*'Exit from the Crisis cannot be Drastic' – Interview of Dr. Subir Gokarn**

Reserve Bank of India (RBI) Deputy Governor Subir Gokarn, who is in charge of monetary policymaking, has ruled out any central bank action immediately after the Union Budget on 26 February and ahead of Reserve Bank of India's Annual Monetary Policy Review in April, unless there is a dramatic slowdown globally. In an interview on Saturday, he also said exit from monetary stimulus "is not an event and it is a process" that started in October with an increase in banks' statutory liquidity ratio (SLR), or the proportion of deposits banks are required to invest in government bonds. The cash reserve ratio (CRR), or proportion of deposits banks are required to maintain with the central bank, was raised in January. "Keep in mind that the response to a crisis has to be extremely swift and even radical because there is a complete erosion of confidence and that situation will not accommodate measured moves. But exiting from that position cannot be so drastic," he said. Edited excerpts:

Despite a 75 basis point hike in banks' CRR, many analysts believe that RBI is behind the curve and you should have gone ahead with a rate hike. (One basis point is one-hundredth of a percentage point.)

The choice between a rate hike and a liquidity measure was essentially driven by the perception that the economic recovery, while beginning to steady, is still not completely robust. We have a number of factors that suggest that within the overall recovery, there are certain imbalances.

The fact that public spending still contributed a substantial portion of growth in the second quarter is a case in point. The growth is very skewed across industries.

* Interview of Dr. Subir Gokarn, Deputy Governor, Reserve Bank of India, with Mint Newspaper, Mumbai.

Much of the recovery in consumption too seems to be driven by the implementation of the pay commission award.

There are other indicators as well. For example, our survey on order books, inventories and capacity utilisation suggests that inventory replenishment is contributing to the recovery, while order books don't reveal the same level of sustainability of sales. When you take all these factors into consideration, interest rate hike might have been a little bit premature. An interest rate action would have sent a much stronger signal about our confidence in the recovery.

On the inflation front also, I think an interest rate hike would have signalled that we are getting into a phase where demand-pull pressures were beginning to grow. We were not really into that situation. As we have emphasised in our policy statement, there was clearly a risk that as the recovery firms up, the steep food prices will spill over into a broader inflation process. But we are not yet in the demand-driven inflation situation.

Now that you have done your bit, you will probably wait for the Union Budget and see what the government will do on the fiscal side, before taking a call on interest rates. Right?

We have made certain assumptions in our policy about what the fiscal stance would be. The basic assumption about the fiscal stance has been what the finance minister had indicated in the July budget statement—of bringing down the fiscal deficit to 5.5 per cent of GDP (gross domestic product). We believe that our measures will accommodate that without putting liquidity conditions at any risk. We have a certain amount of cushion in our calculations.

What do you mean by that?

There could be an increase in the demand for liquidity if credit growth is higher or capital flows are lower than we expect or if the budget deficit and government borrowing are higher than we expect. All these factors have been taken into consideration in our forward-looking assessment.

If our assumptions don't pan out, obviously our calculations will prove to be wrong. But we have to work on the most likely scenario.

If the government does not do what you expect it to do on the fiscal side, will you announce any monetary action immediately after the Budget is presented instead of waiting till April for the annual policy?

The principle we are following is that the mid-cycle actions are responses to completely unforeseen events. We have made certain assumptions (in the policy) which provide for some cushion about what the Budget could imply for financial markets. The Budget, therefore, would be an anticipated event and should not be a cause? for mid-cycle action. If there is a global slowdown of some significance and something happens which is not in line with our assumptions, that may provoke some action but, as far as possible, we want to operate on a schedule.

Some members of the technical committee that is consulted by the Reserve Bank for making the monetary policy were in favour of a rate hike.

It's a collective process and the technical committee is one input into the process. But ultimately the judgement is left to the Governor. Every option was considered, including the option of not doing anything at all. It's not just a question of what to do based on what is happening but also what is likely to happen. There is also the issue of associated risks. Any action you take is going to have some downside and negative consequences. We have taken into consideration the relative significance of these negative consequences too.

Our objective was to maintain a balance. We are clearly moving to a situation in which the focus was exclusively on recovery—from October 2008 onwards—to one in which we have to give balanced consideration to growth and inflation. An interest rate hike, we felt, would have signalled that inflation is being pushed by demand, which was a call that was too early to make at this point.

In September 2008, both policy rate as well as CRR were 9 per cent. With the economy on a growth path and inflation rising, when do we see that level? More specifically, what kind of hikes in interest rates and CRR can we expect this year?

