Emerging Trends in the Global Financial Landscape: India's Challenges and Opportunities [1]

Good morning Symbiosis. Dr. Rajani Gupte, Vice Chancellor, Symbiosis International University, Dr. Bhama Venkataramani, Director, Symbiosis Centre for Management Studies, Mr. Y.M Deosthalee, Chairman & MD, L&T Finance Holdings Ltd., Mr. Alexander K. Sattler, Financial Counsellor & Representative of the Deutsche Bundesbank, members of faculty, students, distinguished invitees and friends from media. It is a pleasure to be in your midst and inaugurate the Third International Conference on Emerging Trends in The Global Financial Landscape. Last seven years have been quite eventful and interesting for all and especially for the policy makers across economies. Crisis after crisis have tested existing policies, forced reorientation of many policies and led to adoption of unconventional policies. In short, the intensity of global financial crisis of the recent past has been such that the financial landscapes have undergone tectonic shifts. Against this background, I would begin with a brief review of the key developments that shape our global outlook at this point of time and the impact of such changes on India. I would briefly highlight the impact of major crises in the past vicennium and then touch upon the various dimensions of India's increasing linkages with the global financial landscape besides current state of external sector vulnerability. Finally, before summing up, I would briefly cover the issues related to foreign exchange reserves which act as the first line of defence when faced with external sector vulnerabilities and volatilities.

A. Global Outlook

Developed Economies

2. The IMF has projected[2] global growth in 2015-16 at 3.5 and 3.7 per cent. The projections are 0.3 per cent lower than what was projected in its World Economic Outlook in October 2014. The revisions reflect a reassessment of growth prospects in China, Russia, the Eurozone, Japan and some oil exporting countries. World trade volume and consumer prices in advanced economies are also projected to decline. The World Bank, in its Global Economic Prospects Report, January 2015, has reduced global growth projection for 2015 from 3.4 per cent to 3.0 per cent. Japan has come out of a technical recession but is still quite some distance away from the Bank of Japan's target of 2 per cent inflation. The Bank of Canada and the Reserve Bank of Australia have announced rate cuts in view of weak growth. Global growth, therefore, continues to be in a sluggish phase, which has been characterized as "*secular stagnation*" by Larry Summers[3]. The US offers the best prospects in the developed world but Eurozone continues to be a matter of concern even as the European Central Bank embarks on quantitative easing (QE) programme to fight deflation. Greece continues to trigger fears of a renewed Eurozone crisis though the European Finance Ministers appear to have reached an agreement to extend Greece's financial rescue plan for another four months. The possibility of a Grexit, however remote, may induce a chain of

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[2] IMF World Economic Outlook Update, January 2015

[3] U.S. Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound: Larry Summers

events which markets may not be prepared for. Ukraine and the Middle East are sources of geopolitical risks. Given the prospects in the US economy, the US dollar has strengthened against most currencies and, in particular, against the Euro, Canadian Dollar, Australian Dollar and the Japanese Yen. With a stronger US dollar and low oil prices, what is of interest is the policy course the US Federal Reserve is likely to pursue – when it will take the first step in a cycle of rate rise and, subsequently, at what pace will it tighten monetary conditions.

