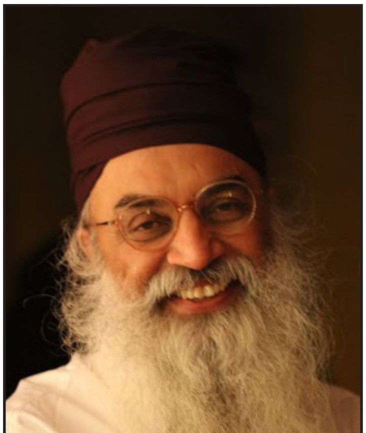
A more focused RBI: Why and how



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Often there are lumpy payments by firms and individuals from their banks to the government. This leads to a liquidity crunch in the economy. Some borrowers find it difficult to get loans from the banks for a while. Accordingly, economic activity tends to suffer.

There are at least three examples of a liquidity crunch of the kind considered above. First, a liquidity crunch happens around the time that the government conducts a big auction to sell some 'rights' (e.g. in the telecommunications sector). Second, there is a liquidity crunch around the time of a deadline for tax payments to the government; it can be income tax, corporate tax, goods and service tax, and so on. Third, there is a liquidity crunch when the government disinvests from a public sector undertaking. In each case, the funds get parked in government accounts with the Reserve Bank of India (RBI). Then we have a liquidity crunch in the economy till the government has spent in a phased manner the amount collected. This is a recurring problem.

When there is a liquidity crunch of the kind considered above in the economy, the RBI does intervene. However, there are some delays and costs attached (more on this later). Therefore, it is important to find a better solution. But before this, let us understand the whole issue better.

True market failure and pseudo market failure

The conventional wisdom is that the functions of a central bank typically include, broadly speaking, the issue of currency, acting as the lender of last resort, maintaining macroeconomic stability, regulation of banking, managing foreign exchange reserves, maintaining a sound payments system, managing the public debt, and acting as the government's banker (Mayes et al. 2019).

The conventional wisdom on the role of the central bank has changed already in one important way over time. The management of the public debt is being carried out or it is being planned to be carried out though a separate Public Debt Office (PDO) or Public Debt Management Agency (PDMA) outside of the central bank and the ministry of finance. The main reason is that there is a conflict of interest if the central bank manages public debt and carries out its monetary policy. However, note that managing public debt was something that could be done outside of the central bank. This was realised over time.

There is one more way in which the conventional wisdom can be changed. This relates to the function of the RBI as the government's banker (see the last function of the central bank in the list above). Such a change can deal with the problem of liquidity crunch that is related to the bunching of large payments to the government. Before we come to how this can be done, let us take a closer look at the basic rationale for central banking.

There are important and true market failures which require RBI's attention. In this context, there is really no alternative to the intervention by the RBI. So it is critical that the RBI looks after some functions. However, it is also important that the RBI keeps away from some functions that can be performed satisfactorily outside of the central banking. This can keep the RBI focused on what are true market failures. It can stay away from taking care of what seem to be market failures but they actually are not. These are pseudo market failures.

We never know when a macroeconomic or financial crisis or near-crisis emerges in the economy. It might just happen in the 'temporary phase' in which the RBI is occupied with or distracted by dealing with liquidity crunch due to bulky payments to the government, which were discussed earlier. So, it is important that we make a change in dealing with the liquidity crunch of the kind discussed above. Then the RBI can stay focused on where it must act and do so quickly.

Let there not be any confusion. It is well known that the central bank can and should act as the lender of last resort when there is a liquidity crunch and the market fails to provide adequate liquidity (Bagehot 1873). However, we need to be careful in applying this principle. All cases of liquidity crunch need not be cases of genuine market failure. Some can be cases of pseudo market failure. This article is considering such a case in which there can be a solution outside of a public institution like the RBI. In this case, there is no need for RBI to act as, what is wrongly called, the lender of last resort here every time lumpy payments are made by the public to the government. The RBI can focus on its core activities and deal with true market failures.

But what can be an alternative way to deal with the kind of liquidity crunch discussed above?

