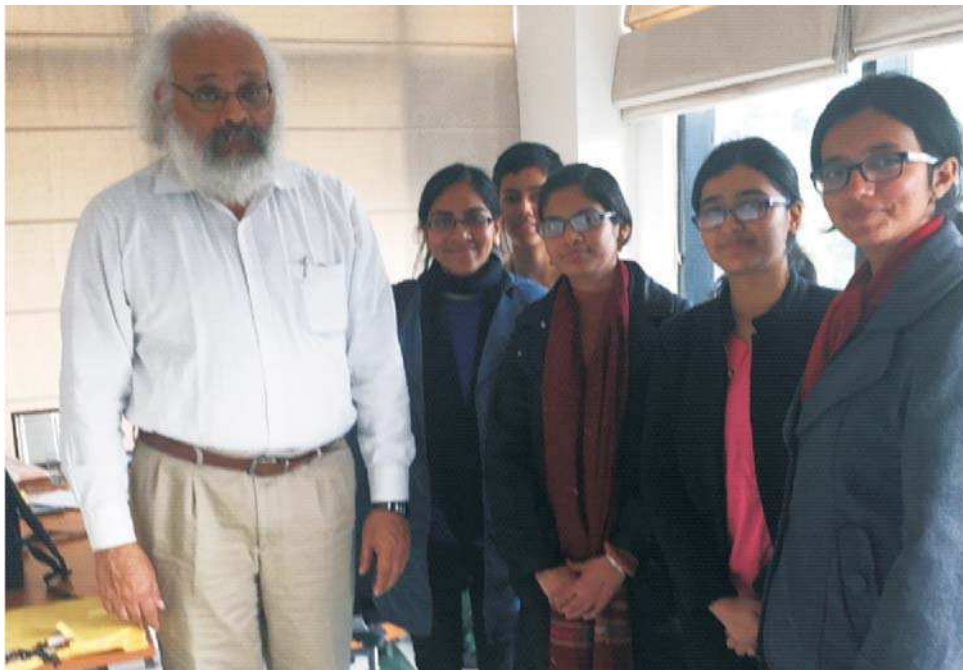


In Conversation With Dr. Subir Gokarn

Dr Subir Vithal Gokarn was one of the youngest Deputy Governors appointed by the Reserve Bank of India on November 19, 2009 for a 3-year term. Prior to his appointment as the Deputy Governor of RBI, Dr Gokarn was the Chief Economist of global rating agency S&P, Asia-Pacific since August 2007. Dr Gokarn has recently joined as Director-Research at Brookings Institution India Center-an independent think tank. He has been appointed as member, Expenditure Management Commission by the Government of India, which is set to submit its first report before the 2015-16 Union Budget. He has also been appointed Chairman of a task force that will set up a Financial Data Management Centre. His current research interests include policy options in health, education and financial inclusion. He also comments regularly on contemporary, global and domestic economic issues.



EB: In view of the emergence of positive drivers in the market last seen during the early 2000s, there is a speculation that India might repeat its growth performance of the 2003-08 period. In this respect, you have written, “it depends on whether there are appropriate policy responses to the major structural barriers to accelerating growth.” We want to know, what are these barriers and how do you define these “appropriate policy responses”?

I have in the course of this article as well as other writings and speeches been talking about three very specific barriers. Well, everyone has his or her own list. While I am not saying it is just three, the three most important ones that I have in mind over the last few months has been food, infrastructure and jobs. The food issue is sort of under control because as you have been probably observing, food inflation has come down sharply and this is partly the result of things the new government has done in terms of selling stocks of rice and wheat to put some cap on price increases. But these are not the structural responses. These are the short-term responses and what we basically need to see in our economy is changing the incentive the farmers have in terms of what they

are producing. Most of the food inflation for the last 7-8 years has been driven by prices of pulses, proteins and essentially vegetables. The main reason for that is that the farmers don't have enough incentive to produce these agricultural commodities. The reason for this again is that procurement by government of rice and wheat has created adverse incentives to produce more rice and wheat even though the consumers are eating more vegetables and proteins. There is a great supply demand imbalance in the economy and it is in my mind an important driver of food inflation. So rebalancing incentives in favor of what people are actually eating is a critical structural reform. That means looking at the whole procurement framework and what kind of incentives the farmers get. In fact, the consumer has been taken out of the equation, the farmer is responding to government signals and not the market signals and that is what has created the imbalance. So, my suggestion would be to move away from what I call the double guarantee procurement framework i.e. guaranteeing both the price and the quantity. Looking at the standard demand and supply curves, the government is telling the farmers that it is fixing the price and it will buy whatever the farmers produce at that price. So, there is no supporting market mechanism. The solution here would be that you move from a double guarantee to a single guarantee, focus on buying enough to ensure food security, change the buffer stocking norms and let the farmers take the risk on other parameters. So, either you say, I will pay a particular price but not commit to the quantity or I will purchase the quantity but not guarantee the price. This creates enough certainty in the farmer's mind about the value of the crops and eventually you will induce them to produce other things. So, that to me, is a very important reform needed in the agricultural sector and off course along with this comes rural infrastructure, transport etc. That is always there, but to me this is the most fundamental requirement.

