SAVE RBI

VOICE

SAVE THE NATION

BULLETIN OF
RESERVE BANK EMPLOYEES ASSOCIATION, KOLKATA

MAY 2015

HIGHLIGHTS

RBI Under Siege ! 1

Explosive Exposure 3

Govt. takes away RBI's reins on hot money invasion

FAQs : Who will conduct PUBLIC DEBT? RBI or PDMA? 7

We are vindicated 11

Governor - speak : 12

AIRBEA Writes to Governor 14

125th Birth Anniversary of Babasaheb Ambedkar 15

DG - speak : 16

10th Bipartite Settlement in Banks : Salient features 26

Book Corner 27

Re : NEW PENSION SCHEME (NPS) 29

United Forum writes to Governor on Pension Issues 31

Also read other off-beat news, reporting and write-ups, news from other units and a detailed report on All India Cricket & Chess Meet - 2015

RBI UNDER SIEGE

"Siege" is a term generally used in military parlance; its dictionary meaning is "a military operation in which an attacking force seeks to compel the surrender of a fortified place by surrounding it and cutting off supplies". Has RBI been attacked by an enemy force, surrounded on all sides, and its supplies cut-off so that it surrenders? In a sense, yes, but the attack does not come from an external source, which RBI is quite capable of deflecting, but from its own Government, the Government of the country, which makes RBI all the more vulnerable and apparently defenceless.

RBI defended the economy of the country, guarded its main life line - the banking system, in most critical situations. Of late, be it the South-East Asian crisis of late nineties, or bursting of IT bubble in the early part of the first decade of 2nd millennium or the global melt-down of 2008 onwards starting from the Mecca of the global banking capital, the USA, gradually spreading its tentacles all over the world, RBI guided the Indian banking system

> ***The Countries that destroy their Central Banks destroy themselves.***
>
> ***–S. S. Tarapore***
>
> *Financial Analyst & former Dy. Governor, RBI*

seamlessly, not allowing the turbulence elsewhere make a dent in it. **Bank depositors, the common people of India, were safe and fully protected, whereas elsewhere they lost trillions in a jiffy never to retrieve.**

RBI could do it because it had several weapons in its armour which it used judiciously even against all odds. Who does not know that in the late-nineties the then Government of the country tried to force **full capital account convertibility** down the throat of RBI, which RBI refused to swallow and which is one of the factors that saved our country's economy from the global catastrophe later. There are umpteen such instances. Whenever there has been surge of foreign capital in our market or sudden outflow, as happened in later part of 2013, which caused a free fall of rupee from Rs.55 a dollar to Rs.69, RBI could quieten the market with its depository of Government securities, along with other measures by the Government. The Government securities, because of their safety, security, sovereign guarantee and high returns are very much in demand by speculative capital worldwide. But sudden inflow and outflow of such capital is hazardous. Government of the country, of whatever dispensation, is interested in such short-term foreign debt for their short-term goals. The RBI, as the sheet anchor of Indian economy, has to look long term. RBI have, therefore, imposed a cap (30 billion dollars) on short term foreign buying, which has not been definitely liked by the Governments of the day. Hence the Government's idea to hand over the entire dealings on Government securities, including depository thereof, to SEBI which, the Government feels, will be compliant unlike the RBI. **But Governments are transient, a political combination replaced by another, while RBI has to be a continuity.**

The array of arsenals in RBI's hands have protected different sectors of economy. The RBI, since inception, have managed the country's, both Central Government and State Governments, public debt well. Besides, after the global melt-down the current world-wide perception is that it is the monetary policy maker which should better manage Government's public debt by better co-ordination. But RBI is being sought to be divested of this sensitive operation.

The Government of the country have targetted RBI - why it should play so many roles - even if RBI have played all these roles exceedingly well for country's long-term good.

