Its Risky to Take a U-Turn Now

Given the global uncertainties and current account deficit, the monetary authority cannot afford to alter the policy course now, feels the former RBI governor.

Three years after leaving the job of the RBI Governor, YV Reddy has been busy travelling in India and abroad, sharing his experiences on both the monetary and fiscal policy fronts.

Reddy, who served as governor at a time when the average growth was over 8%, had come in for praise for the management of India's financial sector.

Will Greece and the world be better off if Greece were to leave the euro zone and revert to the drachma — its original currency — for a while?

I think for the world, it will not be good if the euro zone does not survive because the downside of breaking up is huge even for countries within euro zone. Once the euro zone gets weak and its future is seriously threatened, it is very much an issue of where it will end.

We don't know where it will end. From a global point of view, Europe is seen where a number of countries have fought two world wars. And essentially, it was nationalism or creation of nationalism, virtually on a linguistic basis. At the time of India's independence, some people said India will break up and become like Europe. From there, the political leadership was able to bring together an almost inconceivable political union.

If that experiment fails that would be very sad for Europe and the world in terms of how nations can get together. If you believe in a multipolar world, the euro zone will be an important component. Otherwise, we may be left with one or two important countries. If you talk of globalization, these are the tensions you should learn to resolve.

If you fail to resolve, then basically you are saying that nationalism takes precedence over old coordination policies and across national basis. But my own impression from the interaction I have had with senior political leaders was that they are determined to save it. I think India also has a stake in ensuring that the euro zone does not break up.

Is there any point in having a monetary union without a fiscal union?

That was the most important issue from the beginning. The monetary union was established with a declaration that fiscal coordination was important and then a certain fiscal discipline was agreed. But fiscal disciple was not adhered to. Or when it was not adhered to, some of it was concealed with the help of experts such as Goldman Sachs.

And there was almost not-so-responsible lending by financial institutions because they always had this underlying feeling that the zone will come to support. And also the penalty for not following fiscal discipline was not evident. In a way, the fundamental assumption that fiscal coordination through limits on fiscal deficit will be followed was the foundation of the monetary union.

Once that was broken, it got into problems. So two things which are required for that type of union is a lender of last resort and a central fiscal authority and both of them are somewhat nebulous. Now that has to be more clarified.

India has signaled that it would consider supporting the Euro Stability Fund at a time when it is running a twin deficit — both fiscal and on the current account — unlike China. Should we go ahead?

I disagree with you. India is an important country and it has to demonstrate its interest in ensuring that the euro zone succeeds. It is not in the global interest but in India's interest. Unlike in the case of the euro zone as a whole, India has no spillover effect. If the US carries out adjustments to its currency, there is a global spillover effect because it has structural problems.

Similarly, China will have a spillover effect but the euro zone has not contributed to global imbalance. Internal imbalances of the euro zone are important and how they distribute the burdens within financial, fiscal, taxes and between the northern and southern European countries has to be politically negotiated. In a way, therefore, India has done the right thing by expressing strong support.

During the 2008 crisis, the US did not allow its banks to fail. Do you see a similar thing happening in Europe?

It is very difficult because some of the banks actually have significant public sector elements — Germany and Switzerland. In fact, that is one of the things that complicates the resolution of the sovereign debt problem because if the haircut is accepted, then the capital adequacy comes down.

I think earlier also the leverage perhaps was fairly high for the banking system in Europe but I don't think there is much of a choice. You'll have to meet everybody who has to sacrifice and convince them. There are two things — sacrifice and distribution of the sacrifice. Both of them have to be painfully negotiated across countries and sectors.

One of the major criticisms ever since the financial crisis of 2008 has been the failure of central bankers and politicians in the West. How valid is such criticism?

There has been excessive financialisation. And an excessive ideological belief that the financial sector can lead the real sector. Rather it should be the financial sector enabling the development of the real sector. In a way they expected that the financial sector will enable and lead the efficient allocation of resources for the real sector.

That the financial sector can lead for its own benefit and become an end for itself was not fully perceived because of the nature of the financial sector. It is not as tangible as the others. Then the financial markets have essentially a short-term view. The political leadership has a short-term view. When both these converge, the regulator gets squeezed between this powerful combination.

