POLICY LESSONS FROM THE GLOBAL FINANCIAL CRISIS

by

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1. First of all, I would wish to thank Shri Mukul Somany, Chairman, CII, Eastern Region, for giving me the opportunity and privilege to address this distinguished and august audience. Second, I must congratulate and compliment the CII on very imaginatively selecting “Better Banking for Economic Development” as the theme for the Banking Colloquium. I am also very impressed by the fact that the Colloquium is very well conceived and structured what with all the material and relevant

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topics germane to the subject-matter having been included with just the right focus and emphasis. Also, I could not agree more with Shri Mukul Somany when he says that safe, sound, secure, robust and resilient banking and financial system is a '*sine qua non'* for sustainable, and inclusive, economic growth and prosperity and that is precisely why both financial stability and price stability have informed policy making in the Reserve Bank of India.

2. The recent financial crisis has thrown into sharp relief, as never before, the critical and important role of 'asset price' inflation/asset bubbles also, as opposed to that of shop floor/products/services inflation alone, as a key variable, in monetary policy response. For what happened was unprecedented in that with monetary policy focused only on traditional CPI, interest rates were kept low in spite of exploding prices of assets like real estate/property, credit assets, equity and commodities. And this was all made possible because of the huge current account surpluses in China and other EMEs, and huge private capital inflows into EMEs in excess of their current account deficit, getting recycled back as official capital flows into government bonds of reserve currency countries, especially the USA, resulting in compression of long term yields which, in turn, translated into lower long term interest rates even for the riskier asset classes mentioned above. This chasing of yield, due to global savings glut, in turn, led to a veritable credit bubble, characterized by unprecedented underpricing of risk as reflected in

the all-time-low risk premia with junk bond spreads becoming indistinguishable from investment grade debt ! Such a low interest rate environment coupled with luxuriant supply of liquidity, created enabling environment for excessive leverage and risk taking so much so that American household debt exceeded the country's GDP! In fact, in the US, in particular, the financial sector, instead of being a means to an end of sub-serving the real sector, ended up being an end in itself. Interestingly, in this context, Satyajit Das, a world renowned expert in derivatives, in his characteristic breezy and racy style, describes the financial syndrome as " 'too much' and 'too little' – too much liquidity, too much leverage, too much complex financial engineering, too little return for risk, too little understanding of the risks". This syndrome of too much of arcane rocket science and financial alchemy in the financial sector, almost entirely for its own sake to almost complete exclusion of the needs of the real sector, created a massive 'financial sector – real sector imbalance' which, being, intrinsically unsustainable, culminated eventually into the now-all-too-familiar apocalyptic denouement, entailing cumulative global writedowns and credit losses aggregating US $ 1.6 trillion the estimate of which, IMF has since revised to US$ 4.5 trillion ! This, in turn, led to a sort of the so called 'Ponzi finance culture' where, with personal savings rate at close to zero, consumption spending binge was driven through withdrawal of home equity made possible by omni-present home equity loans rather than through incomes ! Thus, the entire debt binge was spent in consumption and not investment, leading to a veritable partial deindustrialization of America, as it were, with the possible exception of the services sector. All this while, the US

growth story stayed non inflationary due primarily to cheap imports from China, Asia and EMEs.

3. These large and persistent imbalances represented 'unearned' prosperity for deficit reserve currency countries and 'unshared' prosperity for surplus countries. Such a global economic order was inherently unsustainable and unstable from the word go. In other words, the only sustainable and durable global economic growth model would be where growth and prosperity are both 'earned' and 'shared'. And mind you, `unearned` and `un-shared` prosperity are no socialistic/ egalitarian platitudinal rhetoric but pretty compelling real-politik and geo-economic imperatives given the current irreversibly globalised and integrated world. In fact, the whole thing can be likened to cosmic balance/equilibrium/harmony where stars, suns, planets, all orbit within the inviolable discipline of their elliptical orbits which do not permit deviant behaviour beyond the shortest and the longest distance from the suns and stars of the orbiting planets! Any deviant behaviour/conduct, inconsistent with the cosmic harmonious balance and equilibrium, will invite and inflict extremely retributive backlash; the more severe and prolonged the disequilibrium and imbalance, the more wrenching and excruciating will be the resulting pain as is currently being experienced. But the sobering chastising that the world has experienced in the current financial crisis, should stand us in good stead going forward provided all the lessons have been unforgettably learnt, imbibed, assimilated and completely internalized !

4. In refreshing contrast, India ran modest current account surpluses to modest current account deficits with only the latest current account deficit at 2.6 % of GDP due to the impact of the ongoing global recession. Thus, in the post-economic reforms period, through its macro economic policies, India demonstrated that it is committed to, and believes in, ‘earned’ and ‘shared’ prosperity in our economic relations with the rest of the world through sustainable and balanced current account.

