Subir Gokarn: Interview with Business Standard

Interview with Dr Subir Gokarn, Deputy Governor of the Reserve Bank of India, conducted by the Business Standard, Mumbai, 1 February 2010.

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Friday's was the first monetary policy that Reserve Bank of India Deputy Governor Subir Gokarn has been involved with directly, and the experience has been rewarding. "The rigour of the process was a revelation," one of the youngest deputy governors that the central bank has had says. In his first interview to a newspaper after taking charge two months earlier, Gokarn, 50, explains the rationale for the measures. Edited excerpts:

The RBI Governor compared himself with Abhimanyu in the Mahabharata. How difficult is the situation?

The context for that is that it was very easy to do what was done in October 2008 onwards. Once the severity of the crisis was recognised, a lot of actions were taken in a very short period of time which completely changed the balance of the policy stance. Obviously, there is a need to correct it now and to take it to normalcy. So, when you start moving towards that, even if it is a correct thing to do, it can be potentially disruptive. Returning from the situation, the sequence, and pacing the activity is going to be critical. Going forward, that's really the challenge.

RBI expects the government to do quite a few things. The policy statement also makes a lot of assumptions. What happens if these are not met?

The commitment made in the last Budget was that the fiscal deficit as a percentage of GDP will be 5.5 per cent in 2010–11. There is no basis for us to assume that it will be anything different. So, our estimate of the funding requirement in order to support the government borrowing programme, as well as the growing demand for credit from the private sector, has been factored into our decision while increasing the cash reserve ratio by 75 basis points. The policies we make today are because of what we believe the macroeconomic environment will be over the next few months.

So, we have to assume certain things on growth, inflation, liquidity, fiscal deficit, market borrowings and capital inflows. In that assessment, we have to allow, and have indeed done so, for some cushion if some of these assumptions go wrong.

Capital flows are a worry. Have you factored in the possibility of intervening in the market and using instruments to check capital inflows?

An important lesson from 2006 onwards is that nothing should be off the table. When we went in for market stabilisation bonds, it was on the basis of the recognition that conventional instruments were not adequate. In September–October 2004 and since December 2006, we reverted to the use of CRR (Cash Reserve Ratio) as an instrument of liquidity management. Earlier, the position was that we would try and wean ourselves away from the use of that instrument and focus only on policy rates. But, we are now using it (CRR) actively.

The same criterion applies to any measure that might relate to capital inflows, whether quantity restrictions or price restrictions. There is, currently, no proposal to use either of these but if the situation warrants, we will not deny ourselves the opportunity of using them.

What is your estimate of the current account deficit for 2010–11?

We have not put out a formal assessment but we do not see any threat. In any event, we do expect that capital inflows will be more than adequate to cover the current account deficit. We have to decide on how we are going to manage the balance of payment surplus. There is no intervention in the exchange rate market with an exchange rate target in mind. Look at the exchange rate movement during the last couple of years – from a bottom of around Rs 52 (a

dollar) to a top of Rs 39. Such a wide variation does not suggest management of the exchange rate.

Volatility may be managed but the levels over this period of time have not. At the same time, we cannot ignore the fact that massive swings in the exchange rate are disruptive, as many stakeholders do not have the capacity to mitigate foreign exchange risk. Developments like foreign exchange futures obviously help and we are moving further down that road.

RBI has projected 7.5 per cent GDP growth and then talked about unbalanced growth. How do you reconcile the two?

If you focus on the aggregate, the number looks reasonable. But, when you look at the disaggregated picture, it is still an unbalanced recovery. There is still a relatively high dependence on government spending. What this tells you is that the private sector is yet to provide full comfort in terms of its participation in the recovery process. So, that is a risk. Similarly, some sectors such as consumer durables and automobiles are doing very well, while others are sluggish. Again, this suggests a narrow set of drivers and there are risks inherent in that. We do not overplay the risks, but we cannot ignore these either. It is quite likely that our stance would have been different if we had much greater comfort in the broad-basing of the recovery.

RBI has made money more expensive without hiking rates. Was the central bank a bit too hawkish?

The objective (of the 75 basis point CRR hike) was to extract excess liquidity from the system. That's because we are looking at a situation where food inflation is clearly a problem. As the recovery gains momentum, which is what we expect, the risks of food inflation spilling over into more generalised inflationary pressures increase. Our approach to mitigating that risk is by anchoring inflationary expectations, to which excess liquidity contributes.

