‘Real interest rate shouldn’t be over 1%’

At a time when the Reserve Bank of India is facing the challenge of reining in high inflation without hurting a nascent growth recovery, MPC member **ASHIMA GOYAL** told **Bhaskar Dutta** in an interview that the country's real interest rate should not exceed 1 per cent. Going by the MPC's inflation projections, this implies little room for further rate increases in the current tightening cycle. Edited excerpts:

You dissented when it came to the quantum of the MPC’s rate hike. You have said that a real rate of more than 1 per cent — if inflation were to fall more than expected — could hurt growth. What is your preferred real rate?

I think the real rate should not be more than one per cent in today’s circumstances. We are just coming out of the pandemic shock and growth is still recovering, under other types of shocks. But, we don’t want over-heating, so a positive real rate is required. But, it should not rise above 1 per cent.

We have seen regular instances of banks tapping the MSF window as the systemic liquidity has shrunk. Should the RBI provide liquidity when the current surplus drains out durably?

Our durable liquidity is still very much in surplus. It’s because of government cash balances and other factors that there have been temporary episodes of market rates rising above the upper band (of the LAF corridor).

The Reserve Bank has developed a number of other tools to manage short-term liquidity such as the VRR.

They have a lot of space to intervene. Some of the very large durable liquidity created in pandemic times has gone out because of foreign outflows.

This is not the MPC’s domain. However, as an academic who has studied this issue, I think RBI has the tools now and the awareness it needs to counter the liquidity effect of outflows. Our economy really suffered in 2019 when there was a huge liquidity squeeze. I think the RBI has learnt from that too. They need to make sure that liquidity is in surplus — that’s very important for financial stability. Too much liquidity surplus is bad for financial stability but too little is also bad.

You spoke of fear-driven over-reaction when it comes to maintaining rate differentials with the US. Do you feel there is pressure on the MPC to respond to the Fed’s actions?

The MPC’s mandate is domestic inflation and growth. Not the external sector, not the exchange rate which is market determined.

In my view, the interest differential does not matter so much for the Indian exchange rate because we have caps on interest sensitive inflows. It (overseas investment) is a very low share of our debt market.

Therefore we need not worry so much about keeping up with the US Fed rates. The US needs to raise rates because there inflation is high and sticky — much higher than their target band and much higher than our inflation. We have to calibrate our policy rates and our real rates to our inflation.

Q&A

ASHIMA GOYAL
Member, Monetary Policy Committee

You have said that India retains the space for smoothing global shocks. Does this imply space for rate cuts if the global situation were to throw up a fresh shock?

By smoothing, I mean that our rates should be counter-cyclical to our domestic cycle. It includes not just monetary policy but fiscal and external reserve management and capital flow management.

There are a number of tools. We built large reserves and effectively used regulatory macro- prudential tools — these can also be countercyclical.

For example, a lot of the regulatory relaxation given just after the pandemic, was time-bound. That has been reversed with our financial sector remaining very strong.

Bank balance sheets are in much better shape today than they were in the last decade. The financial sector strength and resilience also gives us policy space. It’s not just about cutting rates or raising them.

You spoke of how the high repo rates in 2011, 2014 and 2018 led to a credit and investment slowdown. How would the MPC minimise the growth sacrifice while achieving its inflation target?

Indian monetary policy became too much in stimulus after the global financial crisis. Double deficits and various fragilities followed. It subsequently became too tight; there was over-reaction.

This is what we are seeing the Fed do now. Too much stimulus after Covid-19 and over-reaction now. We are seeing a lot of problems in financial markets abroad. I think moderation is a lesson that perhaps Indian policymakers — both monetary policymakers and otherwise — have learnt. To be countercyclical and not to let the real rates become too negative or too positive.

We have the policy space to do these kinds of adjustments. As long as we react but not over-react, I think we will be able to moderate inflation without hurting growth too much.

It’s also about monetary-fiscal coordination. There is continuing fiscal action on the supply side. For example, the government’s targeted free-food provision is one reason why wages have not risen.

In the 2010s we had second-round inflation because the rural real wages were rising in double digits. Today they are flat. We don’t have those kinds of persistent inflationary pressures today.

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