Rakesh Mohan's Interview with Latha Venkatesh: CNBC, Tuesday, April 21, 2020

Here are my questions

1. First on the RBIs actions: In its latest move the RBI has made the reverse repo the operational rate (by stopping variable rate reverse repo auctions) and cut the reverse repo Without the permission of the MPC. In a way the RBI has side stepped the MPC. Kosher you think?

   I am certainly surprised that the Reserve Bank has done such a policy rate cut through the reverse repo without convening the MPC. Even though I have not been a votary of the inflation targeting MPC framework, I do believe that once such a framework has been established by law it is bad governance to downgrade the MPC, especially in the current circumstances. I would imagine that it would have been easy enough to convene the MPC, even on a remote basis, as everything is being done these days, and to put out such decisions in consultation with the MPC and hopefully with their concurrence. In any case, the RBI has 3 of the 6 members of the MPC, and the Governor has the casting vote. I wonder why they decided to do this and establish such a precedent. I am also curious if this action has violated the law, since the amended RBI Act says that the MPC will decide the policy rate.

   Second, given the excess liquidity that is now in the system, partly through very appropriate Reserve Bank actions, even if there wasn't an explicit announcement that the reverse repo was now becoming the policy rate for the time being, that would happen automatically anyway so I don't see any substantive problem in this change.

2. The transmission of rates along the yield curve has been poor (rev repo at 3.75%, repo at 4.4% but GOVT bonds at 6.5% and state loans at 7.5%-8%) . RBI has since intervened in the govt auction and brought down yields by about 20-30 bps. Your comments? Clever central banking? or crossing the line on monetisation?

   I am not surprised by this. You will recall that in 2008-09 we had gone down even further with the reverse repo rate to 3.25% by April 2009. That action made almost no difference to the 10 year Gsec yield: in fact, it went up from around 6.3% in November 2008 to just under 7% in June 2009 and kept going up further after that. So the current lack of impact on government bond yields does not surprise me. As you might expect, however, the call money rate in the second half of 2009 did hover around the reverse repo rate, as it is now.Furthermore, an examination of trends of 10 year Gsec yields in India shows that it has been in the range of 6.3% to 9% over the past decade or more. This is something to do with inflation expectations, and the supply of and demand for funds, and other interest rates in the economy, particularly the small savings rates.

3. The bond markets are worrying about huge fiscal spending. And hence unresponsive to rate cuts. Whatcan the RBI do to further bring down yields?

   I would look at this somewhat differently. Despite the large existing budget deficit, and expectation of worsening of the deficit, Indian long term government bond yields have remained stable at around 6.5%, and this is what we should have expected. It is also good for the maintenance of financial stability, and for engendering confidence in Indian financial markets.This is partly because of our relatively conservative policy of limiting foreign investment in government debt, unlike other emerging markets such as Turkey or South Africa, where government bond yields have spiked up. Indian credit default swaps have indeed spiked higher by 100-150 bp (from 50bp last year to 200 bp), but that is a part of generalized widening of credit spreads and Indian CDS are not out of line from other BBB- countries. This behavior of the government bond yields and the limited increase in CDS does suggest success of RBIs operations. We should not have expected anything more than this.

4. S&P has changed its outlook on Indonesia to negative. Should India keep one eye on external factors while designing the fiscalresponse?

   Given the global nature of this unprecedented crisis, I feel that the credit rating agencies should have been the first ones to be put under lock down conditions! More seriously, as you know, that the United States has already announced a fiscal relief program of around 10% of GDP, which is certain to go up higher. This is on top of an expected deficit of 5% of GDP prior to the current crisis. The US debt GDP ratio was about 105 % in 2019: so it could well go up to almost 120 % in 2020. I have not heard any market participant or economist commenting adversely on this, given the current circumstances, nor any commentary from credit rating agencies. Remember that S & P did downgrade the US credit rating from AAA in 2008-09. Result: their Indian origin CEO had to leave the firm! Similar actions are being taken by most countries, both among advanced economies and emerging markets. Whereas, we clearly have to keep an eye on external factors, on the fiscal front we are lucky that we have financed our fiscal deficits mostly domestically and we should continue to do so. Hence there would be little impact of any change in our credit ratings at this time. In any case, global capital markets have already reacted to the Corona crisis through significant withdrawal of funds from emerging markets, including India. So the behavior of foreign capital will be much more dependent on such global developments rather than anything that credit rating agencies will do with the present time. So this should be the least of our worries.

