*Interview of RBI Governor, Dr. D Subbarao by Alex Frangos of The Wall Street Journal**

Reserve Bank of India Governor Duvvuri Subbarao sat down with The Wall Street Journal to talk about his efforts to restart India's growth engine and to fight persistent inflation. Speaking from the 18th floor of the Reserve Bank headquarters overlooking Mumbai, Mr. Subbaro touched on a range of issues, including the Reserve Bank's efforts to stabilise the plunging rupee in late 2011, his calls for cuts to government spending, and how it was difficult to increase interest rates several times over the objection of a panel of advisors.

Follows is an edited transcript of the conversation:

WSJ: What is your monetary policy stance right now, are you easing credit conditions or are you in neutral?

SUBBARAO: It's difficult to say what is neutral. But we give guidance in our quarterly policy statements in October and again in January, which is to say that the tightening has peaked, and from here onwards, it's that we've got to come down, that we have to start easing. There was some question as whether the CRR (cash reserve ratio) cut we had done in the January policy was a signal of easing. It depends on how you interpret that. But historically the Reserve Bank has viewed the CRR as a monetary policy instrument with of course liquidity dimensions. So it was both to signal that the interest rate cycle has peaked and also to infuse liquidity.

WSJ: So was it easing or not?

SUBBARAO: I would say it was easing to the extent we had eased the liquidity situation and we viewed the CRR as a monetary policy instrument.

WSJ: You got applause for holding the government's feet to fire on the growth in the fiscal deficit in your January policy statement, saying such spending is fueling inflation. You have talked about this issue in the past, but never so pointedly. Critics say you should have done so earlier. What's your response?

SUBBARAO: If you see our monetary policy statements over the past two years, we've consistently drawn attention to the fiscal deficit concerns having recognised that some stimulus was of course necessary as part of the crisis management. However we thought that this was an appropriate time this time around to call a more pointed attention to this, because this year, the current fiscal year, the fiscal deficit has breached the initial budget estimate and there are a lot of expenditure demands piling up as we see from the newspapers. So we thought it important to call attention to the inflationary dimensions of fiscal deficit, inasmuch as we have combating inflation over the past two years. To summarise, we did call attention to our concerns to fiscal deficit but did so more pointedly this time around because it was a more appropriate and more opportune time to do that.

WSJ: Governments generally are not known to be disciplined on spending in election years and there are several large state elections in India this year. What if they don't heed your advice on spending because of election year pressures.

SUBBARAO: Not just me, there are lots of other people talking about the negative repercussions of fiscal deficits. And I think these negative repercussions will show up more pointedly if the government does not make credible and sizeable fiscal adjustment. For one, the battle against inflation will become that more difficult. Second, private credit will get crowded out. There are lots of people who say fiscal deficits in India have not crowded out private credit in the past. That may well be true to some extent because fiscal deficits have ballooned with private credit demand was low. But now is time when we want private credit demand to pick up and supply to flow. So that would be hurt.

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And third, the twin deficits of current account and fiscal deficits feed on each other. The maneuverability or the room for not making fiscal adjustments is very limited if not nonexistent.

WSJ: What specific things would do think are advisable adjustments to make. Readers see the term fiscal consolidation, but what does that mean exactly?

SUBBARAO: The only discretionary expenditure they can make in the short-term is on subsidies. And there is I believe quite a strong case for making adjustments on subsidies even from the anti-poverty perspective. That said, I'd like to comment on some principles apart from specifics. The finance minister will of course come out with a budget estimate for fiscal deficit for next year in the budget. Beyond that I think he should indicate a roadmap, a medium-term roadmap for fiscal deficit, which they've done in the past and there's a big probability he will do that. I think he should back that up with a credible plan of how it's going to be achieved. Second, I think we also must rely also on expenditure compression in addition to tax increases to build the fiscal adjustment. And third, there must be some focus on the quality of fiscal adjustment, because if you are chasing just the number, it's possible that you would prune out productive expenditure and retain unproductive expenditure.

WSJ: You mentioned some subsidy cuts would be good for anti-poverty programmes. Which ones?

SUBBARAO: If there is subsidy in LPG (liquefied petroleum gas), it's a subsidy that's not going to the poor. It's a subsidy that's going to people who can afford LPG, which is certainly not the poor. Power subsidies are given by state governments according to people who have land, whereas the landless, who are poorer, don't get any subsidy at all. There's got to be some attention paid to the poverty impact of subsidies and targeting subsidies with an anti-poverty focus.

