Who moved my interest rate- Leading the Reserve Bank of India through five turbulent years
By Dr D Subba Rao, former Governor, RBI

On August 26, 2016, the CFA Institute hosted former Reserve Bank of India Governor (RBI) , Dr D Subba Rao. In an inspiring speech, Subba Rao reflected on his stint with the RBI and talked briefly about his recently published book*," Who moved my interest rate?- Leading the Reserve Bank of India through five turbulent years"*. The book is very easy to read and simplifies many complex and technical topics in areas like monetary policy and exchange rate management. The book also talks about the challenges faced in protecting the autonomy of public institutions in a country where politicians are waiting for an opportunity to jump in and offer their advice. In the book, Subba Rao also refers to the dilemmas in public policy formulation where the interests of multiple stakeholders have to be properly balanced whenever an important decision is to be taken. Here is a summary of the address and some key points covered in the book. Before I begin, let me thank Mr. Amit Chakarabarty of the CFA Institute for inviting me to this event.

Introduction

For people not very familiar with the Indian financial system, the Reserve Bank of India or RBI as it is popularly called, is the central bank of the country and one of the few public institutions which the intellectuals of the country hold in high regard. RBI was established in 1934 during British rule. The first governor of RBI, Sir Osborne Smith was actually a professional banker of Australian origin. (Bank of England's current Governor Mark Carney is another rare example of a professional central banker brought in from another country. Former Chancellor of the exchequer George Osborne recruited him from the Bank of Canada in 2012. He is the first non-Briton to be appointed to the role since the Bank of England was established in 1694.) Sir Osborne resigned in protest at what he felt was unwanted government meddling in the affairs of the central bank.

RBI has evolved over the years into " a full service" central bank. The RBI is responsible for monetary policy, keeping inflation under control, printing and distributing currency, keeping the exchange rate steady, supervising the commercial banks, acting as the lender of last resort, managing the payment and settlement system, and last but not the least, partnering with the government in driving the country's development agenda.

An eventful tenure

Tackling the global financial crisis

On September 5, 2008, Subba Rao took over as the 22nd governor of RBI and the 11th Government bureaucrat to hold this position. The key difference in the case of Subba Rao was that almost overnight, he went from government bureaucrat in India's political capital, New Delhi to central bank governor in the country's commercial capital, Bombay. To complicate matters further, within a few days of his taking charge, the world came to an edge as bank after bank became enmeshed in the global financial crisis. In the space of a few days, Fannie Mae and Freddie Mac went into conservatorship (bankruptcy), Merryl lynch had to be taken over by Bank of America, Washington Mutual closed shop, AIG had to be bailed out and Lehman Brothers collapsed. And to top it all, on November 26, 2008, Bombay was held hostage by a handful of terrorists and the city looked like coming to a grinding halt.

Amidst the hype about the decoupling of emerging economies from the developed ones, India had underestimated its integration with the global financial system both in terms of trade and capital flows. The panic in the US spread to India in no time. The BSE Sensex fell by over 25% from 13,518 on Sep 16 to 9647 by end December 2008. Edged out of international financial markets, Indian corporates found themselves in a tight liquidity squeeze, with interest rates in the call money market moving up from 13.1% on September 16 to 18.5% on October 10. As institutional investors started to withdraw their money from India and Indian corporates started selling rupees for dollars to meet their external obligations, the rupee fell from 46.63 to the dollar on September 16, 2008 to 50.52 on December 2, 2008. And as corporates started withdrawing money from money market mutual funds, the strain on the banking system increased sharply.

Those were truly challenging times as central bankers all over the world, including Subba Rao had to throw the rule books to the winds and pursue fairly unconventional monetary policies. Besides cutting interest rates , the RBI opened a rupee dollar swap facility for Indian banks to get easier access to dollars to meet their international obligations. The RBI even established dedicated lines of credit for Non-Banking Financial Companies and Mutual funds so that they had the cash needed to pay off investors wanting to withdraw their money. During the Nov 26 terrorist strike, RBI staff worked overtime to ensure that India's two largest payment and settlement systems, Real Time Gross Settlement (RTGS) and National Electronic Funds Transfer(NEFT) were functional by the following day.