On the infrastructure front, we have had some years of experience with the PPP (Public Private Partnership) model. However, it has not worked. Let's admit that and move on. Why has it not worked? Again there is a huge diagnosis on this. In 2003, when the growth spurt started we had a huge boost in telecom. That was a capacity boost that the economy got but it is no longer available. So that apart, I think ability to get in private money is completely constrained (horribly constrained). So, we have to start thinking how to get in public money and that requires a huge bunch of institutional and financial re-engineering, which the government has got to start thinking seriously about. If you don't break the infrastructure bottlenecks, the growth pattern would not repeat.

Also, I think there are ways to incentivize private sector to invest. But we went about it in a wrong sequence. I think what you need to see are projects coming up to a point where it makes sense for private investors to invest. Instead we got private investors in, right in the beginning. It turned out it was very difficult for them to manage the risk. Maybe, in theory they could, but in practice there were so many uncertainties about projects, delays, regulatory and policy issues. Take the Gurgaon expressway, the Supreme Court has just essentially changed the rules of the game. Obviously they were responding to consumer complaints but that brings in an element of uncertainty in projects that private capital finds very hard to deal with. I am not talking about the merits of that particularly but there are uncertainties about regulations and policies. This risk, our experience would suggest, is very difficult for private capital to absorb. So, I think, you bring private money in more effectively when the project is close to completion. I was in a TV interview today and I put across this argument. I call it FPTP i.e. first public and then private. Somebody else called it reverse BOT (build operate transfer) where you get the private sector to build, operate for 20 years and then transfer it back to the government. Let the government build it and private sector operate it. These are ways of changing the sequence without which I don't think we will get a solution.

The third is jobs, which is obviously, if you look at the numbers, everyone is talking about; a one million per month increment which is of course 12 million new jobs a year not taking into consideration the backlog. We have no experience or record of this kind of development going on. And given that we have always believed that manufacturing is going to be a key absorber of these people, manufacturing growth has been very sluggish. Particularly, on average, it has not exceeded the growth rate of GDP. It has remained more or less constant. That has created aspiration- aspiration to raise the share of manufacturing from 16% to 25% of GDP. However, if you look at how manufacturing functions today, compared to 20-25 years ago, it has become highly automated.

Technology has moved so far away- ahead or behind is a judgment-but so different from when China entered this manufacturing led growth phase. I don't think we can use that knowledge and parameters to decide our strategy. The number of jobs that will be created in manufacturing, the kind of skills that are required to run a modern manufacturing operation; these are issues that we really have to deal with. I don't think that it is an automatic kind of transition. Most jobs are being created in the informal sector. That's not necessarily a bad thing but productivity is really low in the informal sector and the only way we can improve the standard of living is to improve productivity. The only sustainable way via which the livelihood of people can increase is through an increase in productivity.

Also the manufacturing sector does not provide us dynamism in production that the other countries have experienced with their manufacturing and so on. So, this is a huge challenge. These are, for me, some big issues and as I have said before, everybody has their own list and so one could go on. But these are for me the three most important.

EB: In October 2014, the finance Minister ArunJaitely gave a go ahead to a new policy framework that the centre will specify inflation targets for the RBI. How harmful do you think, this will be to the independence and functioning of the monetary authority of the country?