Government bureaucrats may feel uncomfortable at RBI's proactive perspicacity - many a times disagreeing with Government's short term objectives. In country's interest RBI cannot afford to be myopic. It must not. To some it may appear to be its fault. But that is its strength. Government brought several proposals through the Finance Bill 2015 which, if implemented, would have made RBI an absolute non-entity, a mere helpless on-looker at the market goings-on. Good that the Government have retreated at the last moment and opted for "further consultations", which is welcome.

RBI has been mandated to keep inflation in economy manageable, within a range of 2% to 6%, which, from all prognostications and long-term view seems impossible; but at the same time all instruments in the hands of RBI with which RBI could fight the menace of inflation, are either taken away or blunted. It appears RBI has been asked to swim, with a heavy load tied to its feet. If RBI fails, all blame will be its and it will be subjected to flaks and criticism and will be further stripped off. RBI Governor and its Central Board must take a call against this well laid-out trap. RBI **must make it clear that it can undertake the task of range-bound inflation-targetting if it has all the instrumentalities in its command and the right of their unfettered use for the nation's good.**

Let not a very sensitive and important institution like RBI be a plaything in the hands of a few. For their folly, let not the country suffer. We must ensure that. And we appeal to all to come forward to prevent crippling of RBI, to render it into an ineffective, powerless "glorious financial cipher", to quote from late lamented Justice V. Krishna Iyer.

Explosive Exposure

Finance Bill 2015 seeks removal of RBI's reins on hot money invasion

Prelude

While all eyes were set on the proposed formation of Public Debt Management Agency, separating government debt management from RBI to a separate agency, another rather silent and more risky and portentous move to amend FEMA 1999, taking away control of RBI over capital inflow through equity evaded most of the eyes. Not that the two moves were disparate and divided as outwardly they seem, the potential nexus between the two bears worrying outcome for the country and the people in coming days. Let us recount what our ex-governor and chairman of 14th Finance Commission, Dr. Y.V.Reddy said on this account: "The new debt office combines both the domestic debt and the external debt. In other words it is quite tempting for the government to have the debt programme, the borrowing programme to increase the external debt. **The important lesson is that if government securities are designated in foreign currency and/or held by non-residents, it is a source of instability, particularly for emerging economies. So, risk is enhanced by combining the two because it is very tempting to substitute the two."**

The government is in a hurry to charm the external investors for pumping in as much money as they desire without caring a fig for the quality of the buck. RBI has all along been persuading the successive regimes one after the other to stay away from short term capital beyond a limit in equity or bond market, not to speak about G-Secs. This stance often irks the governments. Why these differences in outlook? Because, a government has tenure of only five years and as such are tempted by short term perspective, whereas RBI's perpetuity force it to look in in long term perspective. The government will be happy to acquire huge external capital that may warm up the economy and shoot up the sensex immediately; however, the same capital would not spare any time to exit at a whiff of trouble and lead to an economic catastrophe any time. The RBI and other central banks are always cautious about such possibilities which have occurred so many times in so many countries in recent past. One must understand that RBI is a financial watchdog for the whole system, whole nation, not for a transient regime only.

Proposed Amendments of FEMA

The Finance Minister Sri Arun Jaitley in his budget speech for the year 2015-16 said that *"The Capital Account Controls is a policy, rather than a regulatory matter. I, therefore, **propose to amend, through the Finance Bill, Section-6 of FEMA to clearly provide that control on capital flows as equity will be exercised by the Government in consultation with the Reserve Bank."***

Accordingly, amendments to Section 6 of the FEMA, 1999 have been proposed in The Finance Bill 2015 : *(a) The Central Government may, in consultation with the Reserve Bank, prescribe-- any class or classes of capital account transactions, not involving debt instruments, which are permissible; (b) the limit up to which foreign exchange shall be admissible for such transactions; and (c) any conditions which may be placed on such transactions.*

For the purposes of this section, the term "debt instruments" shall mean, such instruments, as may be determined by the Central Government in consultation with the Reserve Bank.'