Dealing with high inflation

Just when it seemed Subba Rao had come out of his baptism by fire with reasonably high scores, a second crisis started in India, namely high inflation. The Whole Sale Price Index inflation rose to 8.7% over 2010-12 compared to 5.4% over 2001-10. It was a situation of excess demand thanks to the government's affirmative programs such as the highly publicized Mahatma Gandhi National Rural Employment Guarantee scheme that had put money into the hands of people while production of goods and services had not increased proportionately. From an era of low interest rates and high liquidity, Subba Rao had to shift gears and start raising interest rates. He had to do this even as he faced pressure from India's political leaders to keep interest rates low to protect growth.

Arresting the fall of the rupee

And finally, towards the end of his tenure in 2013, Subba Rao faced the challenge of an unprecedented fall in the rupee. That slide was triggered by an announcement by the US Federal Reserve that it was planning to bring to a close the era of loose monetary policy. As capital moved out of India and back to the US, the rupee fell from 55.52 to the dollar on May 22, 2013 when the Fed made the announcement to 67.03 on September 4 , 2013 when Governor Rao stepped down from office. This marked a depreciation of the rupee to the extent of 17% in about 3 months.

While the Fed announcement was the immediate cause of the fall in rupee, the real reason was the unsustainable current account deficit (the excess of imports of goods and services over exports) which had touched 4.8% of GDP in 2012-13. The Indian economy had quickly recovered from the crisis while the rest of the world was struggling. Which meant that India's imports rose faster than the exports, increasing the current account deficit. Around this time, to aggravate the situation, the oil prices had also spiked (India is a heavy importer of oil.) while the imports of gold had gone up sharply. Money which had earlier come to India in search of higher returns at a time when interest rates were close to zero in the US, started to move out on fears of an unsustainable current account deficit. As the rupee fell, Subba Rao had to tighten monetary policy and raise interest rates to make the rupee more attractive to investors. The Indian IT Services industry (like other export oriented industries) benefited tremendously from the fall in the Rupee in the third quarter of 2013. But there were many Indian importers who were at the receiving end. So the RBI had to arrest the free fall of the Rupee.

In all, Subba Rao's tenure was eventful by any standards. In 3 months, during the financial crisis, the RBI brought down the repo rate, the rate at which Indian commercial banks borrow from RBI from 9% to 5%. Over the next few quarters, the rate went down to 3.25%. From March 2010 to October 2011, the RBI raised interest rates 13 times from 3.25% to 8.5% in a bid to control inflation. When inflation came below the target level, RBI again started cutting rates. And finally in 2013, the RBI raised interest rates to defend the rupee. In all, Subba Rao cut interest rates 10 times and raised interest rates 13 times during his tenure, making him in his own words, " the most activist governor to date".

Managing currency circulation

In the RBI Act of 1934, RBI had to ensure that at least 40% of the value of currency notes issued by it was backed by gold or pound sterling. Since then things have changed. Today, in most countries across the world, including India, a currency derives its value from a government decree. That is why it is called fiat money. In return for not linking any fresh issue of currency with gold reserves, central banks are obliged to preserve the value of their currency by keeping inflation under tight control.

A key element in currency management is building in security features to prevent counterfeiting. Banks are expected to check all notes of Re 100 and higher denomination before putting them back in circulation. The RBI also trains commercial bank staff and the police force in detecting counterfeit notes. The RBI is also committed to a clean note policy. It exchanges soiled and mutilated notes for clean ones.

Looking forward, a shift from cash to electronic payments may eliminate these problems. Such a shift to a cashless economy may also be useful for implementing monetary policy in " negative" interest rate economies. During periods of negative interest rates (as is the case in Japan currently) , the central bank wants people to spend and increase consumption to boost demand in the economy. If the system is based on currency notes, people can hoard them in their homes. (Indians are quite used to this practice of keeping cash under their pillows!) But in a cashless system, people would be forced to spend money to avoid having to pay a penalty on their deposits to banks.

But the shift from cash to electronic payments will not happen anytime soon in most countries. Public acceptance and the availability of payment infrastructure hold the key. In India, the situation is in fact quite different. The current efforts of RBI are focused on financial inclusion, i.e. reducing the heavy usage of cash and increasing the use of bank accounts and cards for making payments.

Managing forex reserves

The RBI manages the country's forex reserves on behalf of the government. RBI's forex reserves consist of foreign currency assets, gold and SDRs (Special Drawing Rights), a notional currency issued by the IMF. One of Subba Rao's proud moments was to buy 200 tons of gold from the IMF in October-November 2009. This was essentially an attempt to diversify the asset holdings. But in a manner of speaking, it also marked the reversal of an event which happened in 1991. In the middle of that year, India had to pledge gold to raise an emergency loan from the IMF, faced with a serious current account deficit problem. That event also marked the start of India's economic reforms program. The gold purchase took gold holdings from 4.1% of India's forex reserves on Oct 30, 2009 to 6.7% on Nov 6, 2009. One of the ironies which Subba Rao talks about in his book is that while he ordered this huge gold purchase, RBI had to restrain the general public from buying gold during the fall of the rupee in 2013!