5. The current global economic recession, the worst since the Great Depression, was caused by the apocalyptic global financial melt down and not the other way round which traditionally has so far been the case, where typically it was economic recession that preceded and precipitated financial crises. At the risk of being repetitive, it must be noted that even if global imbalances and accommodative monetary policy provided an enabling environment for excessive leverage and risk taking, it was still the responsibility of regulators and supervisors to have taken appropriate macro-prudential measures, pre-emptively and proactively, rather than reactively. But unfortunately broad spectrum and generic regulatory and supervisory failure worldwide, especially in the West, precipitated the current unprecedented global financial crisis. This regulatory and supervisory inertia to unprecedented build up of risk globally, typical, and characteristic, of the hunky-dory and gung ho financial environment of the pre-crisis days, is most graphically epitomized by what Mark Twain said 100 years ago: "It ain't what you don't know that gets you into trouble; it is what you know for sure that

just ain't so!" In refreshing contrast, in India, we have had remarkable financial stability, not fortuitously, but thanks to pre-emptively and pro-actively delivered prudential measures like increase in risk weights for exposures to commercial real estate, capital market, venture capital funds and systemically important non-deposit accepting Non Banking Finance Companies (NBFCs). These pre-crisis prudential regulatory measures of Reserve Bank of India represented what now are famously known as 'countercyclical capital measures' and have been strongly commended for adoption by various recent Working Groups / Committees of international regulators. Indeed, in the aftermath of the global financial crisis and resulting economic recession, these countercyclical capital measures have been rolled back to cushion the adverse collateral impact of the crisis to considerable beneficial effect to the Indian economy complemented, of course, by duly calibrated monetary policy easing which was earlier preemptively tightened to contain inflationary expectations.

6. The global credit crisis has also thrown into sharp relief a 'strong connect' between 'liquidity risk' and 'opaque off-balance sheet exposures' of whatever description. The appropriate supervisory and regulatory response to these risks would, therefore, be to insist on full disclosure and transparency of off-balance sheet commitments/ exposures and supervisory insistence on an appropriate mix of 'stored' and 'purchased' liquidity and appropriate capital charge for liquidity risk; the higher the 'purchased liquidity' component, the higher the capital charge and the higher the 'stored liquidity' component, the lower the

capital charge. Thus, banking supervisors and regulators need to be more hands-on and pro-active in focusing supervisory attention on this critical risk category than has been the case so far. (In fact, in India the Committee on Financial Sector Assessment (CFSA), Chaired by Dr.Rakesh Mohan and Co-chaired by Shri Ashok Chawla, Union Finance Secretary, almost presciently focused on this critical risk in the month of May itself, much before the liquidity and credit crunch of August 2007).

7. As is invariably the case with any major crisis, the ongoing global financial crisis has unleashed a passionate debate over the design of a new global financial architecture. The opinion on overarching role in global financial surveillance is sharply divided between assigning it to Financial Stability Forum, since rechristened as Financial Stability Board, on the one hand, and to IMF, on the other. However, the trouble has been not so much with the existing, inter-temporally evolved, global financial architecture as really with how it was actually worked in practice. Recent huge losses at global banks running to about USD 1.6 trillion are not because existing best practices failed but because those responsible for implementing and enforcing them failed them ! After all, of all risks to regulators and regulatees alike, human resources risk is by far the most serious as it is the source of all risks as confirmed by the ongoing financial cataclysm. The crux of the matter is what we need is not more, or less, regulation and governance but good regulation and governance. This has been the undoing of both regulators/supervisors and financial firms/banks alike. In the way of example, in the USA, the

traditionally very healthy AAA rated mono-line bond insurers MBIA and Ambac changed their business model from insuring only their staple municipal bonds to insuring CDOs and ABS. While this went unnoticed by insurance regulators, Pershing Square, a hedge fund, spotted trouble and started shorting both equity and credit risk of these two companies. But even after this, regulators failed to take notice and corrective action with the two companies being eventually downgraded several notches. The same is true of financial firms and banks where independent directors on the boards, much less ask right questions, apparently didn't even understand the arcane world of modern finance and banking and according to a column in the Financial Times, after the crisis, one leading global bank ran an advertisement inviting applications for board positions from experienced professional bankers ! Besides, rather than take timely notice of, and act on, early warning signals coming from financial markets, like stock and CDSs markets, regulators chose instead to shut themselves to these early warning signals themselves by banning short selling which act effectively amounted to shooting the messenger for the unpalatable message it had to convey !

8. However, for all the positives about the Indian economy, the fact still remains that in view of the growing integration of the Indian economy and the financial system with the rest of the world, it cannot be the case that Indian economy should have remained unaffected. The Indian economy was collaterally affected primarily through two channels: the Capital account and the Trade account. While India continued to experience substantial net capital inflows,

the situation changed for the worse in September / October 2008 in the wake of Lehman Brothers' bankruptcy, with substantial net capital outflows and this, in combination with widening trade account and current account deficits resulted in the decline of foreign exchange reserves of about USD 60 billion, from USD 316 billion in May 2008 to about USD 255 billion now. The trade deficit widened to USD 120 billion (10 % of GDP) and current account deficit widened to USD 29 billion (2.6 % of GDP).

