

India's looking for a new central bank governor to perform a tough balancing act

Written by Pravakar Sahoo, Associate Professor, Institute of Economic Growth, and Visiting Fellow, Bruegel, University of Delhi

This week's long-speculated [departure](#) of Indian central bank Governor Raghuram Rajan reflected the Indian government's view that he was no longer welcome at the helm. But it also reflects the challenges all central bankers face in driving an economy.

Post the news, there has been a lot of unnecessary hype about his exit and the likely impact on financial and forex markets, and in the longer-term, the stability of the Indian economy.

Rajan undertook commendable work as the governor to control inflation. He also forced banks to initiate cleaning up their balance sheets, improved forex markets in the country, and initiated institutional reforms for transparency in financial sectors. These measures gave confidence to investors, particularly foreign investors, that India was fundamentally more stable. All these steps and achievements improved India's image and the role of independent monetary policy.

Rajan's most important achievement was in sticking to the mandate of the Reserve Bank – inflation targeting. He succeeded in bringing double digit growth in the wholesale price index to a negative number. The wholesale price index is used as an important measure of inflation in India. Consumer price growth was also cut in half, to below 6%. In doing so, he preserved his image as an independent central bank governor, following his mandate and undertaking policy based on economic merit. But the bottom line is, the RBI governor is appointed by the government.

A clash of motives

The differences between the present government and the RBI governor were apparent early on. While Rajan stuck to the RBI's mandate to manage inflation, the government expected him to reduce policy rates a little more steeply and in quick succession to give momentum to economic growth.

As it is monetary policy in India is less effective due to a weak monetary transmission mechanism. This is mostly because of the banks' heavy reliance on deposits, high level of bad loans and the cost of banking. Inflation in India is not always a monetary phenomenon. There are supply-side bottlenecks that cause inflation, particularly CPI inflation. Therefore, it is not an unfair argument that India has huge manpower and underutilised resources which could have been utilised by the lower policy rate induced growth. A bigger cut in interest rates may have

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been accommodated for growth when commodity prices were nose diving.

Higher lending rates have certainly not helped major sectors such as real estate, construction and small & medium industries, which are employment intensive. In fact, there is excess capacity or sub-optimal use of capacity in many industries due to lack of demand. So certainly higher interest rates, particularly in the first year of the new government, did not help the growth momentum as expected.

Further, Rajan's attempt, rightly so, to clean up the balance sheets of the banks left them with little space for further lending. Higher lending rates and banks' reluctance to lend resulted in a slowdown in credit growth in recent quarters which is not warranted for an emerging economy like India. The government, which had come to power on the development plank of higher growth and employment generation, sought declining interest rates to help deliver on its promise.

Apart from clashing with the government on interest rates, Rajan also questioned its socio-economic policies, something outside the mandate of the central bank governor. While the government was trying to promote "brand India" to attract investment and further the growth momentum, Rajan was openly questioning government policies.

The central bank governor is a government appointee, and the independence of the governor always depends upon the level of coordination and understanding with the government. In fact, the central bank governor can always be asked to go by the government, without reason. It could be argued that the Modi government not only stood by Rajan's convictions, but helped him achieve inflation reductions by maintaining fiscal deficit targets.

The perception that Rajan's exit will bring instability and erode the confidence of foreign investors is over hyped. The stability of the economy and confidence of foreign investors depends on policies and fundamentals of the economy and not on any one individual. India's economy remains one of the few bright spots in the world economy, with the highest growth rate among the big emerging economies. It recently [jumped to the 10th largest destination](#) for foreign direct investment, a 26% increase over the year before.

Modi's mission

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The present Modi government is faced with high expectations for higher growth flowing through to job creation. That is the reasoning behind the “Make in India” policy encouraging investors to manufacture in India.

Indian policymakers, including Modi, are well aware of the importance of economic stability and credibility to investors and their investment. Therefore it is wrong to think the government would allow anything or anyone to risk the credibility of policy making in India or the stability of the Indian economy. Indian politicians are far too experienced with the political cost of inflation; therefore I don't see any let up there.

Pravakar Sahoo does not work for, consult, own shares in or receive funding from any company or organization that would benefit from this article, and has disclosed no relevant affiliations beyond the academic appointment above.

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