Interview with Financial Express on Friday, July 16, 2021 - Shri Shaktikanta Das, Governor, Reserve Bank of India

It is not like any other year, when inflation goes up, you start tightening the monetary policy: RBI Governor Shaktikanta Das

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By Shobhana Subramanian and KG Narendranath

Retail inflation print stayed above the upper band of the Reserve Bank of India’s 2-6% target for the second straight month in June, causing the stakeholders to watch its moves more intently. RBI started easing the policy rate since February 2019; it adopted ‘accommodative’ monetary policy stance in June 2019 and has since maintained it, given the grave challenge to economic growth due to the pandemic. Governor Shaktikanta Das expounds on the current priorities of the central bank, which is also the government’s debt manager, in an exclusive interview with Shobhana Subramanian and KG Narendranath.

Excerpts:

Is the latest retail inflation number (6.26% in June, upon a high base of 6.23%) a cause for worry or has it come as a relief (given it eased a tad from a six-month high of 6.3% in May)? How long will the RBI be able to retain the growth-supportive bias in the conduct of monetary policy?

The CPI inflation number for June is on expected lines. The year-on-year growth in ‘core’ inflation (eased marginally to 6.17% in June compared with 6.34% in May. The momentum of the CPI inflation has come down significantly in the both headline and core inflation in June.

The current inflation is largely influenced by supply-side factors. High international commodity prices, rising shipping charges and elevated pump prices of diesel and petrol (which are partly due to high taxes) are putting pressure on input prices. Prices of several food items including meat, egg, fish, pulses, edible oils, non-alcoholic beverages have risen too.

Supply-chain constraints have also arisen out of the Covid 19 related restrictions on movement of goods, and these are easing slowly. Over the last few months, the government has taken steps to address the price rise in pulses, edible oils as also the imported inflation, but we do expect more measures from both the Centre and states to soften the pace of inflation.

Last year, in July and August, CPI inflation was in excess of 6%; in September and October, it was in excess of 7% and in November, almost 7%. That was the time when the Monetary Policy Committee (MPC) had assessed that the spike in inflation was transitory and it would come down going forward. In hindsight, the MPC’s assessment was absolutely correct. Now, the MPC has assessed that inflation will moderate in Q3FY22, so I emphasise on the need to avoid any hasty action. Any hurried action, especially in the background of the current spike in inflation being transitory, could completely undo the economic recovery, which is nascent and hesitant, and create avoidable disruptions in the financial markets.

At 9.5% (real GDP) growth projected by us for FY22, the size of the economy would just about be exceeding the pre-pandemic (2019-20) level. Given that growth is still fragile, the highest priority needs to be given to it at this juncture.

We need to be very watchful and cautious before doing anything on the monetary policy front. Also, all this we have to see in the context of the truly extraordinary situation that we are in, due to the pandemic. It is not like any other year or occasion, when inflation goes up, you start tightening the monetary policy.

The Centre's fiscal deficit is high (the budget gap more than doubled to 9.3% of GDP in FY21 and is projected to be 6.8% this year), but given the huge revenue shortfall, the size of the fiscal stimulus is limited and not adequate to push growth. Yet, the RBI needs to focus a lot on the yield curve to ensure that the government's borrowing cost doesn't skyrocket. Some would say the RBI's debt management function is taking precedence over its core function, which is inflation-targeting. Is the RBI open to creating new money to directly finance the fiscal deficit?

I would not agree with the formulation that debt management is undermining inflation-targeting. In fact, our debt management operations throughout the past year and more has ensured better transmission of monetary policy decisions. We are using the instruments at our command to ensure transmission of rates. Thanks to our debt management operations, the interest rates on government borrowings in 2020-21 were the lowest in 16 years, and private-sector borrowing costs have also substantially reduced. If the real estate and construction sectors are out of the woods now, the all-time low interest rates on housing loans have had a big role in it.

We have not only reduced interest rates in consonance with monetary policy, but have also ensured availability of adequate – even surplus– liquidity in the system through OMO, Operation Twist and GSAPs. These have resulted in lower borrowing costs and financial stability across the entire gamut of stakeholders including banks, NBFCs and MFIs, and, therefore, been very supportive to economic growth.

If you look at the M3, the growth of money is just about in the range of 9-10%, meaning our accommodative stance is not really creating high inflation.

As far direct financing of the government's fiscal deficit is concerned, this apparently easy option is out of sync with the economic reforms being undertaken; it is also in conflict with the FRBM law. In fact, this option has several downsides and the RBI has refrained from it.

What's important is the (high) efficiency with which the RBI is meeting the borrowing requirement of the government. The Centre and states, among themselves, borrowed about ₹21-22 lakh crore, a record high amount in FY21, but at historical-low interest rates. In the current year too, there could be a borrowing quantum of the same order, and the RBI will use all the tools at its disposal to ensure that the borrowings are non-disruptive and at low interest rates.