One question which people keep asking is what level of forex reserves is sufficient for India? Earlier, we would talk about 3 months of import cover. But that was the era when trade flows dominated. Today, with capital flows being several times bigger than trade flows, the level of forex reserves needs to be judged not only in relation to the current account deficit but also in relation to all the foreign currency debt that will mature over the next one year. Reserves are also needed for our central bank to defend the Rupee during periods of volatility. Governor Rao also mentions the time tested truth about forex reserves. In good times, no amount of forex reserves is too much but in bad times, any amount is too little! (Recall what Mark Twain mentioned about bankers. They are people who will lend you their umbrella on a bright and sunny day and take it away when it starts raining!)

Managing NBFCs

Non-Banking Finance companies (NBFC) are different from banks. They do not have access to RBI's repo window for overnight liquidity management. They are also not eligible for the lender of last resort facility offered by RBI to the banks. They are not part of the payment and settlement systems. Last but not the least, most NBFCs cannot raise public deposits. And to the extent a few of them do, they are not covered by deposit insurance. As the access to funds is limited and the cost of funds is higher for NBFCs, they have focused on niche segments where they have a comparative advantage vis a vis banks. And because they pose less systemic risk to the financial system, they have traditionally been less regulated, compared to banks.

But over time, the linkages between NBFCs and banks became more evident. NBFCs started to become conduits for financing the risky activities of banks. Some NBFCs also misled customers by promising unrealistic returns on their deposits. As a result, the RBI during Governor Rao's tenure increased the scope of regulation of NBFCs.

One of the big scams during Subba Rao's' tenure concerned the Saradha group of companies, which managed a Ponzi scheme that imploded and severely hurt many small investors in the eastern part of the country. Subba Rao had to depose before a Parliamentary committee investigating the scam. An immediate outcome was a coordinated action plan by RBI to improve public awareness about fly by night operators and impressing upon the public to be weary of schemes offered by chit funds that promised very high interest rates.

The microfinance sector also came in for severe criticism during Subba Rao's watch. Microfinance companies were found to be charging usurious rates, using coercive practices to recover outstanding amounts from customers and also acting in unethical ways that enticed customers and made them burdened with debt for ever. An RBI committee set up to investigate the practices of MFIs recommended that the interest rate charged on borrowers should be capped.

For Subba Rao, this was a reversal of the interest rate liberalization that had started from the 1990s. The logical closure of this process had happened with the deregulation of interest rates on savings deposits in October 2010, during Rao's own tenure. Another dilemma for the RBI governor was that the MFIs were playing an important role in the financial system. Even if they charged their customers high interest rates, they were providing loans to a section of the population that simply had no chance of getting a bank loan. Would any cap on interest rates throttle the industry? After intense deliberations, Subba Rao concluded that the case for capping interest rates was strong and very much needed for consumer protection. The MFI episode again brings out the dilemma in public policy making, where various tradeoffs have to be kept in mind.

In 2012, seeing that the gold loan business was growing at an unusually rapid rate, the RBI also reduced the loan to value ratio of gold loans from 75 to 60%. The justification here was that many people in India were buying gold enthusiastically and taking loans against the gold pledged to meet expenditures. The assumption was that gold prices would keep going up. But what if they came down! The RBI redefined capital requirements for the gold loan companies. And as a measure of consumer protection, RBI introduced regulations on where and how gold loan companies could store the gold pledged with them , outlined their obligation to make the gold available for inspection by borrowers and prescribed the procedure to be followed for selling the pledged gold in case of a default.

Growth vs Inflation

Students of Economics will be familiar with the Philips curve which talks about the tradeoff between inflation and unemployment. Trying to cut inflation increases unemployment while trying to create jobs by growing faster tends to increase inflation. But this tradeoff is essentially short term in nature. In the long run, unemployment cannot be reduced by tolerating higher inflation.