WSJ: It seems all the parties in the state election in Uttar Pradesh are campaigning to give away free power. That sort of thing would seem to make it hard to cut spending in the coming year.

SUBBARAO: Yes. Sometimes there is concern of how much of a democracy tax we are paying.

WSJ: You said in last policy statement you would be constrained from lowering rates unless there's credible fiscal consolidation. The budget is presented March 16, whereas your meeting is March 15. For a March 15 meeting, is a rate cut still an option given any plan for fiscal consolidation would be presented a day later.

SUBBARAO: We didn't have a precise date when we said that. But I can't really speculate on what this off the table on the table for the next policy review. Theoretically all options are on the table.

WSJ: Some critics say you weren't aggressive enough with rate increases in the beginning of the cycle and some say you were too aggressive in the end and some say both. Which criticism are you more comfortable with?

SUBBARAO: Criticism is part of the game when you are making public policy. It's legitimate that people criticise. And I'm comfortable that the criticism comes from both sides, which must mean we are at least partly right, that some people think we are right. But I must enter some explanation of our unrolling of our tightening over the past two years. One criticism as you mentioned that it was back loaded, that we were sleeping at the wheel and then woke up. That's not the case. The baby step approach that it's come to be called, was justified on three grounds. First, inflation was stemming at that time from supply shocks. There were demand pressures but they were very insipient at that time. Second, we had to support recovery. Around the world there was still the depth of recession and here at home we had to support recovery. And rates had come to historically low levels as part of the crisis management and we couldn't raise them abruptly, so it had to be a calibrated process. So even with the benefit of hindsight, I believe we calibrated the policy stance quite well. The last point I want to make is there's no counterfactual. It's not clear that inflation would not have been much higher if we had not acted. I'd say we are quite comfortable with our criticism, but I believe that our baby step approach for much of 2010 was justified.

WSJ: Wasn't it your responsibility to raise rates earlier in order for the government to realise spending was a problem earlier? Your job is price stability and it doesn't matter what the cause is, you need to tackle it.

SUBBARAO: You certainly need to tackle it but you can't do public policy to teach a lesson or to spite someone. You've got to co-ordinate with the government and there was a fiscal stimulus as part of the crisis and it certainly would take time to wind that down. We were quite sensitive to that. I don't think it would have been appropriate for the Reserve Bank to raise rates regardless of what government was doing just to tell them that the ball was in their court. I don't think that would have been appropriate.

WSJ: People in market are saying measures to maintain liquidity in the financial system such as your OMO (open market operations) and CRR (cash reserve ratio) cut are the only thing supporting government bond yields at these levels.

SUBBARAO: That's one perspective. But you must also recognise that we had said that we'd like liquidity to be within one 1 per cent of NDTL (A measure of liquidity). The last few months, it's been way above that. From a purely liquidity management perspective, we were acting by the guidelines we had given to the market. The question is whether this is supporting government borrowing. When we introduced liquidity for it to be within our targeted range, no destination for that money is indicated. It's for the banks to choose to lend to the government or the private sector. It's not as if we were telling banks to lend to the government.

WSJ: India even at 7 per cent has GDP growth is a very good number globally. But there's a lot of disillusionment in the last year or two from companies. How do you see India portrayed and does it feel different from 2007-2008. Has there been cooling of enthusiasm for the India economic story?

SUBBARAO: Certainly there is a feeling that the economy has slowed down and that it was a slowdown that could have been avoided that we need not have come down to 7 per cent if both the external world as well as domestic policy situation had been better. First, of course is the monetary tightening and the high interest rates, but that's just one factor. There's been a lot of uncertainty about policy in Delhi and getting projects going at the field level in terms of land, power, all the permissions, all the clearances you need to get, which are not so much Delhi-focused but at the field level and certainly about the slowdown in second generation reforms.

WSJ: Any change in economic outlook given the reduced jitters from Europe, the austerity plan passed in Greece overnight, more hope about the US economy?

SUBBARAO: Something happened as we turned the calendar from 2011 to 2012. The fears of imminent collapse two months before Christmas have certainly waned. In Europe the long-term refinancing operation (LTRO) performed better even than the ECB hoped, I think. Then there is the fiscal compact. There is still concerns about short-term funding and still concern about whether the banks will be able to raise the capital. There's less of a concern about an event shock, but still concern about process shocks as we go along and Greece and other countries have to roll over their debt. And the firewalls they wanted to build have to some extent succeeded in showing that Greece is different from other Portugal, Italy, Ireland, Greece and Spain (PIIGS) countries. That's certainly had a positive impact on investor sentiment here. Although our exposure to Europe is not dominant, it's certainly significant. To the extent that Europe seems to be less unstable today, it does help domestic investor sentiment here too and we've seen that on all the market indices.