There is ample liquidity in the system, yet the banks appear to be extremely risk-averse. They would rather park the excess funds under the reverse repo window, than lend to the industry. Even the government's schemes like ECGLS – which insulates banks from credit risk on loans to MSMEs and retail borrowers – and the targeted liquidity policy of RBI for small NBFCs don't seem to change the outlook much. As the regulator, how do you get this fear psychosis out of banks?

The banks have to do prudent lending with proper appraisals. Risk aversion on the part of the banks is arising from the current pandemic situation, and its possible consequences. Demand for credit from the industry is also not as high as one would expect it to be. This is because there is still a large output gap that constrains new investments.

Many large companies considerably deleveraged their bank loans in FY21, while raising money from the corporate bond market. So banks have to lend where there is a demand, and that is one reason why lending to retail sector is growing. There is no gainsaying that bank credit needs to rise; I'm sure banks will indeed lend if there is demand for credit and the projects are viable.

There is a lot of demand for loans from companies that are relatively low-rated. Banks are not willing to take any risk…

Of course, the risk perception (among lenders) is high and, precisely for that reason, the government unveiled the ECLGS scheme (under which guaranteed loans up to a limit of ₹4.5 lakh crore will be extended). If you see our TLTRO scheme or the refinancing support (special facilities for ₹75,000 crore were provided last year to all India financial institutions, including Nabard and SIDBI; a fresh support of ₹50,000 crore has been provided for new lending in FY22), the objective is that they would lend to small and micro businesses. We have also given ₹10,000 crore to small finance banks and MFIs at the repo rate (4%), again to ensure adequate fund flow to micro and small firms.

As for the healthcare sector, banks are allowed to park their surplus liquidity up equivalent of the size of their Covid loan books with the RBI at a higher rate. We are also according priority-sector status to certain loans for the healthcare sector. So, because of the extraordinary situation, we are incentivising the banks to lend more through a series of measures.

As the regulator, our job is to provide an ecosystem where the banking sector functions in a very robust manner. But beyond that, who the banks will lend to or won't lend to must be based on their own risk assessment, and the prudential norms.

In the recent financial stability report (FSR), the worst-case NPA scenario after the full withdrawal of forbearance is foreseen to be better than the best case perceived in the January edition…

We had a much clearer view of the assent quality in the July FSR than when the January edition was drafted, when the regulatory forbearance partially blurred the picture. Still, these are assumptions and analytical exercises rather than projections. These could serve as guidance to the banks in their internal analysis of, say, a possible severe stress scenario. We expect the banks could use these inputs to take proactive, pre-emptive measures on two fronts specifically: increasing the provision coverage ratio and mobilsing additional capital to deal with situations of stress or a severe stress, should these happen.

These assumptions, based on real numbers, could by and large hold true, unless a third Covid-19 wave plays spoilsport.

In the auction held on Friday, you allowed the benchmark yield to go up to 6.1%, while it had long seemed you won't tolerate a rate above 6%…

We've never had any fixation that the yield should be 6%, but some of our actions might have conveyed that impression. After the presentation of the Budget (for FY22) and other developments such as the enhanced government borrowing, the bond yields suddenly spiked. The 10-year G-secs, for example, reached 6.26%. But after that, through our signals and actions (in the form of open market operations, Operations Twist and G-SAP, and our actions during auctions, going sometimes for the green-shoe option or sometime for cancellations, etc) we signalled our comfort level to the markets.

So, we are able to bring down the yield and the rates, by and large, remained less than 6% till about January or so. The first auction that we did last Friday when we introduced the new-tenure benchmark reflected one important thing that the focus of the central bank is on the orderly evolution of the yield curve and the market expectations seem to be converging with this approach. So, it will be in the interest of all stakeholders, the economy, if the same spirit of convergence between the market participants and other stakeholders, and the central bank continues and I expect it will continue.

A jump in the RBI's 'realised profits' from sale of foreign exchange enabled you to transfer a higher-than-expected ₹99,122 crore as surplus to the government for the nine months to March 31, 2021. Are you sticking to the economic capital framework as revised on the lines of the Bimal Jalan committee's recommendations?

One of the key recommendations of the committee is that unrealised gains will not be transferred as a part of surplus and we are strictly following that. We intervene in the market to buy and sell foreign currencies, and what we earn out of that are realised gains. A large part of the surplus transfer constitutes the exchange gains from foreign exchange transactions. So whatever gains we make out of this are not unrealised (notional) gains (which can't be transferred under ECF). We also make losses in such transactions, because RBI isn't in the game of making profit but in the game of maintaining stability of the exchange rate and ensuring broader financial stability.

Last year, about ₹70,000 crore had to be transferred to the contingency reserve fund because it was falling short of the 5.5% level recommended by the Jalan committee. This was because our balance sheet size grew substantially last year due to liquidity operations that we undertook in March, April and May. So, last year the larger size of the RBI's balance sheet required that as much as ₹70,000 crore be transferred to the contingency reserve fund. This year, the expansion of balance-sheet wasn't that much, so the transfer was much less at about ₹25,000 crore.