Interactive Session with Dr. Raghuram Rajan, Governor, Reserve Bank of India

***Question*:** Short anecdote for you, and a question:

On the subject of financial inclusion and bank technologies, I wanted to share that for the last 3-4 years, I have been transferring my staff salaries by internet directly to their bank accounts, whether that is in Howrah, or Bihar or Rajasthan. And there are no problems, in fact it is interesting that the wives keep the ATM cards and make withdrawals and the men either give them the passbooks or keep the passbooks to keep a watch how much they spend.

Question is: Even though they have access to modern banking technologies, it doesn't stop them from spending too much on unnecessary expenses. So how can more inclusive financial technologies, such as those you mentioned in your talk, help citizens make wiser consumption or spending decisions?

Response from Dr. Raghuram Rajan: You said that I had made it sound so simple. It is not. We need a system to replace a system. I hope I did not say that financial inclusion or direct-benefits-transfer is a cure all. I think it is an important part of the solution, because it has the possibility of liberating the poor. But, of course, there is a system we have to put in place to help those who get these transfers, including advice, financial management, understanding different products and so on. Which is why it is a community effort, it is an economy wide effort, it is not going to happen in a day, it is something we all have to work on, there are many moving parts. I hope I conveyed the complexity by saying five “Ps”. At least five “Ps” we have to get it right. In marketing you need only four “Ps” right? It is going to be difficult. I wanted to convey the importance of doing something like this, that you can strengthen our democracy, which seems far-fetched, from direct-benefits-transfer. But I think it is linked, at least in theory if not in practice.

***Question*:** RBI's proposal to phase out old notes, which do not have the year printed. Suggestion – a: Replacing old currency notes under a new series. b: Also consider adding new series of Notes with Rabindranath Tagore, Homi Bhabha, *et al*.

Response from Dr. Raghuram Rajan: I am not quite sure if what you meant is demonetise the old notes and introduce new notes instead. In the past demonetisation has been thought off as a way of getting black money out of circulation. Because people then have to come and say "how do I have this ten crores in cash sitting in my safe" and they have to explain where they got the money from. It is often cited as a solution. Unfortunately, my sense is the clever find ways around it. They find ways to divide up their hoard in to many smaller pieces. You do find that people who haven't thought of a way to convert black to white, throw it into the *Hundi* in some temples. I think there are ways around demonetization. It is not that easy to flush out the black money. Of course, a fair amount may be in the form of gold, therefore even harder to catch. I would focus more on the incentives to generate and retain black money. A lot of the incentives are on taxes. My sense is the current tax rate in this country is for the most part reasonable. We have a reasonable tax regime, for example, the maximum tax rate on high-incomes is 33%, in the US it is already 39% *plus* State taxes, etc., it takes it to near 50. We are actually lower than many industrial countries. Given that, there is no reason why everybody who should pay taxes is not paying taxes. I would focus more on tracking data and better tax administration to get at where money is not being declared. I think it is very hard in this modern economy to hide your money that easily.

***Question*:** About new faces on the Notes?

Response from Dr. Raghuram Rajan: I wondered about why we can't get anybody other than the Father of the Nation on these notes. Because there are so many great Indians. Of course, he stands head and shoulders above everyone. But there are so many other great Indians that we could get on the notes. However, I sense that almost anybody else would be controversial. You mentioned some people in science and literature but even within those areas there is lot of controversy. We just had an example of a sportsman being named to the *Bharat Ratna* and, within sports itself despite this person being somewhat iconic in India, we had a lot of debate about who was really the best.

Unfortunately, it seems that we cannot agree on anybody else.

***Question*:** We do not see a single Indian Bank figuring in the top fifty banks. Is there something which RBI and the government is trying to do on that? If you compare ourselves with China we see quite a few Chinese banks in the top fifty and also their strategy, when Chinese companies go abroad, say Africa, the Chinese banks also go. We do not see that happening with the Indian banks.

Response from Dr. Raghuram Rajan: Our largest bank, the State Bank of India, accounts for about 20% of banking system assets. We have other banks which are 5 to 6% of banking system assets or may be more. Those are very large banks relative to the country. If you look at the United States the largest bank would be a much smaller fraction of the banking system assets than SBI is. Why am I making that point? Because it seems to me the key issue is not so much the size of the banks relative to economy, they are pretty big, SBI, ICICI, Punjab National Bank, they are very big relative to the size of the economy. The problem is the credit to GDP ratio is relatively low and our economy is one-third or one-fourth China's size and one-seventh or one-eighth the US's size. In other words, the solution to your concern about having large banks is to grow the credit-to-GDP ratio from the current levels. China's credit-to-GDP ratio is 160%, we are about 60% of GDP. In other words China does two-and-a-half times the credit we do relative to its GDP. Its banking sector is so much bigger relative to GDP. Of course the Chinese economy is three-and-a-half to four times our economy's size. So grow Credit to GDP, grow the economy and we will have world size banks.