9. Because of the integration with the rest of the world, fall in export demand for Indian merchandise and services, the GDP grew by 6.7 % in 2008-09 compared with an average growth of 9% plus in the previous 3 years. Thus, it will be seen that the Indian economy was much less adversely affected, primarily due to being driven by domestic demand which again had a very strong rural demand component. Significantly, even now the rural demand continues to remain robust, especially for autos, two wheelers, tractors and FMCGs. This was all made possible because of public spending under National Rural Employment Guarantee Programme, Rural Self-Employment Programme and Rural Road Construction Programme under flagship Government sponsored schemes. Indeed, as a critical complement to this effort, financial inclusion initiative driven by leveraging smart card and bio-metric technology, also played a pivotal role. Besides, going forward, with 400 million odd mobile phone subscribers in India, mobile banking has tremendous potential for spreading banking and financial services to rural and semi-urban areas and further economic empowerment of the financially excluded.

10. Inevitably, the fiscal policy had to respond commensurately and Government delivered three fiscal stimulus packages, as a result of which the fiscal deficit rose from 2.7 % of GDP in 2007-08 to 6.2 % of GDP in 2008-09 and is projected to rise to 6.8 % in 2009-10. But, this is not a cause for concern primarily because we need to look at fiscal deficit not in isolation but in conjunction with current account deficit. Thus, even though the fiscal deficit is 6.2 %, the current account deficit at 2.6 % is below 3 %, a level which is considered sustainable. The underlying idea is that current account deficit subsumes fiscal deficit in the sense that high fiscal deficit essentially connotes high public sector dis-saving which can be offset by private sector and house hold sector savings. It is significant in this context to note that Indian economy has been characterized by increasing domestic savings rate financing investment, with domestic savings rate reaching a high of about 38 % of GDP in financing investment of 39% of GDP in 2007-08.

11. Both the Government and the Reserve Bank of India responded to the challenge in close coordination and consultation. The main plank of the government response was fiscal stimulus while the Reserve Bank's action comprised well-calibrated timely monetary accommodation and counter-cyclical regulatory measures. But, not without reasons, concerns have been voiced and, legitimately so, whether going forward the externalities of the global financial crisis will lead to going slow on the financial sector reforms agenda in India. These concerns essentially owe themselves to the ongoing debate in the West where it is apprehended that the pendulum may swing from lax and liberal

regulation to policy backlash and regulatory over-kill. But I may assure that we in India have no reason to be defensive about our commitment to, and pursuit of, the financial sector reforms agenda for the simple reason that crisis, or no crisis, we have, in India, been able to deliver credible and effective regulation and supervision of the financial system. Besides, it is noteworthy that there is just no conflict between financial sector reforms and regulation and supervision; rather there is confluence between the two as effective and credible regulation and supervision is the ultimate guarantee of sustainable financial sector reforms. The fact remains that the Indian banking and financial sector is very well regulated and well-capitalized and has demonstrably proved resilient to the recent global financial tsunami as reflected in the following key parameters: Total Assets: USD 1 trillion, CRAR: 13.18 %, ROA: 1.03%; Gross NPA: 2.41%, Net NPA: 1.12 %, NIM: 2.44 %, Liquid Assets to Total Assets: 33 %. Indeed, as the Committee on Financial Sector Assessment (CFSA) has pointed out, Indian banking sector has scored very high on another critical parameter of duration of equity in as much as this parameter declined from the high of 14 years in March 2006 to 12 years in 2007 to 8 years in 2008 and 2009. In other words, the interest rate risk inherent in the banking system as a whole got nearly halved. However, again according to the Report of CFSA, there has been an increasing reliance of the banking system on `purchased`, as opposed to `stored`, liquidity. Although this may have since improved but needs to improve further going forward.

12. Last but not the least, I would like to take the present opportunity to give sage advice to business and industry as regards prudent use of derivatives. As this distinguished and august audience is well aware, there have reportedly been massive derivatives-related losses incurred by business and industry in India. These losses arose primarily because derivatives were used by business and industry not for hedging but for speculative purposes. The touch-stone that business and industry can use with profit is that any derivatives strategy which promises reduction, or elimination, of hedging cost, or promises enhancing income, is intrinsically speculative and the one that involves incurring hedging cost and promises no income enhancing is intrinsically a hedging strategy. As reported in the media, huge losses were sustained by business and industry on account of complex structured and synthetic, but so much less transparent, derivatives. In other words, business and industry must go in for plain vanilla derivatives which upfront transparently, and explicitly, disclose cost of hedging strategy rather than complex synthetic and structured derivatives which camouflage risk.

13. With these words I conclude my address and wish the Colloquium all success that it deserves and also wish each one of us `better banking` for sustainable and inclusive, economic growth, development and prosperity !

Thank you all so very much.

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