RBI – Working of Surplus Transfer

What is the issue?

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The current public tussle between the RBI and the government involves the transfer of RBI's dividend to the government as one of its issues.

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How does the central bank generate profits?

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- The RBI print currency as well as issue deposits (or reserves) to commercial banks and they are considered as its fixed liabilities.
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- It also buys financial assets from the market.
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- However, it does not pay interest on its liabilities.
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- But the financial assets the RBI holds, like domestic and foreign government bonds, do pay interest and serves as an income for it.
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- So the RBI pays nothing on virtually all its liabilities and get a large net interest income from the financial assets it holds.
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- Also, the total costs of the RBI amount to only about 1/7th of its total net interest income.
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- So it earns a **large surplus profit**, more than all the public sector put together, because of the RBI's role as the manager of the country's currency and this belongs entirely to the country's citizens.
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- After setting aside what is needed to be retained as equity capital to maintain the creditworthiness of the RBI, the RBI board pays out the remaining surplus to the RBI's owner, the government.
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- The RBI had made the largest ever dividend pay-outs to the government with 99.99% of its surplus in 2013-14, 2014-15 and 2015-16.

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- After the RBI's risk analysis showed that its equity position of around Rs 10 lakh crore was adequate, the Bank's board decided to transfer its entire surplus to the government in 2015-16.
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- Yet there were suggestions that the central bank should pay more, a special dividend over and above the surplus it generates.
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- However, there is a more fundamental economic reason why a special dividend would not help the government with its budgetary constraints.
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What are the options?

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- **To RBI** - Much of the RBI's surplus comes from interest on government assets or from capital gains it makes off other market participants.
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- In paying this to the government as dividend, the RBI is putting back into the system the money it has made from it and there is no extra money-printing involved.
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- However, to pay an additional dividend to the government, the RBI has to create additional permanent reserves, i.e., print more money.
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- The RBI takes note of growth rate of permanent reserves consistent with the economy's cash needs and the inflation goals every year.
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- To accommodate the special dividend, the RBI can –
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1. sell government bonds to withdraw money from the public
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2. engage in open market purchases than it has budgeted.
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- However, central banks are apprehensive of threats to their balance sheets because despite having the ability to discharge their financial obligations by

creating money, sustained losses can weaken their ability to conduct policy effectively.
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- Also, mounting losses can compel them to approach the government for capital infusion, which they want to avoid in order to preserve their independence.
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- Thus RBI has only limited options and there were no creative ways of extracting more money from it.
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- **To the government** – The government already flagged the issue of surplus profits and capital in the annual Economic Survey.
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- It has also felt that the building up of buffers such as the Contingency Fund and Asset Reserve by the RBI has been far in excess of what is required to maintain creditworthiness.
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- But the government, on its part, should acknowledge its substantial equity position in the RBI and subtract it from its outstanding debt when it announces its net debt position.
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- This will make them demand less from the RBI side and helps maintaining macroeconomic stability in the country.
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How do other central banks maintain this balance?

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- Almost all central banks are owned by their national governments, and have to transfer surpluses or profits to the Treasury.
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- The **UK** has a formal Memorandum of Understanding on the financial relationship between the Treasury and the Bank of England.
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- The entire net profits are passed to the government.
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- The MoU is formally reviewed at least every five years, and there is a provision for an intermediate review in the event of changes to the risk environment.
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- In the **US**, the Federal Reserve transfers all its net earnings to the Treasury.
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- The Fixing America's Surface Transportation (FAST) Act made it mandatory for the Fed to transfer part of its surplus to the Treasury to fund spending on highways.
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What should be done?

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- The Indian economy is now too big and complex for the RBI to remain a subordinate office.
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- The risk management framework adopted by the RBI board indicates the level of equity the RBI needs, given the risks it faces.
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- Thus the dividend policy becomes a technical matter of how much residual surplus is available each year after bolstering equity.
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- Hence, RBI's autonomy vis-à-vis the Finance Ministry is possible only when the central government reposes confidence and trust in the RBI.
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- The RBI's longer-term view of macroeconomic management ensures an intrinsically varying perspective with the government.
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- During the high-growth years of 2004-05 to 2008-09, voices in India demanding higher surplus transfers to the government remained muted.
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- Aggression in demands for higher dividends now indicates that the government's fiscal position is under pressure comparatively.
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- The government also invoked recently Section 7 of the RBI Act as the first step before issuing a directive to the RBI.
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- Thus, the quantum of surplus transfer remains now as a major factor in defining the central bank's relationship with the government and a settlement has to be reached with both sides showing some flexibility.
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Source: The Indian Express

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