Emerging Market & Developing Economies

3. The recent update on the IMF World Economic Outlook projects that growth in Emerging Markets & Developing Economies (EMDEs) to remain broadly stable at 4.3 per cent in 2015 and to increase to 4.7 per cent in 2016 – a weaker pace than forecast in October 2014. Projection for growth of Indian economy was marginally revised downward from 6.4 per cent to 6.3 per cent. The World Bank, in its Global Economic Prospects Report (January 2015) has also cut down the growth projection of EMDEs from 5.2 per cent to 4.8 per cent for the year 2015. This is mainly attributed to lower growth in China, a much weaker outlook in Russia and downward revisions to potential growth in commodity exporting countries. Deceleration in growth in China has been well known. To an extent, slower growth is policy induced by the Chinese authorities as they aim to reduce vulnerabilities from rapid credit growth and make a transition from an investment-led economic model. What needs to be seen is whether China makes a soft landing and what are the implications for the rest of Asia. Any policy move by China to ease monetary policy will have ripple effect across the Asian region. As regards capital flows to the EMDEs, the Institute of International Finance (IIF) expects 2015 could be another stressful year for capital flows to emerging markets. Total EMDE inflows are projected to decline further, after a substantial drop last year, as the Federal Reserve starts to raise the policy rates and the EMDE growth remains lackluster. Flows during the year are again likely to be volatile, as markets are affected by shifting expectations of the Federal Reserve's policy trajectory, oil market uncertainty and political risks. Country differentiation, a subject eloquently brought out in Ruchir Sharma's book "*Breakout Nations: In Pursuit of the Next Economic Miracles*", will continue to remain a key theme for 2015. While many large EMDEs with well-known vulnerabilities have sought to strengthen their macro policy frameworks, and benefit from lower oil prices, analysis of past Federal Reserve tightening cycles suggests risks of heightened incidence of EMDE crises during the year ahead. There are fears that EMDE markets may be catapulted into currency, sovereign or banking crisis as years in which the Federal Reserve has tightened monetary policy usually have seen more market turmoil. While the EMDE capital flows could be affected, the key question is how sensitive are these to US rate rise. According to IIF's estimates a 0.5 per cent rise in rates, all other things being equal, will sap flows in EMDE by about 10 per cent or US$ 30 billion. This year could, however, be different as the European Central Bank and the Bank of Japan are both following ultra-accommodative monetary policies. This should soften the blow of a US rate rise.

4. What is of concern is the market's discounting of the Federal Reserve's own predictions for future rate rises. The disparity between what the Federal Reserve predicts about the path of rate rise and what the market expects it to do has been well known. A quicker and steeper than expected rate rise cycle in the US would have an impact on EMDE

capital flows. Throughout the past year, the VIX[4] has been averaging about 14.2, its lowest since 2006. The long term average has been 19.6. Any rise in the VIX could trigger a capital outflow from the EMDE.

Outlook on Oil Prices

5. The sharp decline in global oil prices has been well documented in the financial press. While the drop in prices was over 50 per cent since mid-2014, recent weeks have seen an uptick in prices. The up move of about 20 per cent has also been somewhat unexpected at a time when many analysts were expecting oil prices to fall further. The international oil price movement has been the subject of market speculation as well as academic research. Oil prices, as you are aware, reflect not only basic economic forces of demand and supply but also geo-political developments, technological advances in renewal energy, climate change and adoption of energy efficient technology.

6. Changes in production and consumption seem to fall short of a fully satisfactory explanation of the abrupt collapse in oil prices. While oil production has been close to expectations, consumption has been only a little less than earlier forecast. Most analysts seem to agree that daily demand for oil is short of average daily production of a little over 94 million barrels per day by just about 1.5 million barrels. The Bank for International Settlement (BIS), in a recent note[5] has said that the steepness of the price decline and very large day-to-day price changes are reminiscent of a financial asset. The Organization of the Petroleum Exporting Countries (OPEC) decision not to cut production, no doubt, has been a key factor in the fall in international crude price. But, as the BIS study shows, other factors could have exacerbated the fall in oil prices. One important factor could be the substantial increase in debt borne by the oil sector in recent years. Given high debt issued by oil producers, in expectation of high future oil prices, an unanticipated fall in oil price weakens the balance sheet of oil producers who are impelled to sell forward more of their production. Further, debt service commitments may induce producers to maintain production levels and delay production cuts, thereby keeping supply at a level higher than what demand may justify. It has also been noticed that swap dealers may have become less inclined to sell protection to oil producers during times of heightened volatility and balance sheet stress. More study is ofcourse needed to understand the oil price dynamics and its interactions with financial markets and macro-economic factors.

