ASIAN CENTRAL BANK GOVERNOR OF THE YEAR: YV REDDY, INDIA

2nd October 2004
By Kala Rao

EM: When you took over as governor last September India's foreign exchange reserves had crossed $90 billion and are now around $120 billion. India's current account is in surplus for the second consecutive year. This is a dramatically different situation compared to what India faced in 1991 when there was a balance-of-payments crisis. Can you explain what the country has learnt along the way?

YVR: To appreciate the difference, it is useful to revisit the past. I was in the ministry of finance then and was closely involved in managing the crisis. The historic decision taken at that time was not to default on any external obligations; not to roll over external commercial borrowing even though there were offers; and a firm commitment to absorb the burden of adjustment, however painful, domestically, by imposing severe restrictions on imports and pledging our gold reserves. India is one of the very few countries in the world not to have ever defaulted on its external obligations.
We also laid out the parameters for the management of India's external sector. The essential components of this policy were to restrict the current account deficit to a sustainable level; manage the capital account; encourage the inflow of non-debt-creating capital while restricting external debt; and moving to a market-determined exchange rate backed by a reasonable level of foreign exchange reserves. This approach gained acceptance later among other countries after the Asia financial crisis of the late 1990s. This policy package has helped India weather several external and domestic shocks in the '90s, maintain financial stability and enabled the economy to grow.

EM: What are the new challenges you face in dealing with the current situation?

YVR: Today, while India's trade deficit is rising, the current account is in marginal surplus, thanks to remittances to India from non-residents and exports of software services. Our focus now, therefore, is on the management of the capital account. The core issue here is that the exchange rate is not subjected to volatility, and that it reflects India's economic fundamentals. This change in emphasis from managing the current account to managing the capital account required an adjustment of mindset on the part of policy-makers, and this adjustment is continuously taking place – not only in policy-making but also among the domestic economic agents and financial markets.

EM: You have recently pointed to the need for countries such as India to erect a special defence against volatile capital flows. Could you explain what sort of defence you have in mind?

YVR: I referred to special defence against volatile capital inflows in respect of emerging countries like India, based not only on our experience but also on empirical research by many economists, including Professor Kenneth Rogoff [former IMF chief economist]. There is evidence that countries that have not reached a certain threshold are vulnerable to more risks in their progress towards financial integration. The nature of the defence each country needs will depend on the context of a particular country. India's approach is evident in the gradual liberalization and management of the capital account where some capital flows are preferred to others, ensuring adequacy of reserves, and most important, the regulation of the activities of financial intermediaries, particularly the direct and indirect foreign exchange exposures of banks.

EM: Inflation appears to be rising again, and the annualized rate crossed 7% in early August. What are the reasons for this rise? What is your target inflation rate for this year and what issues are likely to affect it in the coming months?

YVR: The current spurt in headline inflation (wholesale price index) is driven mainly by increases in the prices of petroleum products, coal, iron and steel. More recently, international commodity prices appear to be more stable, although there is still considerable uncertainty about international crude oil prices. It is important to remember that the consumer prices index shows a lower level of around 3%, indicating the difference in the weights of different commodities.

Our annual policy statement of May 2004 projected the WPI inflation at around 5% for 2004-05, provided there are no significant supply shocks and liquidity is appropriately managed. On balance, this estimate still holds, though we are keeping a close watch on rising uncertainties. A clearer picture of the progress of monsoon, the strength of industrial and service sector growth and the international inflation picture will help us to refine and update the outlook on inflation. For the moment, we are sticking to the GDP growth estimate we made in May of 6.5% to 7% for this fiscal year.

EM: Earlier this year you relaxed rules allowing more Indian companies to borrow abroad, but what about restrictions on foreign loans raised by Indian financial institutions?

YVR: The decision to allow Indian companies to borrow abroad is part of the strategy to promote investment in the real sector in our country. As regards restrictions to the foreign loans by financial institutions in India, our policy towards management of the capital account differentiates between households, corporates and financial intermediaries. Restrictions on financial intermediaries at this juncture of our financial integration with the global economy are essentially in the nature of prudential regulations both to safeguard the intermediaries and to maintain stability in the external sector. By and large, we will continue to carefully monitor policy with regard to foreign currency exposures of financial intermediaries. In fact, this is one of the defences against volatile flows.

EM: India's financial sector on the whole looks healthy compared to some others in the region. But several small private banks are short of capital, and we have not seen much consolidation yet. Do you think consolidation is needed?