What should perhaps worry us more is the downturn in global trade and possible impacts on our external account, which are not evident yet. Second, in view of the collapse of oil prices we can expect a very significant fall in remittances. These are the developments to be monitored very actively and relevant actions taken to preserve our external stability.

5. What are your thoughts on deficit monetization? Is it pardonable under the circumstances?

The best way of answering this is perhaps to quote the IMF managing director. She describes the current crisis as a totally global crisis which is completely unprecedented. Never before in living memory has there been such a combined pandemic and economic crisis together on a global scale. As I have often said, the so-called global financial crisis was actually a North Atlantic financial crisis just as there had been the Asian financial crisis in the late 1990s. This crisis is of a much larger scale. In her words, “The global economy is on life support”. Hence

> *“We must spend as much as we can, and a little more”.*

Furthermore, there is great uncertainty, both on the economic side as well was on the medical side with respect to the virus developments that may occur. So this is a real Black Swan event in which every country has to do whatever it takes to do what is necessary.

Our strategy has to be three fold:

i. We have to do whatever is possible to protect people from the virus and provide treatment as feasible regardless of income levels.
ii. Make sure that the food supply chain works as well as it can in the circumstances and for the availability of food, especially for the poor who have been rendered jobless by the nationwide lock down.

iii. We also have to make sure that companies, small, medium and large are protected from falling towards bankruptcy, as they are being correctly asked to keep up their payrolls. This is essential to protect the financial sector from the financial backwash of bankruptcies.Given the already stressed balance sheets in the financial sector among some banks and NBFCs, if timely fiscal action is not taken in this direction a worse economic disaster could follow, and make recovery of the economy difficult as and when the lock down is eased.

The upshot of all this is that there is probably no alternative to permitting the direct financing of the government by the RBI as necessary. If we don't use the escape clause in the FRB in such an unprecedented crisis, when would we use it?

If it is feasible to finance the deficit without resort to the RBI, while keeping the long-term bond yields under control as at present, that would be preferable. That will enable appropriate price discovery, and the RBI could conduct almost back to back OMOs. Yesterday, it expanded the WMA limit to the Central govt significantly to Rs 200,000 crore, and has also increased the state govt limits by 60 percent. This is a very good move. It reduces the cost of borrowing for the government to the repo rate; it helps the bond market from spiking up in terms of yield; and gives government and the RBI time to see if further financing is needed from the RBI without disturbing the bond market significantly. Some closer examination will also have to be made of the financing needs of the state governments. One discussion I've not seen so far relates to the needs of local governments. I assume that their relief expenditures must have grown significantly and wonder how they are being financed?

6. A coupleof people are baying for the RBIs reserves. What would be your response to them?

   I am rather surprised by this. One thing that is clear is that the RBI balance sheet will expand very considerably on the asset side as a consequence of all the operations that it is doing and must do. Just to put things in context, in the United States, where I am currently living, the US Fed has, within just a few weeks, increased its balance sheet from around 20% to 30% of GDP. So where is the possibility of using RBIs reserves and deplete its liabilities side? On the contrary, they are meant for just this kind of occurrence.

7. It looks like a waiting game: RBI waiting for Govt to announce a package and govt probably waiting to see if the pandemic ebbs, Should the govt make haste on a plan to support the economy?

   Let me first say that since I'm currently in the United States I am not near enough the scene in India to make definitive suggestions.

