

An assessment of recent macroeconomic developments

(Revised version of the Keynote Address by Dr. Subir Gokarn, Deputy Governor, to the Opening Plenary session of Confederation of Indian Industry's CFO Summit 2011 on December 3, 2011 in Mumbai. Inputs and feedback from colleagues on the Financial Markets Committee are gratefully acknowledged.)

Introduction

Thank you for inviting me to share my thoughts at the Annual CII CFO Summit. In recent weeks, the macroeconomic environment has become particularly turbulent. Global conditions have contributed to a significant rebalancing of portfolios as a result of rapidly changing risk perceptions and appetites. This has led to increased instability and volatility in financial markets, particularly currency markets. On the domestic front, growth is decelerating while inflation remains high, with upside pressures persisting from the sharp depreciation in the rupee. While overall macroeconomic conditions may cause concern, we need to take an integrated and forward-looking view of positive and negative indicators and future risks while thinking about appropriate policy responses. This is what I propose to do during the course of this talk.

The Global Scenario

Let me first speak about the global scenario. Over the past two years, the performance of the major advanced economies has raised significant concerns about the sustainability of the global recovery. By contrast, emerging market economies (EMEs) have generally shown reasonable growth, suggesting that their domestic drivers and increasing linkages with each other have provided some offset to the slower growth in advanced economies. However, periodically, either sovereign debt pressures in Europe or growth volatility in the US, have heightened those concerns. The European debt problem has unquestionably been the dominant global factor over the past few months, which, in turn, has been a source of volatility in asset and currency markets all over the world. As prospects of enduring solutions to the problem have ebbed and flowed, so have asset prices and exchange rates. , After several weeks of anticipation, matters appear to be coming to a head. The prospects of a solution critically hinge on the Euro summit scheduled for December 9th, where arrangements that will help stabilize global markets are expected to be announced.

Impact on India and Policy Responses

The impact of this recent global instability on India has been enormous. India is a structurally current account deficit economy. This deficit is, in turn, financed by capital inflows, which over the past several years, had been large and stable enough to more than offset the current account deficit. For a few months during the 2008-09 financial crisis, the position was reversed and, when that happened, the Rupee behaved much like it did over the past several weeks (Chart 1). Between July 2008 and February 2009, the Rupee depreciated by nearly 17 per cent. Essentially, when capital stops coming in, the current account drives the exchange rate and, naturally, the pressure is to depreciate in the face of the deficit. With the kind of volatility we have seen in global capital flows over this period, virtually all EME

currencies faced pressure to depreciate. However, the eventual magnitude of change reflected differences between countries in current account conditions as well as policy responses.

For the past few years, the exchange rate regime in India has been what might be best described as a "bounded float". There are virtually no restrictions on Foreign Direct Investment (FDI), except for limits on specific sectors, and portfolio investment in equities. However, there are restrictions on debt inflows, driven by considerations of external stability. These limits relate to quantity, tenor and pricing. Short-term debt is the least preferred, because it is seen as most vulnerable to sudden reversals, while long-term debt, despite risk concerns, is seen as contributing to the resource flow into infrastructure, so is viewed more favourably. These controls on debt might be viewed as "structural" or "strategic" capital controls; they are altered relatively infrequently in response to changing macroeconomic conditions and not with a view to impacting the daily movement of the exchange rate.

While we do not target the level of exchange rate, nor do we have a fixed band for nominal or real exchange rates to guide interventions, the capital account management framework helps in the bounded float. If volatility increases, appropriate tools, including those in the realm of capital account management are used. Within these overall boundaries, the exchange rate is determined by daily variations in demand and supply. In the recent episode of depreciation, as I indicated earlier, a sharp fall in capital inflows led to a drying up of supply, while demand on account of the current account deficit continued unabated, leading to the outcome we saw.

There has been a long-standing debate on the merits and de-merits of this exchange rate policy, which has returned to centre-stage in the wake of recent developments. Time does not permit me to go into it here, but it is important to point out that the different policy responses we saw across EMEs to the volatility in capital inflows were largely the outcome of their exchange rate policy framework. Countries that orient their exchange rate regimes to export competitiveness typically have current account surpluses. This is a characteristic of the Asian EMEs and, in this sense, India is a significant exception to the Asian rule. These surpluses are reflected in a build-up of foreign exchange reserves, which may be further enhanced by large inflows of capital and the further accumulation of reserves to prevent currency appreciation, which undermines competitiveness in the short run. In the current global context, when capital inflows stop, reserves built up from current account surpluses provide the capacity to manage exchange rates in the face of external pressure.

India has large reserves, of course, over \$300 billion, but because we have a current account deficit, the reserves are essentially counterbalanced against our external liability position. In an extreme scenario, if there is a large outflow of capital, the adequacy of reserves will be judged by the economy's ability to finance the current account deficit and, over and above that, meet short-term claims without any disruption or loss of confidence. In light of this, the value and use of reserves in the Indian context must be viewed somewhat differently than in the context of a structurally current account surplus economy. Reserves essentially provide comfort to external counterparties that we have the capacity to meet our obligations.

