

“The remedy to improving domestic savings lies in a more efficient banking sector”



PHOTOGRAPHER: KRISHNA PATHER

Weekly speaks to Dr. Duvvuri Subbarao, governor of the Reserve Bank of India, who was recently a guest speaker of the Bank of Mauritius. He talks about the state of the Indian economy, the challenges faced by Mauritius and the policy options available to Central Banks even if some are politically unpopular.

By Touria PRAYAG

■ When we heard that the governor of the Bank of Mauritius had invited you over, our reaction was that he had invited himself. You actually are on the same wavelength on all monetary policy issues. Is that a coincidence?

I don't think it's coincidental because if you look all over the world, at the core, all Central Banks face the same challenge which is balancing growth and inflation. Look at Japan and the US today: it's the Federal Reserve having to adjust its policy to the fiscal stance of government. In a way, the different perceptions of government and the Central Bank are largely replicated everywhere.

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Dr. Duvvuri Subbarao, governor, Reserve Bank of India.



Of course, the details vary according to the country. Mauritius, for example, is a small economy; India is a large one. Mauritius has an income of \$10,000 per capita. We are at \$1500.

■ **Does that make the problems different?**

I don't think so because the issues are the same: balancing growth and inflation and providing an environment of price and financial stability so that investors and consumers can make informed choices. But the mechanics of the problem can differ. For example, how do you set interest rates? How does monetary transmission take place? Then looking at the external sector, what is your policy on the exchange rate?

■ **Coming to the exchange rate, is inflation our biggest enemy? Isn't lack of growth a bigger enemy?**

I wouldn't say bigger or smaller. You need growth – rapid growth – and you need an environment of price stability. I would say the price stability is a necessary condition for growth. It would be futile to believe that you can have growth in a time of rapid inflation. This balance or trade-off between inflation and growth that people talk about, I don't subscribe to because there might be some trade-off in the short term but in the medium to long term, you need price stability for investors and consumers to make informed choices, a necessary condition to stimulate growth.

■ **But when you talk of the long term, the state of the economy in many countries does not give that breather. Many companies don't have time to wait for things to stabilize. And if they close down, workers are laid off.**

But to believe that monetary policy by itself can stimulate growth and answer all problems is incorrect because monetary policy is just one instrument.

■ **Isn't it the most important one?**

It is an important one. But you cannot expect to solve all the macro-economic problems with that one

instrument. After all, mathematically, for every objective, you need one variable. So if you have one policy variable, you have one interest rate. But to believe that you can control inflation, reduce unemployment, stimulate growth and control financial stability with that one instrument is, I believe, asking for too much. As interest rates are important for getting the growth-inflation balance right, you have to have other policies in place for monetary policy to work effectively. Like fiscal policy, external sector policy and exchange rate policy.

■ **Historically, there has been fiscal dominance over monetary policy. Why has that changed?**

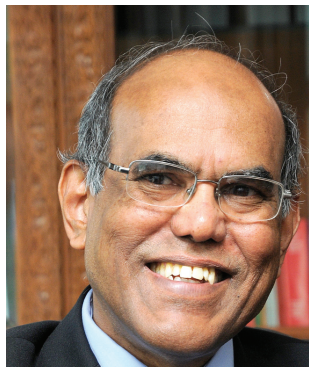
That changed after the 1970s when monetary policy setting and Central Banks became independent. Now, after the crisis, the fear is that once again monetary policy is coming under fiscal policy dominance meaning that fiscal policy is set independently and monetary policy has to adjust. What has to happen is that monetary policy has to be set independently by an independent Central Bank taking into account its assessment of the macro-economic situation and there has to be some degree of coordination. For instance, if monetary policy is accommodating, then fiscal policy has to be tight so that there is adjustment. If both are accommodating, there will be inflation. Again, on exchange rate, as economies are getting more open, you can have imported inflation through the exchange rate. So your external sector policies have to be appropriate. That's a long answer to your question.

■ **You are talking about the independence of the Bank, but this almost invariably creates a clash between the minister of finance and the governor of the Bank. Is that conducive to good government?**

There doesn't have to be a clash. A difference of opinion is quite understandable. You see, governments traditionally have a bias towards growth and the Central Bank's dharma is to manage inflation. If the Central Banks act independently,



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hopefully one will strive for growth and the other will strive for stability and we will have an ideal situation.

■ **But there are no meeting grounds are there?**

No, there are no meeting grounds but received wisdom today is that an independent Bank has served all jurisdictions very well. We should improve upon that, not cripple it. It's okay for governments to set the mandate for the Central Bank but once that's done, they shouldn't dictate how that mandate should be delivered. And that's the issue that's being played out in countries like Japan.

■ **You mean Prime Minister Abe demanding that the Japanese Central Bank be more aggressive in its monetary policy?**

Yes, but the Bank of Japan has, I believe, a view that it is also important for other structural reform policies and the fiscal stance of the government to be conducive for the monetary policy to deliver on its mandate.

■ **The argument of the minister of finance and the economic players here is that our rupee is overvalued. Do you think it is?**

(Long silence)

■ **Come on, tell us!**

Central Banks don't take a view on the exchange rates. *(Hesitates)*. The opinion of the Reserve Bank of India is that the exchange rate should be largely market-determined and that Central Banks should intervene only to manage volatility or to prevent economic disruption. I believe that is the policy in Mauritius too. Whether the exchange rate is becoming volatile or becoming disruptive to the macroeconomic stability is a judgment call that the Central Bank has to make.