7. Oil producing countries, facing an oil shock of a different kind, are also beginning to review their national budgets which depend on oil revenue. The impact across countries has been asymmetric – most Gulf nations and Norway have built sufficient reserves in their sovereign wealth funds (SWFs). But some other high cost producers could be at risk if price continues to fall. In recent weeks, the trend seems to have reversed and, ironically, market analysts seem to welcome the move as the oil price equilibrium appears to be somewhat restored.

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4 VIX is a ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options. It represents one measure of the market's expectation of stock market volatility over the next 30 day period. The idea of a volatility index, and financial instruments based on such an index, was first developed and described by Prof. Menachem Brenner and Prof. Dan Galai in 1986.

[5] Note available at https://www.bis.org/statistics/gli/glibox_feb15.htm

B. India and the Global Financial Landscape

8. With that background, let me turn to the Indian context: Where is India placed in the global financial landscape? India is perhaps the only major economy where growth prospects have not been revised downwards. When its peers in the BRICS group seem to be following with China on a slowdown trajectory, Brazil staring at stagflation, Russia reeling under recession and South Africa facing declining growth, India is emerging as the leading light of the EMDEs. Political stability combined with strong commitment to fiscal and monetary discipline and economic reforms promise rapid growth. Given our advantages of demographic dividend and a large entrepreneurial class, India should be the destination for global capital if we take steps to address structural bottlenecks and enhance productivity of the economy.

The journey so far

9. Till the early 1980s, India's trade regime was autarkic with very high nominal import tariffs and also non-tariff barriers. From the late 1980s, the government began dismantling the import licensing system and simplifying the tariff structure moving towards a more open trade regime. The crisis year 1990-91 was a watershed year in Indian economic history: India faced an external payment crisis. Fundamental changes were carried out in industrial, trade, banking and exchange rate policies.

Current Account

10. Being a developing and energy deficient country, India's current account position has always been in deficit barring for a brief period in the beginning of the last decade. India's export performance has progressed commendably: exports have gone up from US$18.1 billion in 1990-91 to US$ 314 billion in 2013-2014. The composition of exports has shifted from labour intensive products (e.g., textiles) to capital intensive goods (e.g., engineering). India's trading partners have also changed with greater share of emerging markets. Export of services has also seen phenomenal growth increasing from US$ 4.6 billion in 1990-91 to US$ 151.5 billion in 2013-14. Concomitantly, merchandise imports also rose as India's economy grew and progressively got integrated with the global economy. Imports rose to US$ 450 billion in 2013-14 from US$ 24 billion in 1990-91. While there has been rise in energy related imports, such as, oil and coal, import of precious metals, particularly, gold also increased in the recent years. Notably, apart from the rise in domestic consumption, sharp increase in oil imports was partly due to rising POL exports as well. Overall, merchandise trade persistently remained in deficit. Invisibles, on the other hand, have been a support with private transfers/remittances being steady and consistent. India remains the largest recipient of officially recorded remittances in the world and received about US$ 70 billion in 2013, covering about 15 per cent of imports. As a result, current account deficit (CAD) generally remained range bound barring 2011-12 and 2012-13 when it shot up to 4.2 per cent and 4.8 per cent of the GDP respectively. From second quarter of 2013-14, CAD has steadily declined and has been well within the sustainable range. Looking at the recent trends, CAD increased to US$ 10.1 billion (2.1 per cent of GDP) in Q2 of 2014-15 from US$ 7.8 billion (1.7 per cent of GDP) in the preceding quarter and US$ 5.2 billion (1.2 per cent of GDP) in Q2 of 2013-14. The increase in CAD was primarily on account of higher trade deficit contributed by both a deceleration in export growth and increase in imports. With the steep fall in

international oil prices, CAD during the current year as a whole, however, is expected to be less than last year's figure of 1.7 per cent of GDP.