During Governor Rao's tenure, some senior political leaders took the stand that while the government was trying to promote growth, the RBI was rigidly focused on controlling inflation. In his book, Subba Rao argues that no central bank, not even an inflation targeting central bank like the ECB or Bank of England can afford to be insensitive to growth. An important point which he makes is that low and predictable inflation is good for economic growth in the long run. Low inflation reduces uncertainty for businesses, reduces the possibility of unreasonable wage hikes and generally improves the investment climate. Low inflation is also important for the poor and the middle class and the pensioners, with a limited monthly income. High inflation is effectively a regressive income tax on such segments of the population.

In any case, low interest rates are difficult to sustain when the government's fiscal policies lack discipline. The huge budget deficit that the government was running around this time was seriously undermining the RBI's anti-inflation stance. Subba Rao was often frustrated by the government's stand. As he mentions in his book : " (The RBI) was left to do all the heavy lifting to manage the tension between growth and inflation while the government took the easy way out with its loose fiscal stance."

The problem of data

As in the case of companies, Central Banks need quality data to be able to take the right decisions. Unfortunately, the RBI is handicapped by the lack of quality data. Data on employment and wages, the Index of Industrial production and the Services sector which makes up 60% of the GDP are unreliable. The poor quality of data is compounded by frequent revisions in data relating to output and inflation. As a former RBI governor put it, across the world, the future is uncertain but in India, the past is also uncertain!

Central bank communication

Until recently, the thinking was that central bank polices should speak for themselves. And the communication of the heads of central banks had to remain cautious, bordering on the vague. Alan Greenspan of the Fed is said to have remarked in 1987: " Since becoming a central banker, I have learnt to mumble with great incoherence. If I seem unduly clear to you, you must have misunderstood what I said."

More recently, that thinking has changed. Clear and confident communication on the part of central bankers have restored confidence in the markets on many occasions. After Sep 11, 2001, the Fed made two statements that had a great calming effect on the markets: " The Federal Reserve system is open and operating. The discount window is open to meet liquidity needs." In April 2012, the ECB President Mario Draghi mentioned that he would do " whatever it takes" to save the Euro. That statement had a greater impact than all the conclaves and summits held by Eurozone leaders. Many Central bankers are realizing that in an atmosphere of uncertainty and anxiety, being transparent helps. Today, market participants want to know the true state of the economy so that they can make the necessary adjustments in their strategies.

Central bank autonomy

The principal aim of monetary policy, as Subba Rao explains in his book, is to maintain a low and steady inflation rate consistent with the economy's potential growth rate. In the short term , a central bank may have to raise interest rates, in the process, causing pain. But such pain may be very well justified by the benefits obtained in the long run. Politicians however, have a general tendency to compromise long term sustainability for short term expediency. During his tenure, Subba Rao would regularly have a difference of opinion with the Finance Minister who would keep pointing out that RBI's tight interest rate policy was inhibiting investment and hurting growth. Subba Rao's response would be that even if nominal interest rates were higher, the real interest rate (Nominal rate – inflation) was lower than during the period of the global financial crisis. If interest rate alone was the driving factor, investment must have gone up. Clearly, what was holding back investment was not so much high interest rates but policy and implementation bottlenecks.

Differences of opinion between political leaders and Central Bankers are common in other parts of the world too. Our German colleagues would know that their Finance minister, Wolfgang Schauble has been extremely critical of the ECB for keeping interest rates low and for maintaining excess liquidity. Mr. Schauble has even held Mario Draghi responsible for the rise of an anti-Euro, anti-immigration political party in Germany. Similarly, our friends in the US would recall that President George Bush Senior had wanted Alan Greenspan to reduce interest rates to boost growth. But Greenspan had refused to budge. After losing his bid for the second term, Bush(the only US President who did not get reelected in the last 25 years) is reported to have remarked: " I reappointed Greenspan and he disappointed me." But in India, things can go much further! Thus, it is a common practice for the Finance Minister to call a meeting of all the heads of public sector banks after each monetary policy review of RBI and advise them not to raise lending rates even if the RBI has increased the policy rates. (The compelling need to show they are very powerful is a distinguishing feature of Indian political leaders!)

Concluding Notes

The former RBI governor, Dr Subba Rao wrote his book, " Who moved my interest rate? with three objectives in mind:

- Explain the challenges faced in leading a large central bank
- Make people aware of the dilemmas involved in public policy formulation
- Demystify the working of India's central bank

Hope this short write up provided you with a flavor of these themes. For those interested in knowing more, I strongly recommend that you read the book. As mentioned at the start, this is a very easy to read book, written in a non-technical way. At the same time, it has depth, is rich in content and not a popular science book as the title may imply.