   Having said that, let me just use the US example to speculate what is needed in the country. The lock down in the US is nowhere near the severity that has been invoked in India. Public transportation is running including trains, buses and airlines, although of course with very low frequencies. Grocery stores are all working, and other essential services. Whereas there is a stay-at-home order people are allowed to go out for essential activities including walks for exercise purposes. Nonetheless, as you know the US government has rolled out a US $ 2 trillion relief program with very wide coverage. Discussions are going on for a further package of up US $ 450 million. More than 22 million people, about 13.5% of the labor force, have already filed for unemployment insurance. The maximum in the time of the North Atlantic financial crisis in 2008-09 was around 600,000. Despite the rollout of these programs there are long lines in most cities of people looking for food packets being given out by the government and by NGOs. This is in a country whose per capita income is 25 times ours and is mostly organized. So I can only imagine the kind of suffering that must be taking place in India where the vast majority of labor is in unorganized activities, with no financial backup to sustain themselves when there is no work for the kind of period where we have had the lock down. The only silver lining that I can think of for us is that around two thirds of the population still rural and so the human damage could be correspondingly lower.

   So yes, I do believe that the government must come out with a fiscal relief package which is tailored to our own needs.

8. What should be the main elements of a plan to revive the economy.

   At present, our concern should essentially be with relief. I have already talked about the need for providing adequate support to the less well-off: whether it is through the equivalent of a universal basic income, but appropriately targeted through the Jan Dhan system, through the MGNREGA, and so on.

Whereas, as I understand it this is being done to a significant extent, I've not seen yet programs to support enterprises of all the different sizes, small medium and large. The government has asked all enterprises to keep paying their workers through the lock down. In addition, all enterprises have different elements of other fixed costs such as utilities and rent. Different businesses we have different lengths of staying power in the circumstances where there is almost no revenue but they have to keep up the payment of their fixed costs. This would naturally lead to cascading bankruptcies, depending on the length of the lock down. So there is an urgent need for a well-designed program to help enterprises of all sizes: this would essentially have to be done through banks since they have relationships with almost all such enterprises. I'm glad to see that the RBI has already announced re-finance packages for SIDBI, NABARD, and NHB.

I would suggest one other measure. Unlike the United States or other developed countries where policy interest rates are zero or even negative, even if we reduce the policy rates to below the current level, the likelihood of lending rates going below the current levels is very low. That is what we also experienced in 2008-09. So my suggestion is that the government should contemplate and across the board interest-rate subsidy of 2 to 3% for on lending by banks, and possibly NBFCs for a specified period of time. I had made a similar suggestion in 2008 also but it will not accepted then. The cost of this is quite low in the current circumstances. So additional lending Rs 100,000 crore would mean a fiscal cost of only Rs 2000 crore. The modalities of such a measure would need to be worked out in some detail but I do feel that this would be much more effective than any further attempts to reduce policy rates.

9. What's your assessment of the Indian economy this year? Are we in danger of contraction? Can revival take a long time?

The Indian economy will almost certainly suffer a recession this year: the extent of the recession will of course depend on how long we continue with the lock down and how we then succeeded in lifting it. I have not done quantitative work to make any estimate of Indian economic growth in fiscal '21. The IMF is estimating the global economy to contract by 3% in 2020. Furthermore, we don't yet have estimates of the downturn in global trade. No doubt, we will be seeing a very significant contraction in global trade which will clearly affect the Indian economy.

10. Never waste a crisis, they say. Any reforms you will push through in this hour of crisis?

I have to say that this is a somewhat different crisis: not one of our own making. So in that sense this may not be the best time to think of economic reforms. Our full attention must turn on sheer survival of the and its recovery

11. Indian Govt has tweaked rules to prevent Chinese entities from buying Indian assets without govt approval. Your comments.

I am not familiar with the specific provocation that has led to this policy announcement, and the urgency for doing it during these troubled times. So I cannot provide an informed comment. As a general issue, however, in view of the extensive damage that European and North American economies are suffering, and the relatively quick recovery that China and other East Asian countries may exhibit, it is probably not in our economic interest take such measures with respect to China, looking to the medium term and long term prospects for the global economy.

I have heard some discussion in recent days suggesting that we are well poised to take advantage of the movement of manufacturing and other activities from China as a consequence of the current crisis. This move will certainly not help in this direction. It should be understood that much of the FDI that has gone into China did not come from the West: it came mostly from within Asia. So if we are to attract activities from China they would come along with both Chinese and other Asian investment. Our move to not join RCEP will also hinder manufacturing from coming to India. If we do want to take advantage of the situation will also have to undertake other reforms, particularly land and labour reforms that have been hanging fire for a long time.