the deserving citizens. Thus, the central bank must work extensively on economic wellness of the citizens be it a farmer or a banker himself. It must provide justice to all its objectives independently and judiciously.

- **Monetary Perspective**

Are falling interest rates an indication of an upcoming crisis?

Continuously falling interest rates and poor quality of assets of the banks are two primary and most commonly discussed reasons for any financial crisis to occur. According to basic economic logic, continuously falling interest rates, increase the purchasing power of individual consumers and enable them to buy more at the same price. It is true that interest rates help regulate inflation, bond yields and price levels in the economy and indirectly affect its growth, but if they go beyond certain levels, they often lead to a 'liquidity trap'. Liquidity trap is a scenario where current interest rates are low and interest rates on savings are high, thus, rendering monetary policy ineffective. It affects bondholder's behavior as he prefers savings deposit over bonds and also, impacts the financial state of business. Liquidity trap is dangerous for the economy and recovery takes a lot of time and effort. None of usual interest rates monitoring mechanisms such as increasing money supply work and serious efforts must be made to pull the economy out of it.

Low levels of interest rates may drop down even further and pose other major challenges, such as negative interest rates and helicopter money. There are examples of economies that are facing negative interest rates for instance, the European countries and Japan. **Negative interest rates** were initially launched in Europe. Now they have been implemented almost across the globe. They face stiff opposition in Japan and the Scandinavian countries due to various in-built flaws. The low interest rates enable each individual to make use of the credit facility of the banks. But how many of these individuals are actually capable of repaying the loan? Not Everyone. This raises the level of Bad Debts and NPAs in the banking system. Secondly, low interest rates do not change the demand and even prompt investment in capital intensive technologies, ultimately, leading to unemployment- leading to **social economic** crisis. The bonds and share markets also get impacted. Hence, there exists a global debt

crisis, asset bubbles, deflation, inequality, instability and finally a hampered economic growth and crisis surfacing. This is a cause and effect relationship – cause is such central bank policies, and effect is the creation of a new crisis.

Conclusion

As per the study and observation, it is mainly the ineffective governance and poor legislative system overlooking the monetary policy issues that are sowing seeds for the next financial crisis, or for that matter, an economic or socio-economic crisis in India. Even in 2008 when the global breakdown occurred, a major impact on Indian economy was not seen as the financial sector and structure of India is quite different from the rest of the world. The Indian financial sector is characterized by small but multiple issues, which might become the basis for the next crisis. The strange fact is that, prediction of the triggering factor can't be ascertained. All that can be done is to implement some of the precautionary steps right from the grass root level and continuous monitoring of the steps. As suggested, the RBI can focus on inculcating healthy financial habits and increasing financial awareness among the masses. It could also gain larger autonomy and control the activities in the financial sector, including those of the government. It should take adequate measures on the governance front like those mentioned in the paper and have a system of checks and balances at crucial steps. Suggestion like creation of a unified financial agency or revamping of financial legislature to fit to the changing requirements should be made. Moreover, it should be staffed adequately and decision making should be quick and efficient. If crisis is to be prevented, it is high time that steps are taken before further damage occurs.

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