WSJ: What makes India so vulnerable to global financial markets, as we saw last fall with rupee falling during the worst of the euro mess. What can you do and what can India do to make sure the next time the effect is less severe?

SUBBARAO: All emerging economy currencies have depreciated in the pre-Christmas months, but Indian rupee depreciated more than other currencies. All of you wrote and as we know the rupee was worst performing currency in the world or whatever. What explains that is that we are a current account deficit economy. South Africa too is current account deficit. Those emerging economies that had a surplus or a small deficit were less hit than countries that have a sizeable deficit like India, and that deficit was growing. So the rupee depreciation was a result of external flows practically thinning out and driven by the dynamics of the current account deficit.

What can the reserve bank do, we've in fact done what we could do which was to curb speculation in the market and to encourage capital flows of a more stable nature but there are limits to that. All the things we've done to raise deregulate interest rates on NRI (non-resident Indian) rupee deposits, on raising the limits on FII (foreign investor) exposure to equity and debt markets and curbing speculation. But eventually we need to make the balance of payments more robust to inspire confidence. There it's quite clear. We need to diversify our export destinations and product mix.

As far as imports are concerned, we need to reduce the dependence on oil imports and one way to do that is to deregulate petroleum product prices. Gold imports of course have increased partly as a reflection of a safe haven. We need to provide other safe havens. We need to attract more stable flows. FDI for example and finally we must within the Reserve Bank encourage, if not pressurise our corporates to hedge their foreign exchange exposures. They don't do that adequately. They do cost benefit calculations, if the rupee is not moving rapidly, they calculate the cost of hedging is higher than the risk they take by not taking. But as happened in the pre-Christmas months, it can certainly overshoot, so we'd like corproates to hedge more. But not proscribe that, we want to leave it to the banks and the corporates.

WSJ: When you lifted foreign investor quotas and non-resident deposit rates last year, it brought in capital and helped the rupee. Was it something you were going to do anyway? At your core, do you want India's markets to be more open or do you like the protection that exists?

SUBBARAO: I'd like our capital account to be more open and these are measures we should be taken. Of course we took them under some sort of pressure so the interpretation that you made is quite appropriate that maybe these are crisis driven measures, but certainly they were on our road map of liberalising further.

WSJ: So were you taking advantage of a crisis?

SUBBARAO: In a way it was timed as such, but even otherwise we would have done them sometime.

WSJ: Do you see currency volatility continuing?

SUBBARAO: I cannot really speculate on how the currency will move. That's dependant on a number of factors. But certainly I'd like to see less volatility in the market in the currency movement and less of a need for the Reserve Bank to intervene so that the exchange rate is determined by forces of supply and demand. And yes, when we are a stronger economy, when capital flows are of a stable nature are coming, the exchange rate will be subject to less volatility. And again, that will be an appropriate platform for taking further capital account reforms.

WSJ: With the rupee a bit more stable around 49, is now a good time to build reserves?

SUBBARAO: I can't speculate that but we had used some reserves certainly.

WSJ: Given the thirst globally for emerging market debt, why not open India even more to foreign investors.

SUBBARAO: Certainly we would like more FII (foreign institutional investors) in corporate debt but you must recognise that even the existing limit is not used up. There is something out there we have to fix about the appetite for the corporate bond market. It's not a restriction placed on the capital account front. As far as FII on government debt, yes certainly, we have expanded that quite rapidly in the last three or four years, but there is need for going a bit more cautiously, because as we've seen during the crisis, countries with large sovereign debt exposure to foreigners suffered destabilising volatility. So we need to balance the concerns of stability with concerns of less expensive foreign flows.

WSJ: When you take over in 2008 did you make a conscious decision to take a more hand's off approach when it comes to foreign exchange interventions?

SUBBARAO: That's a judgment outsiders will have to make. By inclination, I believe that markets should be allowed to function and that we should minimise our intervention and that's good for building the resilience of the economy.

WSJ: But it does help on the monetary policy side, as a flexible exchange rate makes your interest rate policy more potent?

SUBBARAO: Certainly. That's very fresh in my mind. I gave a speech last week on the impossible trinity, so to the extent you have a freely floating exchange rate you have greater, more independent monetary policy.

WSJ: Are you satisfied with the intervention you undertook last year on the foreign exchange market?