While the recent sharp depreciation has in certain quarters led to an assessment of "helplessness" in dealing with the kind of global turbulence we are seeing today, our strategic behavior should not be misconstrued as an inability to lean against the wind. Consider the following alternatives. Not using reserves to prevent currency depreciation poses the risk that the exchange rate will spiral out of control, reinforced by self-fulfilling expectations. On the other hand, using them up in large quantities to prevent depreciation may result in a deterioration of confidence in the economy's ability to meet even its short-term external obligations. Since both outcomes are undesirable, the appropriate policy response is to find a balance that avoids either.

That balance can be found in precisely the structural capital controls that I referred to earlier. Resisting currency depreciation is best done by increasing the supply of foreign currency by expanding market participation. This, in essence, has been our response. We increased the limit on investment in government and corporate debt instruments by foreign investors. We raised the ceilings on interest rates payable on non-resident deposits. The all-in-cost ceiling for External Commercial Borrowings has been enhanced. All these channels will help to expand the inflow of foreign exchange. These capital control measures have been supported by a series of administrative measures, which are aimed at curbing the capacity (or temptation) of market participants to take positions against the Rupee, which may further aggravate the pressures to depreciate. For example, entities that borrow abroad were liberally allowed to retain those funds overseas, which in this environment, would fetch them some windfall gains. They are now required to bring the proportion of those funds to be used for domestic expenditure into the country immediately.

In sum, within the broad parameters of our "bounded float" approach to exchange rate management, we do have the instruments and the capacity to enhance supplies of foreign exchange into the market and, as has been demonstrated by these recent actions, will use them as appropriate. Within this overall framework, let me address the issue of direct intervention. As we have said, our policy approach does not involve strong intervention in the currency market to achieve a specific rate target. The risks of doing this have already been pointed out. However, in excessively volatile market conditions, "smoothing" interventions that help to keep markets orderly and prevent large jumps that can induce further spirals, are entirely justified and have been carried out.

To sum up my thoughts on this issue, let me re-emphasize that our broad objective. It is to ensure that we find a balance between the short-term risk of the Rupee spiralling downwards and the medium-term risk of a loss of confidence in our ability to meet our external obligations. We do have the instruments to do this in the form of strategic capital controls, which can be used to enhance the supply of foreign exchange. These will be used as appropriate, with the goal of ensuring that the availability of foreign exchange does not become a de-stabilizing constraint.

However, we must accept the likelihood of global turbulence persisting for some time, with the consequent impact on asset price and currency volatility. This is a risky environment and everybody would be well advised to mitigate their risks to the extent possible. Over time, the hedging options for various stakeholders, including banks, corporates and small exporters have increased. Accordingly these

stakeholders are advised to be vigilant and well-prepared with appropriate risk mitigation strategies, even while central bank acts to smooth excessive volatility.

But, beyond this, if we do see the short-term risk of a downward spiral escalating, we will not hesitate to use all available instruments. Notwithstanding our preference for a strategic approach to manage our external exposures, we would like to reiterate that to safeguard macroeconomic stability, use of intervention to mitigate the impact of sharp and large movements in the exchange rate would remain an instrument in our armoury.

The Domestic Scenario

Liquidity

Let me first address the immediate concern about Rupee liquidity, which, in some ways, is related to the external situation. For several weeks now, the tightness of domestic liquidity conditions has been highlighted by the fact that borrowing under the Liquidity Adjustment Facility (LAF) have been significantly above our comfort threshold of one per cent of Net Demand and Time Liabilities (NDTL). Recent developments in our liquidity management approach have involved making a distinction between the monetary stance and the liquidity stance (Chart 2). In December 2010, we exploited this distinction by carrying out Open Market Operations (OMOs) to inject liquidity into the system, despite maintaining an anti-inflationary monetary stance.

We appear to be in a somewhat similar situation now. Some of the tightness is attributable to the smoothing interventions that were carried out in the foreign exchange market. But, that apart, given the overall conditions and the additional pressure, even if transitory, that will be exerted by the advance tax payments in mid-December, domestic liquidity conditions are expected to remain stretched for some time.

Here again, the broad objective is to ensure that these conditions do not hamper the smooth functioning of financial markets and disrupt flows to the real economy. We have been injecting liquidity into the market through LAF and OMOs and will continue to do so as conditions warrant. Of course, we must guard against the risk of excessive accommodation, since this will conflict with our current monetary policy stance. But, having made a distinction between the two, we will try and ensure that liquidity remains adequate without threatening the inflationary situation. In short, the endeavour will be to keep it within the parameters consistent with our comfort levels for a liquidity deficit.

We do have a range of instruments to help us achieve this objective. Currently, the banking system as a whole holds government securities to the tune of 29 per cent of NDTL, which is five per cent above the statutory requirement of 24 per cent. This reflects a relatively large capacity for liquidity infusions, about ₹ 2,74,000 crores, as and when the need arises. It is called the Statutory Liquidity Ratio (SLR) for a good reason. OMOs are our first preference for liquidity injection, since they are tactical in nature and do not require a change in any policy stance, real or perceived. Further, although , OMOs are currently being used to make those infusions, the LAF window is always available to the system to the extent of this

surplus capacity. In addition, the recently established Marginal Standing Facility (MSF) allows banks to use a further one per cent of their SLR holdings, which, given the interest rate structure, they will only do in situations of extreme stress. In recent weeks, there has been no recourse to this window, which could mean that there isn't too much stress in the system. In a sense, this window serves as an early warning indicator and we watch it very closely.