***Question*:** Governor, you very articulately and accurately described the circle of dependence which prevents the consumer from getting access. I give the theory, I think consumers will want the access. The problem with circles of dependence is that they become cosy and the question is nobody who has the power to make change wants to break the circle. When you go and talk to government, to people who have the power to break this circle, are you finding any willing accomplices in breaking this? Or are you going to be the loneranger having to fight this all out by yourself?

Response from Dr. Raghuram Rajan: No, I did not want to indicate that there weren't people, well-meaning politicians, well-meaning leaders out there who want to make a change in the system. My sense, I said that the government is going to announce this plan, probably not for the theory I am putting on the table, but for a variety of other reasons. The government wants to improve the quality of public services and wants to improve financial inclusion. So, for whatever reason I think the broader objective of creating choice for the poor is certainly something that people are talking about and thinking about. What I wanted to put down was a particular theory as to why I think this is so important today, because when people think about direct-benefits-transfers, they do not look at all the things that it could change, all the dimensions in which it could be such a powerful tool in changing the dynamics at the lower level. Of course, as Ms. Piramal said, there is lot more that needs to be done than just this.

***Question*:** How is Indian economy positioned as to the Global economy? What are some of the risks that we could still be facing and how is India positioned now in this no easy-money regime now?

Response from Dr. Raghuram Rajan: First let me correct the impression that seems to go around on the web that I was saying a crisis is imminent. That was not my intention, this was a long interview, if you read the interview, I was basically saying that I worry that monetary policy in a number of countries is doing too much. Instead of the political system taking action, reforming the economy, etc. and industrial countries do need reforms. Because there was political paralysis, they were relying on the monetary authorities to provide whatever boost there should be to the economy. I thought this was dangerous, because the monetary authorities across the world are boosting asset prices rather than real activity. If the asset prices leak out in a short way that would create immense volatility and potentially some people could be caught out by that. That said, I have no doubt that when interest rates start picking up in industrial countries, we will be tested. We will be tested by capital outflows and my hope is that we have done enough in terms of strengthening the macro-economic fundamentals of the country and in trying to move capital flows towards the safer end as well as in building up reserves that, that volatility will not affect us anywhere near the extent it affected us last year. I hope we have buffered the economy against that. But, I would be the last person to say we should not worry about volatility when that happens, because across the world every economy will be tested for a little while. Simply because we have sort of blown this up for a long, long time. I was having a discussion with Mr. Ruchir Sharma this afternoon and he pointed out that the increase in asset prices during this recovery has been the fastest that he has seen on record. That suggests that we have blown things up. The increase in asset prices has not been accompanied by an increase in real activity. It has been one of the slowest improvements in real activity, but one of the fastest improvements in asset prices. That suggests a disconnect we should be worried about when the time comes for the interest rates to go up.

Question**:** The Finance Minister has said the prices will fall only when the industrial output goes up. In today's environment where regulations are getting very transparent, but the time-lines for projects are getting very difficult and changing drastically what it was ten years back. The RBI should look at the projects vis-à-vis timelines to actualising the end point. In comparison to US & Europe the cost of products are more expensive in India. Not only the cost of the product, the wastages and the replacement, etc., we end up being very expensive. Industrial output with regard to the current regulation environment, we would like RBI to look at timelines in projects.

Response from Dr. Raghuram Rajan: Recently we allowed banks to structure loans in a more flexible way, what we call the 5/25 structure where much of the construction would get done in the first five years and then the whole loan could be re-structured and sold, if necessary, to people outside the banking system. So, there is some flexibility introduced through that kind of structure, which is meant partly to get at this idea that things have become a little more uncertain in the system. We also allow restructuring when you can get somebody in for about 25% of loan. We just brought it down from 50% to 25%, the idea is when you want to restructure something, let somebody outside independently say it is worth doing and when they come in you can allow restructuring. We have been working on allowing greater flexibility given the more uncertain environment. But, let me stress that the best cushion to uncertainty is more equity. We have capitalised projects with very thin equity partly based on the successes of 2005, 2006 & 2007 and we need projects with much more equity based on what has happened since. We need to bring in more equity into the system, some of it will come from promoters, but some of it has to come from the larger public, because just relying on foreigners to bring in that risk capital may not be enough for the growth we need.

***Question*:** I admire your objective but I disagree with the way you are looking at reducing the poverty as such. The direct cash transfers for a country where we have 300 million people who are below the poverty line, I wonder what that is going to do to our deficit. Also, how is it going to incentivise people to work hard, it sounds like Robin Hood economics to me, you take from the rich and you give it to the poor. Why don't we look at more job creation, for doing that why don't we reduce the interest rates for the industry? That would be trickledown effect for the poor people. I am from the construction industry.