Capital Account

11. India depends upon capital flows to bridge the CAD. Foreign Direct Inflows (FDI) and portfolio investments constitute a major share of the flows. Debt flows, External Commercial Borrowings, in particular, have gone up substantially but, as a share of total capital flows, debt flows have declined from 80 per cent in 1990-91 to about 30 per cent in 2011-12. Total capital flows reached a peak of US$ 107 billion in 2007-08 but collapsed to about US$ 7.2 billion in 2008-09 indicating volatile nature of such capital flows. In the current fiscal year so far, India has witnessed a net inflow of about US$ 25 billion in the form of FDI and about US$ 36 billion as portfolio flows as against about US$ 21 billion and (-) US$ one billion respectively in the corresponding period of the last year. During 2014-15, capital flows would be more than adequate to finance CAD.

Impact of falling oil prices

12. The oil price fall has definitely been a boon to EMDE, especially countries like India which are energy import dependent. It acts like a fiscal stimulus and world consumption is expected to get a boost as consumers spend less on energy. The oil price decline is beneficial to India, as it results in lower inflation and gives comfort in budget and fiscal management. Crude oil import in 2013-14 was US$ 165 billion, about 36 per cent of the total import bill. In April-November 2014, it was US$ 90.3 billion, about 28.3 per cent of total import. According to some estimates, a US$ 10 a barrel fall in oil prices will reduce the country's import bill and, hence, the CAD by US$ 10 billion or 0.48 per cent of GDP. Another estimate indicates that 10 per cent reduction in crude oil prices will reduce Consumer Price Index-based inflation by around 20 basis points (bps) and bring about a 30 bps rise in GDP growth.

13. This provides an ideal setting to bring the current account back to health on a sustained basis and as also work on fiscal consolidation. This is too valuable an opportunity for us to miss. The oil price decline beyond the US$ 70-75 level has, however, given rise to unexpected consequences. Is the fall in oil prices unambiguously good for the world economy? Oil producers have been cutting back on future investments. This implies cutting back on jobs in the oil and gas industry as well as support services. Energy stocks have suffered losses. The fall in oil price seems to be the single most factor important behind falling inflation in most economies. The fear of deflation grips central banks as consumption could decline and real burden of debt will go up if inflation were to turn negative or remain low for a long period of time. For India, the negative could be in terms of lower remittances and capital flows from the affected countries.

C. Major Crises in the Past Vicennium

14. The major crisis faced by India in the past are Asian Financial Crisis in 1997, LTCM & Russian default in 1998, Dotcom Crisis in 2000, Subprime Crisis in 2007, European Sovereign Debt Crisis in 2011 and Fed Reserve announcement of tapering in 2013. Talking

of the crises, Dr. D Subbarao, former Governor, Reserve Bank of India[6] had said "*... in matters of economics and finance, history repeats itself, not because it is an inherent trait of history, but because we don't learn from history and let the repeat occur."* Hence, it is imperative for EMDEs like India to internalize past crises and take effective steps to safeguard against future shocks.

Impact of crises on India

15. These crises impact India in various ways. Firstly, increased volatility in the exchange rate and equity markets could lead to depletion of foreign exchange reserves, weakness in the economy, increasing threat of rating downgrades, diminishing investor confidence and volatility in capital flows. Second, Balance of Payment (BoP) parameters come under stress due to moderation in growth of major trading partners and commodity price volatility impacts macro-economic parameters, such as, inflation and fiscal deficit. Third, corporates are unable to raise foreign capital which imports financial problems from off-shore to on-shore and unhedged foreign currency exposures translate into on-balance sheet concerns impacting the credit worthiness of the corporates. Fourth, financial institutions experience difficulties in accessing international financial markets. Fifth, monetary policies of developed countries tend to impact macro-economic parameters of the country, e.g., recent experience of announcement of tapering of asset purchase of the Federal Reserve. On May 22, 2013, Chairman Ben Bernanke first spoke of the possibility of the tapering of Fed's purchases of securities. This and subsequent statements collectively known as '*tapering talk*', had a sharp negative impact on the emerging markets. Around the period, domestic concerns pertaining to high CAD, moderation in growth, high fiscal deficit, high inflation and policy uncertainty were some of the major concerns for foreign investors.