YVR: There are issues relating to private-sector banks, and these relate to strengthening the corporate governance, insisting on “fit and proper” test for the Board of Directors, probing the links between bank ownership and commercial affiliations, and on adequate capital. Capital is only one of the reasons why the issue of consolidation needs to be addressed.
We do not see any difficulty in raising capital domestically to finance the growth of Indian banks provided they are managed well. At a macro-level, we have a surplus in the current account of balance-of-payments and our savings-investment balance is positive. Our equity markets are fairly well developed, and our banks have raised significant amounts of capital. Foreign direct investment will have plenty of opportunity to be put to use in priority areas such as infrastructure and where we could use higher levels of global expertise.

EM: Several Asian governments have also borrowed abroad in the past year to take advantage of lower interest rates. Can you explain why the Indian government has not raised a sovereign foreign currency bond yet and continues to finance its large budget deficit exclusively from Indian savings?

YVR: Sovereign bond issuance has to be seen in the context of management of capital flows, aggregate external debt and the cost effectiveness of the transaction to the borrower. I have always advocated extreme caution in regard to our sovereign borrowings though some have argued that a sovereign bond issue helps develop a benchmark rate and credit rating for other Indian borrowers.
Of course, India has a cautious approach towards debt-creating flows and totally avoids commercial borrowing. In fact, the government recently pre-repaid some high cost sovereign borrowings in foreign currency and substituted it with domestic currency loans. It is good to recall some facts relevant to the issue of sovereign borrowing.
First, the downside risk of countries with high fiscal deficits issuing sovereign bonds is that it can be destabilizing as evidenced in Argentina, Turkey and Brazil.
Second, the cost of issuing a relatively long tenor bond in foreign currency with open ended foreign currency risk and wide spreads is linked to the credit rating of the country and for whatever reasons, our rating is less than appropriate for a country with a no-default record.
Third, if the government decides to hedge its foreign currency risk, then there is the question of whether there is a market liquid enough to absorb the government's hedging requirements.
Fourth, the positive saving-investment differential in our country reflects the presence of absorptive capacity of the domestic economy for government borrowings.

Finally, the government has been able to raise the resources internally at a progressively lower cost despite the increase in size and the lengthening of the maturity profile of government's market borrowings.
In brief, considering all the issues of costs and risks involved, both for the government and for macro-stability, issuance of foreign currency denominated bonds by the government of India is inadvisable at this stage.

EM: Recently the central bank put out draft rules on ownership levels in private Indian banks that put a limit of 10% on ownership by a single group including foreign direct investment. What is the thinking behind this?

YVR: According to current regulations the central bank's approval is needed for ownership in excess of 5% in the equity of a bank. In the interest of transparency, we issued comprehensive guidelines on the process of granting such approvals in February this year. The draft that you are referring to addresses issues of governance and it is under discussion. The objective is to be more transparent in our conduct of policy. In most countries there are restrictions on ownership of equity in one bank by another, for domestic as well as foreign banks. We propose to have a similar framework. One of the objectives of such restrictions is to ensure that market takeover of one bank by another bank occurs with specific knowledge and approval of the regulator and is in line with public interest.

EM: The previous government announced that foreign banks would be allowed to incorporate in India or continue to operate branches as they do now. Has the central bank finalized the rules for incorporation and will foreign banks be free to open as many branches as they require once they fulfill those conditions?

YVR: The guidelines have yet to be announced by the RBI. We are working on it, and they will be consistent with our commitments to the WTO. Of course, the current policy of licensing of branches of foreign banks will continue in line with our commitments to the WTO.

EM: Do you see a need for any changes in the election procedure of the heads of the Fund and Bank so that they are opened up for all nationalities?

YVR: Being a multi-lateral institution the candidate should be selected by an open process to identify the ideal person. This time there was a significant change in the process, candidates from several non-traditional countries were considered, and the principle has been established. We hope that this will be the way forward.

Biography

Yaga Venugopal Reddy is the 21st governor of the Reserve Bank. Prior to his appointment in 2003 as governor, he was India's executive director on the board of the IMF. A graduate of the Indian Administrative Service, he has spent most of his career working in the areas of finance and planning both at state and central level. Between 1996 and 2002 he was deputy governor of the central bank, where he looked after monetary policy, exchange rate policy, internal and external debt management, foreign exchange reserves management and economic research. Reddy is also an honorary senior fellow at the Centre for Economic and Social Studies at Hyderabad.