No, in fact the whole framework of inflation targeting is that the central bank is a target taker, the central bank cannot decide the target. It's like saying if you're playing a game you will set the rules, you'll decide where the goal-posts are. In any modern inflation-targeting framework, the target is set as a kind of understanding or formal contract, between the central bank and the Government or the parliament or the ministry. For example, in New Zealand, which I think is one of the first countries to adopt the inflation targeting framework, the Governor's job was contingent on the target being met, so he or she could be fired if the target was violated. In The Bank of England, it's not so drastic or dire but every quarter the Governor has to submit a report called 'Inflation Report' to the Parliament with justifications and reasons if the target is not achieved. He has to provide explanations as to what circumstances caused the deviation and why the bank did not respond the way it should have. So the contract between the Government and the central bank, in this case, the RBI, is a necessary part of the inflation targeting framework. So it's not a question of harming; the internal logic of the framework is that the target is set from outside. It's like self-evaluation, you know, that you're doing an exam and you get to grade it as opposed to you doing an exam based on certain standards which are set from outside which allows people or a system to compare across individuals. So, similarly, if the central bank sets the target, it obviously has a conflict of interest; it could set a target that it'll find really easy to achieve. So, the target has to be set from outside and then the central banks performance can be judged on how effectively it achieves the target. And, obviously, it has to be left alone to achieve the target. It cannot be influenced in any way to do things that are not consistent. It is here that the autonomy and independence issue comes in. Now whether it works or not is separate, larger debate altogether and you have to understand that the framework is not intrinsically good or bad, efficient or inefficient. It has a set of requirements; there are conditions that need to be fulfilled that will allow it to function or not function. Some of these conditions have to do with the relationship between the government and the central bank; others have to do with the intrinsic structure of the economy, which is, in our case the variability of food prices that weakens the ability of the central bank to keep a tight lid on inflation. So, you have to work around those things if you want to introduce the framework.

EB: It has often been alleged that the central monetary authority in India does not enjoy the kind of independence that a central bank ought to have. What are your views on this?

I don't think there is any sort of absolute standard of independence. The very nature of the appointment process

of the Governor is an indicator of independence; that is who can appoint the head of the RBI, who can fire him, who is he accountable to. That is the formal aspect of independence; there is an informal aspect to it too, which is the culture of the Central Bank. Even with all these appointments and so on, does the government regularly interfere with and try and influence the Central Bank. I think you have 180 countries and every Central Bank of these countries can be slotted somewhere in this sort of continuum.

There are issues of formal arrangement, like in US where the Governors of the Federal Reserve are appointed for an 18-year term. Now, an 18-year term would mean that the Governor is completely immune to any administrative or Presidential intervention. He can only be fired in case of malfeasance. The Chairman is appointed for a 4-year term but the Chairman is also a Governor and here, there is definitely Presidential discretion. The President can choose to or not to re-elect someone as a Chairman. But that's the formality of the process, the culture is more important; which is regardless of how appointments are made and what legal protections the leadership of the Central Bank has, does the Central Bank and the government behave in ways that institutionalize independence and give it credibility? That's the key question. And I think it varies, certainly both across countries and within the country depending on the economic situation.

On the Monetary Policy issue, you know, when you look at the news there are constant public statements by the Finance Ministry and other parts of the government that you should do X or Y, usually it's to reduce rates, but effectively I think the Reserve Bank is doing what it believes is the best thing. You can question the merits of an action, but I think that should be the extent of the questioning and not whether it's being done under duress or pressure.

So I'd say functionally, in my experience and observation, in the current framework that goes back to late 90s and mid-90s, independence is more or less in place.

EB: In the wake of the ineffectiveness of the implementation of the Jan Dhan Yojana do you think it is yet another populist policy?

Well, the criticism can be from two sides; it can be an empty promise with no prospects of any impact or it can be that it's just not gone far enough. I think there is a very significant breakthrough in this model compared to what was earlier the case. The first phase of inclusion was emphatic on accounts. More accounts opened, that meant inclusion. However, one must remember that account is not a product, it's a channel. It's like saying, you have a TV set, you know but in itself it's of no use. You have to have something that brings the content onto the display. So you need to have a cable, DTH or an antenna, whatever it is. Similarly, an account without appropriate products flowing through it is a meaningless thing. But, again without the channel you can't pass the product. So, they are complimentary. The first phase was to create a channel and the second phase is what the Jan Dhan Yojana has done, which says fill the pipelines with something that people find useful. The two aspects of the programme that have emphasised the product side of it and not just the channel side are the overdraft facility and insurance. The overdraft facility will be available from April 1 if you have an Aadhaar number with the limit set to INR 5000. Now you take any person you pass on the street who is in some sort of trade, say a vegetable vendor or a fruit seller; INR 5000 for him as a source of credit is extremely important. Typically, his daily transactions will not exceed that. It usually falls very short of it. So, he gets to borrow INR 5000 from the formal sector with an interest rate, which is close to 10%. This means that if you borrow INR 100 you get INR 90 to spend. The interest is taken up front. You might say that this is exploitative but at that small level of capital the marginal productivity is very high. So, if you are borrowing such small amounts your productivity is high enough to justify that 10%. So, people are borrowing at 10% but probably generating a 35%-40% return on capital. Now, if you reduce the rate at which capital is borrowed, hopefully not to an extent that lending becomes unattractive, then the income opportunity goes up. You are effectively substituting overdraft for his current

dependence on informal sector. However, there is nothing wrong with the informal sector, as it is just a market outcome. But when you give low cost capital, it is bound to increase his livelihood options.

