Can the RBI fill the Budgetary Hole?*

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In the search for resources to make up for sluggish tax revenue growth, one source to which the Finance Minister rising to present Budget 2020 can legitimately turn is the Reserve Bank of India (RBI). But the government's draft on RBI funds cannot be arbitrary, at least for four more fiscal years. The controversy over the principles that would determine how much of its annual surpluses the central bank should retain as its "economic capital", to deal with risks and contingencies, and how much should be transferred to the government as 'dividend' was settled for five years by a Bimal Jalan-chaired committee.

Being an arm of the state, when the aggregate surplus of the RBI is positive, the government has a claim on a part of that surplus. On the other hand, how much that dividend would be, depends on the share of its surplus the RBI seeks to retain, in order to beef up its "economic capital". Economic capital refers to the funds kept in reserve to ensure the resilience of the central bank and facilitate its interventions to ensure monetary, financial and external stability. For example, it must be in a position in situations of banking system fragility to serve its "lender of last resort" function and provide the necessary emergency liquidity assistance, without hurting its own balance sheet. It must also be able to bear the loss of the rupee value of its foreign reserves when a surge in foreign capital inflows results in rupee appreciation.

The surpluses with which the RBI can build its capital stem from two broad sources. One is from any positive revaluation of the foreign exchange and gold reserves it holds, which follows a depreciation of the rupee or increase in the price of bullion. But when these assets are valued at prevailing market prices by being 'marked to market', these surpluses are notional, with gains being realized only when the assets concerned are actually sold. The second broad source of a positive or negative surplus is the net income the RBI earns when the returns on its investments, in government bonds or deposits abroad for example, exceed the costs of its liabilities, such as deposits held by the banking system with the central bank.

The Jalan committee was of the view that immediate adjustments of the principles that govern the quantum of required Economic Capital are needed only in the case of the contingency fund created from the "realized equity" of the RBI, resulting from the second source of surplus noted above, and excluding notional surpluses resulting from foreign exchange or gold reserve revaluation. When the committee submitted its report, the level of capital in the form of "realized equity" with the RBI amounted to 6.8 per cent of its assets. The committee, based on its estimation of what was required to address potential risks, recommended that this be reduced to between 5.5 and 6.5 per cent of the RBI's balance sheet. Influenced by the government, the RBI opted for the lower 5.5 per cent figure.

This had two implications. The first was that the existing sum in the contingency fund was in excess to the tune of 1.3 per cent of the RBI's then balance sheet. That excess, amounting to Rs. 52,637 crore, could be immediately transferred out of the "contingency fund" and be reclassified as income. It also meant that none of the surplus available in 2018-19 had to be set aside to meet the revised Economic Capital

requirements of the central bank. The second implication was that, in future, after a part of any annual realized surplus is set aside to cover shortfalls in economic capital relative to that required to keep the contingency fund at 5.5 of a growing balance sheet, the balance can be transferred to the government. Since the reduction of the required ratio to 5.5 per cent would reduce surplus retention by the RBI when compared to the past, the government would have access to more resources at any given level of the balance sheet of the central bank.

The resolution of the controversy gave the government a bonanza of Rs. 1,75,987 crore in 2018-19. There were two components in that bonanza. One was a once-for-all pay off of Rs. 52,637 crore, which was the ‘excess capital’ that the RBI had accumulated over time in its contingency fund, when assessed using the new guidelines recommended by the Jalan committee. The other was a sum of Rs. 1,23,350 crore which the RBI transferred to the government, which was almost the whole of the net income in the previous year 2017-18. This too was some kind of a bonanza, since the RBI’s net income in 2017-18 was only Rs. 50,004 crore and the average net income over the four years ending 2017-18 stood at Rs. 53,112 crore. In sum, the huge transfer in 2018-19 was in substantial measure made possible by a convenient 250 per cent increase in its net income that year. The size of the surplus was extraordinary and unusual. The RBI attributes most of this increase to increases in interest income from securities and exchange rate changes affecting foreign exchange transactions.

Fiscal 208-19 is unlikely to be so favourable. The government will not get the once-for-all bonanza resulting from reclassification of a part of the contingency fund reserve as income. It is unlikely also to obtain the windfall increase in net income that characterised 2017-18. For similar reasons the Finance Minister cannot credibly provide in the budget for 2020-21 a dividend from the central bank of the magnitude recorded in 2018-19. Resources from the RBI to plug the deficit in the budget are bound to shrink.

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