Response from Dr. Raghuram Rajan: I was waiting for the plug for lower interest rates. I have absolute sympathy for your point that creating good jobs is the best way to liberate people from poverty. We need to create far more good jobs, we need to create frame-works so that those jobs are enabled, allow new firms to enter and grow, we need to do all that. These two solutions are not mutually exclusive. When I say direct-benefits-transfer, let me ask you the question? How much money do you think the government is spending today on all these services per person, already? According to a study co-authored by Mr. Devesh Kapur, my recollection is it was in the order of tens-of-thousands of Rupees per person that was already being spent on maintaining all these facilities across the country. The point about direct-benefits-transfer is not to add a whole new set of benefits that would be transferred. It is about transferring existing benefits far more effectively than they are being done today. Eliminate the middleman in some of these direct transfers, in the transfer of pensions, in the transfer of scholarships, eliminate the middleman and make sure that it reaches the final beneficiary quickly to the full amount. You could think about folding in some of the subsidies, rather than subsidising the kerosene, which leads to leakage and over-consumption. Can I give you the equivalent in terms of a direct-benefits-transfer, which may not therefore distort the price and create also further problems in the economy. The whole idea behind the direct-benefits-transfer is not necessarily to increase the quantum but to transfer what is already out there in a much more efficient way. My point is that rather than providing the service if you give the means to the poor to buy the service - you are empowering them, you are giving them status, you are giving them respect and that will make a huge difference in how they get those services. On the issue of interest rates I think I have spoken enough, so I will not speak more.

Question**:** By giving direct transfers, there could be lot of savings for the government. Would you recommend the same amount of direct transfers to everybody, which is what happens now, we spend the same amount of money on everybody including perhaps the rich. Would there be same cash transfers to everybody, or would there be some graded scheme and what sort of transition we would have as people become rich to withdraw the cash benefit.

Response from Dr. Raghuram Rajan: Very good questions, I actually have a foot-note in the written version of the speech on the issue of how do you get out of it. Clearly, you do not want to create a welfare class, which lives only off that and does not improve and I have talked a little bit about it in my talk also. But there are things like earned income-tax credit, which the US gives, which allows you to get out of a situation where you are getting benefits without losing all those benefits every time you earn, but sort of makes it taper-off in a way that gives you the incentives to go out and earn. We have to think about something like that. That is the problem of success. If in fact the people we are directing transfers to start earning income in a big way, that will be a good thing. But we need to target this very effectively, yes, it makes no sense for the rich to get these transfers. My friend Mr. Abhijit Banerjee said what we should do is make everybody stand in line every month. Even though it goes directly to their accounts, let them go stand in line and have to sign somewhere so that there is a cost of getting the transfer and the rich will self-select out. They have to be there in person, they cannot send their assistants or someone-else to do it for them. That is an interesting idea, but we have to find ways of trying to target the beneficiary in a proper way. This is where I believe the information technology will help. Supposing somebody has a fifty-thousand rupee account somewhere, may be few of those pieces of information will tell you that perhaps this person has enough and therefore you would taper-off. They would have to be completely outside the information system to continue receiving these transfers. There are lots of ways in the villages of identifying people who are relatively wealthy. None of this is exact, but it would work to diminish the people who are misusing the system.

Question**:** Financial safety over the long-term has two essential pre-requisites, one is financial inclusion which you have addressed very well and the second one is stopping the erosion which happens because of inflation. In this connection in the monetary policy you had spoken about refurbishing the CPI inflation index points. The financial inclusion which is going to the poor could have some inflation protection? It is very cumbersome to issue bonds to all of them. The deposits could have some kind of CPI inflation index. Also whether CPI inflation index can be targeted as a long-term pension type of instruments for the benefit of all?

Response from Dr. Raghuram Rajan: Typically benefits, say food benefits would be indexed. Because it would be at what price you can buy food at in the market, there would be an indexation there so that you can buy the necessary quantity of food. The problem with looking for the government to insure you is that, it is not clear whether the government is the best risk manager in the economy. Often whenever the government offers guarantees it under-prices those guarantees. It is worth looking at, but the danger I will tell you is if the government gives inflation-indexed pensions, may be pensions-linked to the standard of life at a certain future point, you can take it from me that the government will under-provision for those pensions and some future government will have to deal with the problem of having to pay them out. It is not clear to me that you want to impose the risk on future generations by this kind of government guarantee. Better that the private sector, the individuals themselves, figure out ways to insure themselves. You are right that they are *not* that financially sophisticated initially, that's where we have to do work to inform them. Government as the answer to everything, in my sense, eventually it could become a problem.

Thank you very much.

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