Sequel

Under the extant provisions of the FEMA, the government regulates the current account transactions. FDI policy is the exclusive domain of the Government. However, the regulations governing all capital account transactions, irrespective of equity and/or debt instruments are framed by the Reserve Bank, in consultation with the Government. But the Finance Bill wants to shift this power also to the central government. The danger is that once RBI is off the picture, the government may be prompted to invite more and more external capital through 'equity', the definition of which only the government will determine under the above mentioned proposed change. **There are several quasi-equity instruments or debt instruments, which are camouflaged as equity instruments. Regulations of such instruments are essential to contain the stock of external debts.**

2. **Our external debt has gone up to USD 461.9 billion in December 2014, accounting for 23.2% of the GDP.** The current growth and stock of external debt is unsustainable and needs to be moderated for sustainability of external debt. **Too much capital flows, either through equity or debt routes would not only significantly influence the exchange rate, but also the money supply and interest rates, besides influencing asset prices, particularly of sensitive assets, such as equity and real estates.** Unbridled debt flows accentuate the stock of external debts, currency risk and pressure on current receipts.

3. Non-optimal (much beyond current account deficit) flow of capital impacts the monetary management. In such a situation, the Reserve Bank would decide on the timing, quantity and quality of inward capital flows so that it can calibrate its forex interventions and sterilisation measures. To the extent that inward capital flow impacts liquidity conditions, it becomes necessary for the Reserve Bank to involve the banking system through imposition of reserve requirements and open market sales of securities. Such measures can impinge on the banking system and may not be in consonance with the medium/long-term policy objectives. Financial markets, both private entities and Governments have short-term horizons and when initiation of policy relating to portfolio equity flows is exclusively with the Government, it makes the task of the Reserve Bank as monetary authority and the regulator

of the banks and the financial markets much more difficult.

4. In India, the forex reserves accretion is invariably on account of a capital account surplus and not due to a current account surplus and hence the composition of the inward flows, either in the form of equity and/or debt assumes importance. **Capital flows into India comprise FDI as also debt/portfolio equity flows and the latter are not only volatile but can undergo sharp directional shifts of sudden "stops" and "reversal".** There is widespread concern among several central banks in Emerging Market Economies about the added pressures on monetary management due to the prevailing extraordinarily strong and volatile cross-border capital flows.

5. **Let us recall how the sudden flight of capital had caused free fall of rupee only two years back. The possibility of early tapering of Quantitative-Easing Out programme by the US Fed triggered large selloffs by the FIIs, especially in the Government bond market leading to heightened volatility of Rupee in line with other EME currencies.** The hardening of long-term bond yields in the US and other advanced economies increased their attractiveness, prompting foreign investors to pull funds out of riskier emerging markets, which had received large capital inflows in search of higher yields. The Indian Rupee became one of the worst performers during the period from the second half of May 2013 to August 2013. **Rupee depreciated sharply by around 19.4 per cent against the US dollar from the level of Rs 55.4 per US dollar on May 22, 2013 to a historic low of Rs 68.85 per US dollar on August 28, 2013.**

6. Another area of serious concern is the investments by non-residents in the equity and debt instruments through **Participatory Notes (PNs),** although a liberalized FPI (foreign portfolio investment) regime is in place. As on March 2015, the total investments made through PNs account was Rs 272,078 crores, and represents 11.3% of the total investments made by the FPIs. The Reserve Bank's stance has always been that the issue of Participatory Notes should not be permitted. In this context, ***Reserve Bank had pointed out that the main concerns regarding issue of PNs are that the nature of the beneficial ownership or the identity of the investor will not be known, unlike in the case of FPIs registered with a financial regulator. Trading of these PNs will lead to multi-layering which will make it difficult to identify the ultimate holder of PNs.*** Both conceptually and in practice, restriction on suspicious flows enhance the reputation of markets and lead to healthy flows. Reserve Bank, therefore, urge that issuance of Participatory Notes should not be permitted. **With the shift of regulation making power to the Government, there will not be much opposition in pursuing a liberal policy on this undesirable route of portfolio investment.**