When we looked at an increase of 50 basis points as the possible starting point, we felt it would not be enough. We felt that a 75-basis point hike would provide a better balance between anchoring inflationary expectations and sustaining the momentum of the recovery. The goal was certainly not to surprise the market.

What is RBI's assessment on credit flow? If the overall liquidity for the last two months is still around Rs 100,000–110,000 crore, then the credit growth that banks have been talking about is not there.

The projection for credit growth is a function of a number of things. Some sectors are doing better than the others, but overall demand for credit is still relatively sluggish. Corporates are using alternate sources of funding and internal accruals. So, when growth picks up, as we expect in 2010–11, it will have some impact on credit growth. We will have some indication of the borrowing schedule after the Budget and we will ensure the liquidity scenario does not become destabilising for growth.

You have talked about real estate prices. How big is the threat to the banking system and was there some talk of putting some checks on lending?

We don't have a view on what real estate prices should be. The concern is driven by the degree of exposure the financial sector has to the sector and whether that exposure is a source of risk that could destabilise the system. If we feel the exposure is becoming threatening, we will take measures. We don't want to do anything directly to real estate. We don't want to tell banks not to lend to real estate, but banks need to be aware of the risks their exposures to this sector add to their portfolios.

What are RBI's expectations from banks?

One, the needs of the legitimate borrowers should be met fairly. This applies to small and medium enterprises, as there is a perception of inadequate flow to this segment and it is

hurting the ability of these businesses to take advantage of the recovery. Two, it is important to play safe. Here, in the context of segments such as real estate, banks should not jump on opportunities that appear very attractive in the short term, while compromising on prudence. We do not want to squeeze the recovery and deny the needs for financing, but we do not want them to go overboard in risk taking. That's the balance we are expecting.

How big is the threat of large bad debt on the restructured portfolio?

It is clearly something you need to watch out for. It may put some stress on certain individual banks. When the restructuring option was given, it was based on the premise that genuine borrowers in distress as a result of the liquidity squeeze would be subject to that restructuring. The risk was that assets that were not fundamentally sound would also be given the option. You cannot blame the concept of restructuring.

Some automobile companies said yesterday that the sales momentum would lose steam after the CRR hike.

Let me use an automotive analogy. If you are driving a car at 100 kmph and know the road ends five kms later, what do you do? Do you begin to gradually apply the brakes now or do you wait till you are near the end of the road and then slam the brakes? Both are legitimate options: the question is which is riskier. We clearly take the view that if we see a barrier, which is now in the form of inflationary pressure building up, it is better to use the first option and gently apply the brakes. This way, you gradually adjust to the optimal speed and it is safer than the second option which can throw a lot of things out of gear.

Outside RBI, people always wonder how much backseat driving is done from Delhi. Now that you have been in RBI for a while, do you find an element of backseat driving?

At the end of the day, we basically want the same thing, which is growth with stability. We want growth to be as high as possible, we want inflation to be as low as possible, we want financial stability and we want stability on the external front. At any given point in time, priorities may differ somewhat, but the overall framework is one of co-ordination. We have said in our policy that the government should bring the fiscal situation under control. Would you accuse us of backseat driving?

Next year, private sector loan demand will pick up, while government borrowings will remain around the same level and inflows are expected to rise. So, will it be one of the tougher years from the policy making perspective?

There is some notion of a trend rate of growth, say, in the 8–9 per cent range. If the economy grows beyond that trend, that is overheating. We cannot remain over the trend for a long period of time without stoking inflationary pressure, for the simple reason that the economy does not have the capacity to grow faster than that rate. If the factors you are talking about take the economy above the trend, the risks of overheating develop and from a macro-economic stability perspective, we have to address those.

Our focus is on whether this is being done within the overall capacity of the economy to sustain that growth rate. If growth is above trend, we need to find ways of dampening. There is some difficulty, of course, in identifying what the sustainable trend is in such a dynamic and volatile environment. This is an ongoing analytical objective.

This is your first monetary policy. What are your first impressions about RBI?

The process is very intense and the amount of information and analysis that comes in is much larger than I appreciated as an outsider. What I have discovered is that the density of information and the amount of processing is huge. So, the confidence in the correctness of the decision is far more than it would have been, based on the data that I had available to me on the outside. It's an extremely consultative process, both internally and externally, with RBI staff from many departments, banks and other market participants. The rigour of the process was a revelation; I did not appreciate it from the outside.