SUBBARAO: Yes. I would think so, especially on speculation. If you don't intervene, the speculative forces could be self-reinforcing which is that exporters would defer bringing their receipts in and importers would buy forwards. That's a self-reinforcing feedback loop. To the extent that we curbed speculation and showed that determination, it certainly helped.

WSJ: So 54 rupees to the dollar was a level you weren't comfortable?

SUBBARAO: I can't really comment on a specific exchange rate. We were looking at the first derivative, not the stock figure, but the rate at which it was going.

WSJ: Are these foreign exchange measures temporary, do they fit in you capital account liberalisation trajectory?

SUBBARAO: Some of them do fit in with our capital account thinking. Some of the measures to curb speculation, they are permanent until removed, but that's not saying much. We'd have to take a view on speculative tendencies and if we believe we are robust enough and there's no scope for speculation we will roll them back, but that's no indication that rollback is on the radar screen.

WSJ: Oil prices remain elevated, a major concern for you, as mentioned in the latest policy statement. How will you deal with that if they persist?

SUBBARAO: Oil prices are a big factor and largely beyond our control and are very complex economic and geopolitical factors that drive oil prices. Just looking at the world situation, the US growth situation is quite modest and Europe is probably in a recession and Japan is growing but you know. Oil prices should have come down or should have been much lower than they are today. Evidently there is something going on there that is keeping pressures up. Partly it's liquidity. Even the LTRO money, it's not clear it's being used all in Europe and some of it is being used in speculation. And then there are the political factors, which is Iran. If Iran is outside the world pool there could be price pressures. If Saudi Arabia because of fiscal concerns, its commitment to extend fiscal supports to other Arab countries, to meet that commitment they might want to keep oil prices at a certain level. There's economic factors, there's political factors there are market factors, all of them that determine oil prices which are largely out of control. Inasmuch as we import 80 per cent of our oil and more than a third of our imports, so oil prices are a big factor for inflation management, for the fiscal deficit and for macroeconomic stability for the country.

WSJ: Does that make India's relationship with Iran and this deal to pay for oil with rupees, how critical is that? Do you talk about the central government about this?

SUBBARAO: We are conforming to the UN sanctions as far as dealings with Iran are concerned. And UN sanctions do not prohibit purchases of oil from Iran. As much as we purchase oil from Iran, we've got to find a way to pay for it and our effort has been to continue to make our payments.

WSJ: How do you see growth for the 2013 fiscal year, starting in March 2012?

SUBBARAO: We expect growth to be higher in 2013 than in 2012, partly because at some point in time we might start easing the interest rate cycle. Partly because the external situation will be more stable. The world recovery will pick up. And I'm hoping that a confluence of factors, including the sentiment factor that is inhibiting investment will have run out, and that positive sentiment will revive. Animal spirits will come back into play.

WSJ: What about inflation. Why do you feel confident enough to talk so openly about cutting rates?

SUBBARAO: I think inflation should start coming down. The decline we've seen in November and December is largely to food prices, within food to vegetable prices. But we've also seen demand pressures easing. We've seen a decline in non-food manufactured product inflation, which is our measure of core inflation, which I believe peaked some months ago. We've seen pricing power of corporates coming down. And growth itself, if it moderates to 7 per cent, which means both investment and consumption pressures are lower. I believe it will come down through fiscal year 2013, but at a gradual pace.

WSJ: How would you rate your performance as central bank governor?

SUBBARAO: I think it's inappropriate for me to make a mid-career judgment on my career but it's for others to make a judgment. I've had enormous challenges, very difficult situations, but the reserve bank is a great institutions, I've had tremendous intellectual support and advice which I hope has steered the country through challenges.

WSJ: Speaking of that advice, the technical advisory committee, you haven't seen eye-to-eye with them on the pace of rate increases, why are you not agreeing?

SUBBARAO: We have enormous respect for what the TAC (technical advisory committee) has to say and for the last, let's say the second half of calendar 2011, when we continued to raise rates, many of our TAC members had expressed concerns about inflation, but had advised that we must pause but without any explanation about how inflation would come down unless we had acted. We weighted their advice against our own judgment and acted as we did. I do hope we get some credit for putting it out in the public domain.

WSJ: How difficult was it to make those decisions with the committee so close to you disagreeing?

SUBBARAO: It's difficult. It's certainly something you don't do lightheartedly. You do think twice before going against their advice.

WSJ: You've mentioned being more open, talking to the press and analysts and publishing minutes. What's your inspiration for that and why do you think it's better for the deliberations to be more open rather than guarded?