7. If the Reserve Bank has no say in initiating policy relating to these volatile flows, the Reserve Bank would

be constrained to take monetary policy measures, both direct and indirect and administrative actions to deal with the adverse consequences of such flows; such measures may not be what the Government or industry and the business community seek, leading to overall dissatisfaction. **In the situation of excess capital flows, while the benefits accrue to big corporates and other private sector entities, the cost of sterilization (i.e. buying of foreign currency from the market and corresponding sale of Government securities to neutralize liquidity) would crystallize on the exchequer, which tantamount to private benefit, at public cost.**

Conclusion

In the given background it is of utmost importance that no change in the function of RBI should be imposed as regards to capital account regulation, since it will destabilize the monetary management of central bank and make the country very much vulnerable to external shocks and sudden directional reversal and flight of capital.

There is no need to alter the existing rules relating to investments by the Foreign Portfolio Investors (FPI). Such flows are volatile and impact the financial markets and players. There is a need to exercise caution in opening this window further. The experiences in the past are testimony to the adverse impacts of such flows during financial crises. There is a need to vest the Reserve Bank with the management of all types of capital flows, excluding FDI. In regard to foreign investment in domestic financial markets, India's policy has always been to increase access in a calibrated and gradual manner. Though India is sensitive to the demand for opening markets to foreign investors, the advantages of widening and diversifying investor base which improves demand for financial instruments, including Government bonds need to be kept in view along with the considerations about financial stability arising from **sudden-stop and reversal risks**. These risks manifested during the quantitative easing in USA in May 2013. The financial stability implication of **'investment tourists'** exiting at a whiff of trouble has always to be kept in mind.

As already said the most portentous issue is the potential nexus between the dual changes in RBI's functions, i.e. public debt management and control over capital account transactions. **Since in the proposed change public debt would comprise both domestic and external debt, and with RBI's restrictions on capital inflow in equity removed, the possibility of unfettered external investment in** government securities leading **the country** to sovereign debt crisis **cannot be ruled out.** Since long a section of our ruling elites cherish for a totally free, unshielded and unsafe liberalization, caring not a fig for the nation and the people. All concerned with the nation's long-term interests and welfare must try with all their might to stop and halt this ominous move.

Voice is your mouthpiece. Read it and circulate it

Who will conduct PUBLIC DEBT ? RBI or PDMA?

Q.1 What is the main reason for GOI to create a Public Debt Management Agency?

Ans. The main reason advanced by the GOI is that RBI has conflicting interests managing the debt management function on the one hand (which requires minimization of the cost of borrowings of GOI by keeping the interest rates low) and conducting monetary policy on the other hand (which requires the interest rates to be kept high to fight inflation). Hence GOI wanted to create a separate Public Debt Management Agency (PDMA) taking the function away from RBI.

Q.2 What is wrong with the above argument (Q1)?

Ans. The above argument is wrong on many counts. First, while RBI has managed the public debt for the last several decades, it has never allowed the conflict of interest to come to play and compromise on the efficiency of either function.

RBI has always managed to stave off inflation by tight monetary policy. At the same time, RBI has developed excellent skills and expertise to efficiently market the government debt in terms of choice of tenor of debt, amount of floatation of debt and timing. RBI has also sufficient expertise in terms of choice of auction methods (uniform price auction or multiple price auction) depending upon the prevailing market condition. Further, it has to be recognized that RBI has managed to market the fast increasing quantum of govt. debt exceedingly well by elongating the maturity profile of the debt but at the same time, keeping a tight control on the cost of debt.

Thirdly, RBI has never been affected by conflict of interest. On the other hand, RBI has used the opportunity to conduct both the functions by perfect coordination. In fact, there is now a growing realization that Central bank is the most appropriate authority to conduct debt management because, it is the Central Bank, which can coordinate this function with monetary policy. If the debt management functions were to move away from RBI, there is a likelihood of lack of coordination leading to sub-optimality in conduct of debt management.