Beyond this set of instruments, there are others, like the SLR itself and, ultimately, the CRR. But, in thinking about these instruments, we must keep in mind that they straddle the divide between liquidity and monetary management, which, at the current juncture, we are intent on maintaining. To summarize the broad objective on this front, it is to ensure that domestic liquidity conditions do not destabilize financial markets or flows to the real sector, within the overall confines of the current monetary policy stance. Importantly, we must realize that large fiscal deficits cannot be accommodated fully by OMOs. Fiscal consolidation is a high priority. Inadequate progress on this front will weaken monetary control and impact medium term inflation expectations.

Growth and Inflation Dynamics

Finally, let me say a few words on domestic growth and inflation dynamics, which take us from the immediate to somewhat further into the future. Here, I am treading on familiar ground, since it is just about a month since our last quarterly policy review. Of course, some things have changed since then, most notably, the extent of depreciation of the Rupee since that announcement. In and of itself, this clearly heightens inflation risks. These risks are perhaps aggravated by the fact that, amidst all the global turbulence, crude oil prices have remained quite firm. While the relative stability of oil prices in dollar terms would have provided a strong favourable base effect for domestic inflation beginning in December, this will be offset somewhat by the depreciation of the Rupee. However, our projections suggest that the impact will not change the anticipated downward trajectory of inflation. If a sustainable solution to the European sovereign debt problem emerges over the next few weeks, global portfolio rebalancing could reverse the movement in the Rupee, which in turn will help moderate the inflation risk. Importantly, apart from oil, prices of some other commodities have shown some signs of softening, which is obviously positive for the inflation outlook.

On the growth front, the recently published estimates for Q2 of 2011-12 substantiate the general expectation of a moderation in growth during the current year. Some of this is attributable to the cumulative impact of interest rate hikes. In this sense, it is an expected outcome of monetary policy actions, which, as is well-known, work to curb inflation by moderating demand. Typically, a growth deceleration precedes an inflation deceleration, so the pattern playing out now is consistent with the expectation that inflation will begin to moderate over the next few months. This has been the basis of our projections and guidance on future policy actions. Of course, there have been other factors that have impacted aggregate demand, especially the investment component. However, just as with the exchange rate and inflation, there are growth risks as well. Persistent global turbulence is always going to adversely impact the investment climate, which may be further aggravated by domestic conditions. Apart from interest rates, investment activity, which is critical to sustaining high growth with low

inflation, is also sensitive to a number of other factors. Policy actions, both on the fiscal and regulatory fronts, that can favourably impact the investment climate will be critical to mitigating the risks to growth. These run the gamut from tax reform to land acquisition to skill development. A number of initiatives on each of these fronts are visible, but quick resolution and implementation is the key.

An important risk factor that we have been consistently highlighting is food. Although data from the most recent weeks points to a steady decline in food inflation, the likelihood is that food prices will remain a persistent source of inflationary pressure unless there are significant improvements in productivity, both at the cultivation stage and in the distribution process. Many forces need to be brought into play quickly to achieve this - infrastructure, technology and extension services, reform of market institutions and re-alignment of price incentives and financial services that can support them.

However, to come back to the growth and inflation view over the next year, in a scenario in which global turbulence reduces, we should see inflation moderating, which would then help the growth cycle reverse. Even in this scenario, reforms that improve the investment climate are critical. If global uncertainty persists, making us even more dependent on domestic drivers to sustain growth, these reforms become absolutely essential

Concluding Remarks

Let me conclude by summarizing the main points that I wanted to make in this address. First, in dealing with global turbulence and its short-term impact on India, we need to balance between the risk of a rupee spiral and that of a loss of confidence. Our capital account management framework gives us the capacity to do this and we will continue to use that capacity as appropriate. We have to recognize that volatility may be with us for a while and we have to deal with it. However, if the risk of a spiral escalates, reflected in sharp movements in the exchange rate, we will take swift action as and when necessary.

Second, domestic liquidity may be showing signs of stress. Here again, we have the instruments and the willingness to use them, in the context of our distinction between liquidity management and monetary policy.

Third, while there are many challenges to managing the growth-inflation dynamics, both external and domestic, they are manageable. Moderating growth will help ease inflationary pressures, which in turn will help growth stabilize. Of course, accelerating growth over the longer term without provoking inflation requires many structural changes, on which the policy establishment must put the highest priority.

Let me end by thanking the organizers once again for inviting me to speak at this event and for accommodating my scheduling constraints through the use of this video recording. I trust that my remarks have served as a useful input to your discussions. My best wishes for a productive day.

Chart 1: Exchange rate of Indian Rupee



Chart 2: Exchange rate of Indian Rupee