Analysts are speculating on this. But I am not going to comment about the likely magnitude of change. In pre-Lehman (Brothers Holdings Inc.) days, the rates and CRR were raised in response to over-heating of the economy, combined with strong supply-side inflationary pressures. We were dealing with two reinforcing drivers of inflation. Had there been no Lehman collapse, there would have been some normalisation, but the crisis happened and the pendulum swung to the other end, with an exclusive focus on reviving growth. It happened extremely quickly. In the space of a few weeks, the repo rate moved from 9 per cent to 4.75 per cent and the reverse repo also came down from 6 per cent to 3.25 per cent.

There has to be some process to return to normalcy. That process began in October without any direct action, but SLR (statutory liquidity ratio) was raised and the policy stance shifted from managing the crisis to managing the recovery.

Keep in mind that the response to a crisis has to be extremely swift and even radical because there is a complete erosion of confidence and that situation will not accommodate measured moves. But exiting from that position cannot be so drastic.

It is like the climax in a movie where the bomb disposal guy has to decide which wire has to be cut to defuse the bomb and it's a 50:50 shot. If he cuts the wrong one, he blows the ship up and if he snaps the right one, he becomes the hero.

In a sense, the policymakers are in a similar situation now. They have to carefully decide what instruments they are going to use and at what pace. We will see a very cautious exit in sharp contrast to the frenzied action that we saw during the crisis.

So, you will withdraw at a slow pace.

It has to be. And this is not unique to us, it will be the global strategy. The exit is not an event; it is a process. So when we made our assessment in October or in January, we also took into consideration the likely trajectory of variables that play a role in our decision-making. The policy announcements every quarter are part of a sequence, based on a combination of our outlooks and the new information that comes to us between announcements.

As far as the April announcement is concerned, one, the Budget will have been announced. Two, we will have a better sense of credit and capital inflows. Looking ahead, by mid-end July, we will have a sense of what the macroeconomic impact of the monsoon is likely to be. Whether it's positive, neutral or negative, it will be a significant input in our July and October calculations.

Do you have a number in mind in terms of rate and CRR hike?

No. However, we are very clear about our objectives. We do not want to be disruptive; we do not want to see the recovery being impeded in any way by financial constraints. At the same time, we do not want to see an overheating situation.

It is tougher to take a call now than in the wake of the crisis?

Yes, absolutely. The simple reason for that is when the patient is dying, there's nothing to lose. You pump in every possible drug that you have. But when he is recovering you have everything to lose by making the wrong move. The only choice that you had in September-October 2008 was to act and to act quickly. Now the choice is far more difficult. You make the wrong move and the recovery process could derail.

In the time of crisis, the coordination between the Government and the Reserve Bank was easy, but now it will have problems as government will always want growth and may not see your point of view.

Conflicts are more interesting to the media than collaborations. They give you headlines. The fact is, in a crisis, everybody comes together and everybody agrees on what needs to be done. When the situation returns to normal, you return to debating about different weights and priorities that are given to attain different objectives.

You have former Reserve Bank Governors in the system—Manmohan Singh, C. Rangarajan. They must be influencing you a lot.

Their role as central bankers is only one dimension of their professional identities. They are participating in the policy debate and as part of that they have a view on what the central bank should or shouldn't do. That's part of the value of having an open system.

We have inputs coming in from all over the place. We take them on board and we basically look at the arguments and assumptions underlying those inputs as part of our own decision-making process.

The Reserve Bank has done many interesting things—making the policy document brief and teleconferencing with analysts across the globe. Any plan to make the minutes of the technical committee on monetary policy public?

There are two aspects to that. One is the institutional framework itself. The members of the Federal Open Market Committee (FOMC) of the US Federal Reserve have a statutory responsibility and it is important for the public to know where they stand on a particular issue.

Our committee members have an advisory role. While involving them in the process, we want to give them full freedom to express their views within the framework of our internal debate. They may not be as free in their advice if they knew that their position or recommendations would be made public. So it's a trade-off. There is no unambiguous benefit to any particular form of transparency versus another and it entirely depends on the institutional context.

You have started reaching out to the outside world on financial literacy and inclusion. Why did you need to wait till RBI's platinum jubilee year to do this?

I don't think it was a question of waiting. These initiatives have been going on at some level. What has happened in the platinum jubilee year is a complete commitment of the senior management to the programme. Therefore, instead of doing it on a piecemeal basis, there is now a very coordinated and focused effort.

In my case, I went to a village outside Hyderabad four days after the monetary policy. I couldn't have asked for a more striking contrast. For one month, I completely focused on the making of the monetary policy and four days later I was talking to school kids and self-help groups about financial inclusion. They are worlds apart. But this also brought home to me the fact that inclusion is as important an agenda as macroeconomic stability.

A de-stressing exercise?

It was that too. But more than that, it made sure that you don't just get caught up in the abstraction of the monetary policy and lose touch with reality. My outreach exercise was a phenomenal experience. It's something I would like to do as soon as every monetary policy announcement is over.