Q.3 Which model (Central Bank conducting Debt management or a separate authority doing it) is considered best worldwide?

Ans. : Different countries follow different models and there is no unique model. Hence, it is not appropriate to pass a judgment that one model is superior to another.

Q.4 If that is so, why is RBI not in favour of an independent PDMA?

Ans. : The main argument here is why is the Govt. trying to fix something which is not at

all broken. In fact, there are several things in the country which are completely broken and crying out for attention which the Government is yet to take up.

Q.5 Was it not the RBI which raked up the issue of hiving off debt-management function about 15 years back?

Ans. : Yes, it is true that RBI had broached issue way back in 2002. But, even at that time it was clearly mentioned that the function could be moved out of RBI only after the fiscal deficit is brought under control. This condition is still to be met, as at present too.

In fact, after the global financial crisis, the public debt of many countries has bloated up and India is not an exception to this.

Q.6. Why are you opposing Government Securities regulation function being taken away from RBI and given to SEBI?

Ans. : As mentioned earlier, RBI has managed the Govt. Securities market quite well. In fact, it has so well nurtured and developed the markets over the last 20 years that many other countries want to take a leaf out of India's experience.

Further, SEBI is traditionally the regulator of exchange-traded markets. As all of us are well aware, Government bonds are traded in OTC markets, the world over.

In fact, defying this international trend, the stock exchanges in India introduced a trading segment for G Secs. in the exchange some years back. Till today, this exchange-platform has not attracted the investors at all.

Q.7. Don't you think that the Government of India should do its own debt management function?

Ans. : In fact, such a model has a greater conflict of interest, as the banks in India are the largest investors in G Secs. Since the public sector banks are owned largely by GOI, there is a likelihood of GOI bringing pressure on the banks and forcing them to invest in G Secs. This is a real conflict of interest.

Q.8 Don't you think that money markets in general and repo and reverse repo, in particular should be regulated by SEBI?

Ans : No. RBI is the Monetary Authority of India and hence conduct of monetary policy is aided and facilitated by RBI having regulatory control over money markets, including repo and reverse repo, which are the basic instruments in money market.

As you are aware, RBI injects liquidity into the system by conducting repo operations and absorbs liquidity from the system by conducting reverse repo operations.

If the regulation of money markets, repo and reverse repo is taken over by SEBI, then RBI's role will be that of a mere money market participant and its role as a monetary authority will get undermined.

It must be borne in mind that, unlike SEBI, RBI itself operates in several markets like money, forex, Govt. bonds, derivatives, etc. with the over-arching objective of maintaining financial stability. If another regulator lays down the rules of operations in these markets, it will certainly cripple RBI from performing its functions effectively.

Q.9. Are you trying to say that RBI will not like to subject itself to any discipline/ rules regulations?

Ans. : No I am not saying that. All that I am trying to advocate is the independence of the monetary authority for its effective functioning and thereby, the financial stability of the country.

Q.10 What has so far been the role of RBI in managing the debt of state governments?

Ans. : Till now, RBI manages the debt of GOI by legal mandate, flowing from the RBI Act 1934. As per Chapter III, Clause 21A(b) of the same Act the RBI "may by agreement with the Government of any State undertake the management of the public debt of, and the issue of any new loans by that State" and accordingly all States of India excepting Jammu & Kashmir have entered into such agreements, by virtue of which RBI is their debt manager too. RBI has established considerable credibility in servicing the debt of the state governments. There is, therefore, no need to review this role.

Q.11 Will PDMA henceforth manage the debts of State Government?

Ans. : No, as per the Bill, the proposed PDMA will only manage the public debt of central government.

Q.12 Who will then look after the public debt of the state governments?

Ans. : Since the Government Securities Act 2006 covered both the central and state govt securities, and the Finance Bill 2015 has proposed to repeal this Act, a legal void has been created as regards the management of state governments' securities. There is no agency to look after their securities as per the proposed changes in various acts?