The second is insurance and that covers both life and financial. These are products flowing through the pipeline. Thus, the concept of an account or a product and the link between the two is what the Jan Dhan Yojna is trying to achieve. Therefore, I think that it is a very logical second phase to the inclusion strategy.

Now what are the critiques? One is that is that the Jan Dhan Yojna has no promise. I don't believe it has no promise for it is a logical extension or logical evolution. I think the more valid critic is the delivery mechanisms. Can banks live up to the expectations, business models, and organisation structures, which allow them to operate at this level efficiently? If not, then what other institutions are you creating to plug that hole? You have institutions like payment banks, small banks coming in. Are they going to play their role? I think those are questions we haven't been able to answer. Also, the second would be that who is going to bear the cost? Is the government going to bear the cost or is the account holder going to bear the cost or is it going to be split between the two. We need to have clarity on this. These are operational details we need to work on. At some point of time somebody is going to figure out what the best way of doing this is. There'll also be trial and error. Things will look like they are improving and then it'll look like they are being implemented. That's how systems work.

EB: The RBI acted on the recommendation of the Urijit Patel's committee and shifted to CPI as a measure of inflation instead of WPI. Do you think it was a move for the better?

I think there was never any question that the CPI benchmarking was better than the WPI. It was a matter of practicality. Before the new CPI was published in 2011 there were several different CPI's and no national index and each one had a different composition of basket. So, you could not actually aggregate or combine them to take out an average as they included different things. So, unless you have a national CPI that replicates or reflects the consumption pattern across the country, it could not have been used as an inflation index. You could have said that let's choose industrial workers basket but that again leaves you open to criticism that you are actually not representing everybody's interest. So, the transition to a national CPI was the first step towards moving to inflation targeting. Having done that now, the logical issue is that can we use it. However, the move towards CPI would have happened inevitably. You did not need a committee to focus on CPI. Instead, we need a committee to look into the transition in the monetary policy framework but not in the CPI.

Having said that, there are issues about the CPI index itself. It is still 47% food weighted and this is a lot. It is the highest weighting food has been given in the CPI in all the G20 countries, which is what we should be comparing ourselves with. So, with food inflation being so volatile, it is sort of difficult to control it and I think that is a kind of issue that monetary policy needs to keep in mind. And, given that the rest of the index is significantly composed of services, service inflation is naturally linked to wages because services are labor intensive. So, food prices naturally translates into higher wages and so on and so there is a link between food and the rest. The CPI is only four years old now and it is going to take a while to figure it all out. But, in principal that CPI is a benchmark, I think it was an inevitable process. As long as you have a national index, it is highly justified.

EB: In your article titled 'Greek Tragedy Act II?', you wrote about how the road to recovery for Greece is going to be nothing less than bumpy, and with France now being called the sick man of the EU, do you think that this conglomeration of countries is losing its solidarity and relevance in the present world?

Well, let me give you a sort of contrast to provide a context for this. India is a fiscal and monetary union. It has a centralized fiscal authority even though you do have sub power to tax, i.e. cities can tax, states can tax but the bulk of the tax is collected by the centre. And there is a single central bank with a single currency. But we are not an integrated market because every state has sub power to tax differentially from others and therefore the