But what happens if regulators also get a feeling that they should be acceptable to financial markets. The regulator is judged by how market friendly it is. Just see the last 10 years. The regulator is supposed to give forward guidance to markets and consult them.

In many cases, your committees are packed with the regulated than the regulator. My own feeling is that everybody is supporting counter-cyclical policy (CCP) and this is no surprise when there is a bust because CCP helps financial markets. But tomorrow will they support when there is a boom, is the question.

Do you think the baby-step approach of a 25-basis point increase adopted in India was a wrong one? Did we tighten rates too late? And should there be a pause when headline inflation is still high?

We need to go into the elementary aspects of the Indian situation. You have a supply problem of inelasticity then you have an aggregate demand problem. We are not talking of a shock. There is moderation. In such a situation, monetary policy can't do anything about monetary rigidity.

If, on the fiscal side, we are adding to aggregate demand and supply is less, the monetary authority can say there is no point in me trying to contain because aggregate demand will not be contained. It will only be crowded out.

Only the private aggregate demand will be contained. If the monetary authority does not act, it will spill over to the current account deficit which is already at 3%. At this stage of current account deficit, and given the global uncertainties, I don't think a monetary authority can afford to take the risk of not containing aggregate demand.

Hasn't the situation in India worsened because of poor fiscal management?

We did not have too much of headroom because we had a structural deficit. If you do not have a structural deficit, then your capacity to carry out a counter-cyclical policy is more. In countries where they did undertake fiscal stimulus, there are two characteristics that were found qualitatively. The stimulus is something you can withdraw.

Secondly, the investment, then productivity, possibility like in China. In India, there are three problems. One, we started with a relatively weak fiscal situation. Secondly, we viewed programmes such as NREGA and rural pay as a stimulus whereas actually they are not easily withdrawable and thirdly, the revenue component was more than the capital component in the expenditure.

All these put together have resulted in some sort of a fiscal problem. And many people felt that the budget was too optimistic. Such fears have come true, and therefore, it is time we have a very honest introspection of the fiscal parameters.

I'm not saying that if you are giving something to the poor that is not the one you should be cutting. You should be cutting where you are not giving something to the poor. In the name of fiscal stimulus, we should not try to simply reduce expenditure. In fact, you should increase the revenue and you should be able to identify where the revenue enhancement should be.

Inflation doesn't seem to be coming down at all in spite of 13 rate hikes? What do you think is the reason?

Interest rate is a manifestation of the problem; Current account deficit is another problem. What is the sustainable current account deficit is the problem.

As someone who has supervised the Indian banking system, how do you view the assessment of the rating agencies — Moody's and S&P — who have divergent views on Indian banks? Hasn't the government soured it with the way it has handled banks as a dominant shareholder?

One rating agency says it is stressed. The other rating agency says it is stable. Both are right. Because the economic situation and NPAs are increasing for a variety of reasons and capital is under stress, which is a fact.

But it is also a fact that they have fairly distributed assets and liabilities. If it is government run, it will start with a fairly strong capital base, and it is nobody's case that there will actually be any threat to any depositor. Rating should not be taken purely in terms of the bottom line.

I would say anybody who is handling investments should analyse both the positives and negatives and each rating agency gives different weights — fiscal, financial, political economy, etc. There are significant elements of truth in terms of analysis of both the rating agencies. You should look at them and it is a good warning that you should take. The negative conclusion is not appropriate. But there should be a warning so that you take timely action.

Should the government exit as owner of banks?

See, there you cannot take the government alone in the sense you may have some instances where some industries may be less than desirable, but you would not even know these things about the private sector. It is not as if in the private sector it doesn't happen, I would not stretch it too far.

Yes, the public sector has some elements of directed lending which can be negated, but because of government support, there is a lot of trust from the people. It is a virtual guarantee of deposits.

How bad do you think is the problem of bad loans of Indian banks?

The recent disclosure of the NPA position is really a greater transparency of an accumulated problem because of the computer recognizing such loans. I don't think this should be taken as a trend.