Q.13 Was it not necessary for the central government to take consent of the state governments before repealing G S Act 2006 and creation of PDMA?

Ans. : Of course, as per article 252 of the Constitution of India in such cases affecting state governments, any legislation has to be carried in only after having consent of the concerned state governments. More importantly, it has to be ensured whether State Governments would like their debt management to be serviced by a Government - neutral, apolitical, non-partisan Reserve Bank of India or an agency under Central Government like the proposed PDMA, which, even if termed "autonomous" will be practically a wing of the Ministry of Finance.

Q.14 Cannot RBI still service the public debt of the state governments?

Ans. : Since State debt operations depend on central government securities and the fact is that the public debt of the states, the rate at which these sell, is benchmarked to central government securities, it will not be possible for RBI to separately service the management of public debts of the state governments.

Q.15 Will it not then adversely affect the state finances?

Ans. : No doubt about it. RBI as the debt manager of State Governments underwrite and stand guarantee for State Government Loans which is a big support for the State Governments. RBI, being the regulator and supervisor of the banking sector, generally persuade commercial banks to purchase State Government Loans, when floated, and that is why all State Government Loans are subscribed in time. Interest rates also remain uniform. Importantly, RBI as the banker of the State Governments and as "lender of the last resort" would always stand by States if they were in difficulty in regard to servicing the debt. That would give investors confidence for investing in State Governments Loans. If RBI guarantee is not there henceforth, State Governments, particularly those who are in financial straits, will find themselves in difficulty in selling their loans. Either their loans will not be subscribed or remain under-subscribed or they

will have to shell out higher rates of interest to persuade the investors. The weaker the States, the higher will be their interest burdens.

Q.16 With RBI off the picture, will the debts of the states have to depend on the credit rating?

Ans. : Oh, yes. Credit rating influences at what rate states would borrow. However, credit rating is also influenced by the fact that RBI is a debt manager. If RBI is not debt manager, credit rating will also be influenced. Then, that will influence the cost. Therefore, independent debt agency of the centre has serious implications for the management of public debt by all the states and very serious implications for centre-state fiscal relations.

Q.17 There is a widespread criticism that RBI has failed miserably in popularizing Govt, securities amongst retail investors. Do you agree?

Ans. : We need to understand that, world over, the Government (and the corporate) bond market is institutional-investor-driven and not retail-investor driven. Even in a country like US, retail investors invest in mutual funds, which, in turn, invest in government bonds.

Further, in India, the retail investor, who has a flavour for G Secs already has access to National Savings Certificates (NSCs), which are also G Secs. It is therefore difficult to bring retail interest into market-based Govt. Securities.

Despite these drawbacks, RBI has initiated several measures like non-competitive bidding, creation of Primary Dealers, etc. to attract retail interest.

Q.18 What about the depository function for G Secs? Should RBI continue to manage SGL for G secs? Why?

Ans. : As mentioned earlier, RBI conducts several monetary operations involving G secs either as Collateral (repo and reverse repo) or through outright sales/purchases as in the case of open market operations. Further, RBI also does a critical function as the regulator of payments systems. For ensuring smooth functioning of payments systems, RBI provides intra-day liquidity to banks by accepting G secs as collateral. Given the criticality of all these functions, RBI has to maintain the SGL of G Secs, both from the perspectives of efficiency as also financial stability.

Q.19 Do you think that stock exchanges have no role in marketing G Secs?

Ans. : I am not saying that. If the stock exchanges would like to attract retail interest, let them take initiatives, by all means. But, there is no need to cripple RBI to further this objective.

Q.20 Do you agree with GOI withdrawing all these clauses of the Finance Bill?

Ans. : I not only agree, but congratulate the govt for doing so, realising the short-sightedness of the proposals.

> ...By a continuing process of inflation, governments can confiscate secretly and unobserved, an important part of the wealth of their citizens... As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless..."
>
> John Maynard Keynes