An alternative solution

At present, the RBI acts as the government's banker. Now consider an alternative. Let the government use some commercial bank like the State Bank of India (SBI) or even a well capitalised and reputed private bank like the HDFC Bank as its banker (and not just as an agent for collection of taxes and other payments). In fact, the government can use more than one good commercial bank as its banker. This takes care of the safety of government deposits, given the nature of such bank(s). Such a bank can be, as is already clear, a public sector commercial bank or a private sector commercial bank. Deposits of the government with the RBI in this context are not necessary. They can be with good commercial banks (this is consistent with Smith 1936).

If there is a need for extra safety, we can even have the status of a senior claimant for the government amongst the depositors in the remotely possible event of a bankruptcy of a commercial bank that acts as a banker to the government. Such a status may seem unfair to the public but we have such a provision already though it is implicit. At present, the government keeps its deposits with the RBI. If the latter runs into difficulty, it can still pay the government by simply issuing more money. This can be inflationary. In other words, there can be an inflation tax on the public, which is to ensure that the government does get paid by the RBI. All this implies that the government is, *de-facto*, a senior claimant even at present in its deposit holdings.

Let us return to the suggested solution. This can help avoid the liquidity crunch due to the bunching of large payments to the government. How? Under the present system, as seen already, when there is bunching of payments, this leads to a liquidity crunch in the commercial banking system. The reason is simple. Funds gets parked in accounts of the government with the RBI. In contrast, under the proposed system, it will be merely a transfer of funds from private accounts to government accounts within the commercial banks. Consequently there is no liquidity crunch within the commercial banking system when there are lumpy payments to the government under the proposed system.

It is true that many banks can lose deposits and a few banks can gain deposits for a while under the proposed system. And, this can create a liquidity crunch for many banks. However, the liquidity constrained banks can always borrow from the banks, which have liquidity precisely at that time and would indeed want to lend.

In fact, the banks which act as the bankers to the government under the proposed policy can, *ex- ante*, sell a line of credit to other banks. When lumpy payments are made, other banks can invoke their line of credit, and borrow from the selected banks. Such arrangements can be left to the commercial banks (Goodfriend and King, 1988).

It may be that on some rare occasion, the inter-bank market fails despite an *ex-ante* line of credit arrangement. In such situations, of course, there is a genuine market failure and the RBI will indeed need to intervene. But this is different from the more frequent interventions that have become all too familiar over time.

A precedent

It is interesting that in the past the current account facility of the RBI was available not only to the government but also to some other institutions. This was eventually removed (Reserve Bank of India, 2001). The argument in this article is simply an extension of the argument previously made in 2001. In other words, the current account facility should not be used by the government just as it is now not used by quasi-government agencies. There is another issue.

Definition of money, and fluctuations in money

Under the present system, liquidity as measured by the money in circulation with the public shows significant fluctuations around its long-term growth. This is true whether we consider the narrow definition or the broad definition of money. One reason is that when there are lumpy payments to the government, the money supply falls and later when the government spends the funds eventually, the money in circulation gets restored. We can make an improvement in this context with the proposed system.

At present, the money held by the government in its accounts with the RBI is not included in the definition of money in circulation with the public. This needs to change under the proposed system. In the latter case, money held by the government with the commercial banks needs to be included alongside money held by the public. It is true that the government is special and different from the public in many ways. However, this does not imply that it should be special in every way.

If government deposits are included in the empirical definition of money, then the fluctuations in the quantity of money will get reduced. The reason is simple. Before the payments to the government are made, the bank deposits are included in the definition of money. And after the payments are made, the deposits are still included in the definition of money. Only the ownership/distribution of the bank deposits has changed from the public to the government.

Concluding remarks

There are some true market failures and the central bank needs to play an important role in such cases. It is best that the central bank deals with these issues instead of being involved in dealing with the so-called liquidity crunch in the economy due to lumpy payments to the government. That can be dealt with more simply if the commercial banking system is at centre-stage *for this purpose*.

It may be argued that the RBI or the government is unlikely to follow an advice of the kind suggested here. So it is pointless to make, what is otherwise, a sound argument. However, the role of a research economist is to make an argument on the basis of sound economics and persuade the policy makers and the public. The role of an economist is not to see what will be (immediately) acceptable to policy makers (Philbrook, 1953).

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