SUBBARAO: I was wondering whether it's more to do with my leadership or my personality style. Communicating with the market and communicating openly does help get the appropriate feedback and getting a reality check on what you are doing. There are of course certain times and certain things you have to keep confidential and be unpredictable, but we try to minimise that. I expect that you'll be roughly right as Keynes said, and precisely wrong.

WSJ: Can you talk about the health of the banking system. Some see a deleveraging process going on, higher non-performing loans and the fiscal situation on the government side makes it difficult to recapitalise the state-owned banks. How concerned are you about the banks?

SUBBARAO: NPLs (Non-performing loans) have grown and have grown quite rapidly in the second half of 2011 calendar year, and that's partly to be expected when the economy is not growing that fast and when restructuring had been done during the crisis. The incidence of impaired assets out of restructuring would certainly be higher than the overall sample. But we've done stress tests, and they show that our banks will remain profitable and will have no capital concerns even under fairly significant stress in terms of the some of the restructured assets turning into non-performing assets. Still that's a concern, and it's part of our regulation and supervision process and looking into that and advising banks to improve on their portfolio situation.

WSJ: People get very worked up about growth being as low as 6.9 per cent. Historically that's high, but on flipside, that level is such an elastic economy there's so much catching up to do, anything less than 5 per cent is practically recessionary. Where's your level? How good a number is 7 per cent?

SUBBARAO: For India to come down from 9 per cent to 7 per cent is as difficult an adjustment to make as for the US to come down from 2 per cent to 0 per cent, when your growth rate falls rapidly. What is our potential growth rate, noninflationary stable growth rate? We said before the crisis it was 8.5 per cent. After the crisis, some studies showed it was about 8 per cent. But now we've seen inflation, even when the economy was growing at 7.5 per cent, indicating the noninflationary growth rate is about 7 per cent or so. But that is not destiny and that we are not locked into a 7 per cent growth rate. We should certainly accelerate that, and it's certainly possible to do that, but for that, supply responses must come.

WSJ: If you could wave your magic wand on the Indian economy, what structural impediment in the Indian economy would you want fixed, improved FDI, balance of payments, investment growth?

SUBBARAO: I think public finance reform. All the things you mentioned are equally important and unlikely to work in isolation. But I'd think public finance reform at both the central and state governments would go a long way in providing a platform for all the other reforms to take off.

WSJ: What about reforming the Reserve Bank. It's a very big organisation. You manage interest rate policy and are in charge of issuing government debt, which some see as a conflict of interest as your incentives might be to keep borrowing costs low for the government when inflation argues for higher rates. Should that change?

SUBBARAO: I believe not. The Reserve Bank has a much wider mandate than most other central banks. We are the monetary authority and issuer of currency, but we are the regulator and supervisor of banks, financial markets and non-banks, the external sector we are responsible for, and we have a huge development mandate. That's served the country quite well.

In particular about the debt management, as to whether that should be hived off from the Reserve Bank. The case for that was to made on the ground that there was a conflict of interest for the Reserve Bank to do debt management, because it interferes with monetary policy. Second, that the fiscal deficit was on the way down, therefore there is possibility for an independent debt management office. I think both those arguments have lost part or most of their validity. I believe there is a quite a bit of synergy for the RBI to be doing the debt management, because raising resources of the size the government does in India, is not just a matter or raising resources, it has implications for interest rates, for liquidity for credit flow and for the macro-economic situation. Given that fiscal deficits and government borrowing are so high, I think there is quite a bit of synergy between a central policy which is charge of monetary policy which is also doing debt management?

WSJ: What's the synergy, that you not issue debt?

SUBBARAO: No. That's not an option. That we can ensure, that as much as the government has to borrow, that there is sufficient liquidity so the private sector crowding out is minimised. We can ensure that the interest rates are still manageable and competitive for the private sector. And also recognise that the conflict of interest angle is somewhat overplayed. When 70 per cent of the banking sector is with the government, there is a conflict of interest if debt management is done by an office that has some affiliation with the government.

I don't think we will use our function as the debt manager to put pressure on the government about the fiscal deficit. There are other avenues to pressure and to argue our case. As far as debt management is concerned, we want to be efficient debt managers.

WSJ: How much does China, as India's largest trading partner, weigh on your economic analysis?

SUBBARAO: Perhaps we reckon with that possibly less than we should be doing. Our trade with China is growing, our links with China are growing and we've allowed corporates to raise debt in yuan. I think Chinese economic management, particularly their economic policies should be part of our reckoning more than it is now.

WSJ: You were recently reappointed for another two year term, running out in September 2013. Would you like to serve after that?

SUBBARAO: No.