■ **Only the Central Bank?**

I believe so, because why do governments take a position on the exchange rate? Because they believe that a certain exchange rate has implications for importers and exporters. Right?

■ **Yes. And doesn't it?**

Maybe in the very short term. I believe that export competitiveness is determined more by productivity levels rather than by the exchange rate. I don't think that any country has been able to gain an extended competitive advantage through the manipulation of the exchange rate.

■ **Your minister of finance said “we will go on the path of growth alone if others are not willing to support us”. And these ‘others’ are probably you. Do you have the same conflict that we have here?**

I wouldn't call it a conflict, but there are definitely differences of opinion and differences that we talked about earlier are quite natural depending on where you are coming

from. I also want to say that I have excellent liaisons with our finance minister.

■ **Is that why he calls you "others"?**

(Laughs) I don't know where and in which context that statement was made but I can quite understand if he has a different take on the growth-inflation balance.

■ **It is more than a take. He is saying that you are not supporting him.**

I cannot really interpret what he said. I've admitted that there have been differences of opinion but we have a good mechanism of managing those differences.

■ **The picture you painted of the economy of India is not a very rosy one. Is it as bad as it sounds?**

I don't know but growth this year is going to be the lowest in a decade. Inflation has come off the peak but is still quite elevated. We are going to have historically the highest current account deficit this year. And investment has decelerated. So there are challenges. But I also said in my talk that the India growth story is still robust. India's promises are still there. The growth drivers are all intact. And if we do the right things from now on, we can make the promises come true.

■ **When you say that, you do not sound very convinced that the government will do the right things. Are you?**

Well, the government is doing some of the right things. But this is a democracy. All democracies go through the struggle to do things that are politically unpopular in the medium term. But in the short term, there might be a political cost.

■ **What are these 'right things' in a nutshell?**

The first thing is fiscal consolidation in India. To contain the fiscal deficit is very important for monetary policy to be effective and contain inflation. It is important for the savings rate to go up, it is important for the government's quality of expenditure to improve so the biggest thing to do for fiscal consolidation in India is

to reduce the subsidies.

■ **Subsidies on food?**

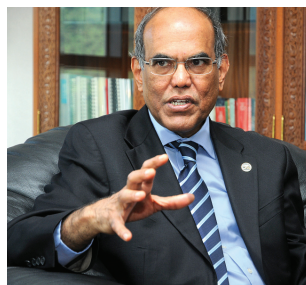
On food, fertilisers and petroleum products.

■ **Isn't that politically suicidal?**

That is what I am saying. In the short term, there are political costs. But in the medium term, it is good for the economy.

■ **Are you asking for the poor to pay the full price of the food they eat?**

Otherwise the poor will pay the price anyway through inflation. It is a question of how the poor get the best deal out of the economy. I believe that fiscal consolidation is actually an anti-poverty measure. Today, in India, it



"To believe that monetary policy by itself can stimulate growth and answer all problems is incorrect."

is not just the poor who get subsidies. A lot of the non-poor are getting them as well and some of the poor are not getting subsidies.

■ **So what you are asking for is not actually to eliminate subsidies but to target them.**

Target and streamline. Because subsidies of this size are unsustainable, so we are asking for streamlining and we are asking for targeting. That is one thing: politically unpopular but necessary. Then you have to raise investment.

■ **What is the point of coming up with suggestions which will never work? There is no government that will commit political suicide, is there?**

I believe governments do take politically difficult decisions. In his speech in Israel, President Obama said politicians will not take difficult decisions unless people ask them to do so. So in truly functioning democracies, people should force politicians to take difficult decisions which are in the long-term interests of the country. Politicians have to look beyond tomorrow to see what's coming five years from now.

■ **You were finance secretary to the government of India between 2007 and 2008 and you were secretary to the Prime Minister's Economic Advisory Council before that, so it is not unfair to ask you about your take on the Double Taxation Avoidance Agreement (DTAA), is it?**

No, I would prefer not to answer that question because that is something that has developed in the last two or three years after I have been away from the government.

■ **But you did not go into hiding after that. You must be aware of the press articles in the Indian newspapers.**

I believe that both governments have agreed to rework the agreement in order to prevent abuse by irregular, unlawful investors.

■ **There is a lot of talk in India about round-tripping through Mauritius and nobody**

is even talking about Singapore. Do you know why?

(Evasive) No, I have never thought about why nobody is talking about Singapore. It depends also on the confidence of the regulatory jurisdiction in these countries.

■ **Do you think that Singapore has a better regulatory system?**

It would be unfair for me to say that.

■ **Forget about now. Let's talk about the period when you were there...**

It's not as if, even if you are a finance secretary, you have a complete world view of which jurisdiction is more effective. So, it would be inappropriate for me to answer the question. About the India-Mauritius DTAA, what I have understood is that it is up for some renegotiations to prevent and minimize abuses. There is round-tripping and there is a need to prevent that.

■ **Yes. But the money comes out from India. So shouldn't this prevention happen in India?**

It should happen in India and it should happen in the other partner countries. India should make sure there is no money generated through money laundering and around the world there should be no jurisdiction where this round-tripping is possible. It's both a question of opportunities too.

■ **What do you see as the major specific challenge for the Mauritian economy?**

You need to improve your domestic savings in order to reduce dependence on foreign savings. You need to generate domestic savings. For that you need to have a competitive and efficient banking sector which can give a higher rate of return to the savers but at the same time give competitive rates of interest to the borrowers. That means that the net interest margins of the banks must be small. In other words, banks must be more efficient in financial intermediation. If you accept that improving domestic savings is a challenge, the remedy lies in the banking sector becoming more efficient. ■