movement of goods across state borders is constrained. Now, the EU actually evolved in the opposite direction. It started off as a customs union so movement of goods was the first achievement, and seamless movement of goods. That basically meant a harmonization of the indirect tax system so that you have a VAT across the union. Then it moved to monetary union but it has not yet moved to a fiscal union and a banking union. It does not have a unified banking regulator and it does not have a unified fiscal authority. All it has is a customs union and a monetary union. Now of course, the customs union is even bigger because the customs union has 32 members and the monetary union has 23 members. There are some frictions intrinsically but when you focus, it has achieved a degree of integration but it's not perfectly integrated, just as India has achieved a degree of integration but is not perfectly integrated. So, you have very contrasting outcomes. India's experience would suggest that fiscal and monetary union go hand in hand and the EU's also moving towards that. But they started with a premise that even though they would not have a fiscal union they would accept certain fiscal rules. The Maastricht Treaty laid 3% of GDP as fiscal deficit target. Now, what happens when that breaks down and when countries violate the target is really what you're seeing play out in terms of fragility and differential impact across countries. And, then, there is no unified financial regulator so banks in different countries are impacted. The Irish problem was essentially a banking related problem. All of this points to the great difficulty in harmonizing when you have multiple authorities. Well, they have reached where they are, and it is the second-generation countries by and large who have had the greatest difficulty. Italy is a first generation country and one of the original members. It has also struggled but it's not very much on the news. However, it is all-negative news for the other countries and Italy is not very much in that. But France is actually one of the core countries and even though the economy may not be doing very well, it certainly has both the institutional capacity and the overall economic strength not to be at the same level of vulnerability that Greece or one of the smaller ones are. The core of the EU is robust because they have a common set or a compatible set of institutions. Even though the economy might not be performing very well it's not under threat of collapse. The peripheries, which are the second-generation entrances, are more vulnerable. That is partly because when they came in, the institutional development had obviously not reached the level that allowed them to integrate fully. So fiscal management, regulatory capability and the role of the state overall are things that are somewhat difficult. This explains to me why these economies have struggled and then they are locked into an exchange rate. Let me just give you a contrast between Greece and three Eastern European economies i.e. Poland, Hungary and Czech Republic. They joined the customs union but they did not join the monetary union, so they have flexible exchange rate. If you travel from Germany to, say, Czech Republic you're moving from the Euro to the Czech currency, the Koruna. Floating exchange rate is a very powerful, very effective shock absorber. It absorbs the impact of external shock and prevents them from being transmitted through domestic variables. But Greece is in a fixed exchange rate because Greece is a part of the Euro. So Greek developments do not translate into a change in the effective exchange rate and this means that the shock travels through to the real variables. The lesson from this is that the merits of a floating rate are being demonstrated for economies like Greece. If you don't have a floating rate there is nothing that absorbs the shock. It's a very tricky situation. Greece's GDP in 2014 is 23% below what it was in 2009, over a 5 year period. We talk about being frustrated and disappointed at 5% growth but Greece has actually declined with the average of 5% a year. You can imagine the impact it has had on the quality of life. Public services have become completely degraded because the government has fired so many of its staff. I met a number of people who visited and it really is extremely disturbing. I think this degree of problem could have been avoided by a floating exchange rate. Now whether you can go back to this is a question I raised in that article; neither choice is an easy choice. In 2010, when this option was being discussed, somebody estimated that it would take 9 months to print a new currency because of the lack of printing capacity. The press capacity, the ink, the paper, all of these are not readily available, they have to be customized. That is a logistic and not a policy issue. The policy issue is are you better off staying in the EU or are you better off exiting. And my answer to that is that I don't question the logic of the customs union. I think the customs union is a very powerful force because seamless movements of goods and people are very good for a large economy. There are huge risks involved in getting out of this system; even if they are short-lived they could have lasting impacts. This is a tricky choice. What's likely to come out of it is slightly renegotiated terms but I don't have a prediction on this.

EB: From your long experience with Indian policymaking, what are some themes and questions that you think need attention for future research by young researchers like our readers?

Well, I think that there are two issues that you need to research. I have spent three years of my life in policymaking, else I was always on the periphery. I think one realisation that comes is that because often things won't work in the kind of time that's anticipated, the entire outcome is different. Things can actually look very different because the variability of time is a factor that theory does not take into account. If you are doing it theoretically, say if you are looking at the impact of a procurement policy change, for example, a steady state comparison- you give a farmer a different set of incentive and maybe next year he'll do exactly what is predicted and that may or may not happen. You've made a change, you've expected an outcome but that outcome did not materialise. Is that good or bad for the economy is an open question. So, if people aren't responding to incentives in the way that theory predicts, not because they don't want to but because there's something else that prevents them to, then I think it a significant analytical issue.

The second issue I think is, sort of related, and deals with contracts and governance and so on. How do you ensure that people deliver? What is the right mix of rewards, punishments, public pressures, incentives and disincentives that actually allow people to deliver? Now PPP is a very classic example of this because virtually in all PPP projects, the underlying conditions of the contract change dramatically. So you know delivery didn't happen. But also, there is a reason for why these conditions change. Why were they not anticipated and what was the contribution of the government to this? What was the contribution of the private sector to this? These are open-ended questions. The argument that the government should be spending more money on infrastructure is essentially reflecting this difficulty of enforcing contracts. I think we have to be able to draw from our various PPP experiences to see what exactly went wrong and are there some generic factors that contributed to it and how do we address them? Is government the only solution or are there different kinds of contracting frameworks? I think that is an important research idea.

So, broadly these are the two important things if you are looking at policy-oriented research. The similar logic and questions apply to education and health. Also what determines delivery, how can we incentivise things, how can we govern and monitor things and what contributes to lowest cost delivery without compromising on quality are questions that can be researched upon.