16. The impact of announcement of tapering and domestic concerns was evident in the form of tightening of liquidity and higher volatility in all market segments along with sharp decline in stock prices. For example, during the period May 22, 2013 & August 30, 2013, the Indian Rupee depreciated 15.5 per cent against the US Dollar, as against depreciation of 6.04 per cent of Russian Rouble, 6.88 per cent of South African Rand and 14.08 per cent of Brazilian Real. Equity markets declined with Sensex declining from closing of 20,062 on May 22, 2013 to 18,620 on August 30, 2013. Portfolio capital inflows which were buoyant till the third week of May 2013 began retreating as US yield hardened and yield spread narrowed significantly.

Policy measures taken to curb volatilities

17. Reserve Bank had stepped in to curb excessive volatility in the foreign exchange market and responded by increasing the short term interest rates and by tightening the Rupee liquidity in the system. Special swap window was opened for public sector oil marketing companies for meeting crude oil related dollar demand. Banks mobilized about US$ 34 billion under FCNR (B) scheme and Offshore Foreign Currency Borrowings for augmenting the foreign exchange reserves of the country. To ease pressures on rising CAD and discourage import of gold, quantitative and other restrictions were placed on gold imports in consultation with the Government of India. To further encourage longer term foreign

[6] Remarks by Dr. Duvvuri Subbarao at the release of Reserve Bank of India's History Volume IV by the then Prime Minister Dr. Manmohan Singh in New Delhi on August 17, 2013.

currency inflows, the external commercial borrowing mechanism was rationalized & liberalized and limits for foreign investment in G-Sec were streamlined and increased coupled with relaxation in FDI caps in some sectors.

D. The Seven Coupling Channels

18. It is relevant to note that the Indian economy is now more interlinked with the world economy than before; global developments have considerable influence on different segments of domestic economy through various channels. With growing globalization and integration with global economies, the spillover impacts can be felt through the following seven channels (or the 7Cs) - Commerce, Capital Flows, Commodity prices, Confidence, Carry Trades, Contamination and Central Banks' action & communication channels.

Commerce Channel

19. For India, with its persistent CAD problem lower and sustainable level of CAD is very important having far reaching implications on the policy making processes and also on the way international institutions and investors view us. The earnings from export do provide cushion in the balance of payments, aids in flexibility to import goods that are critical for our development besides positive spillover effects on the domestic economy in terms of improvements in quality and productivity.

20. Export sector faces a number of challenges, notable amongst them, are uncertain global demand. The challenge is to search for new markets and new products for existing markets. Whether our newly found export destination countries would remain insulated from the global financial crisis? India's trade performance had improved significantly in 2013-14 led by a modest growth in exports and compression in imports. While exports grew on the back of stronger global demand and a more competitive Rupee in 2013-14, contraction in imports was driven by decline in gold and non-oil non-gold imports. Exports have grown by 2.44 per cent for the period April-January 2014-15 to US$ 265.03 billion from US$ 258.72 billion last year. Over the same period, imports have grown by 2.17 per cent from US$ 375.25 billion to US$ 383.41 billion. The trade deficit is marginally higher during April-January 2014-15 over the previous year.

21. With the slump in international crude prices taking its toll on exports of petroleum products, and non-oil export growth also decelerating sharply, merchandise exports shrank in Q3 of 2014-15 after two consecutive quarters of growth. Export performance has been hamstrung by weak global demand conditions and the persisting fall in unit value realisations. The real appreciation of the Rupee may also have had some effect. The fall in international crude prices translated into a sizable saving on account of POL imports, despite a pick-up in import volumes in Q3. Gold imports also moderated, coming off the seasonal cum pent-up demand spurt in September-November. On the other hand, non-oil non-gold import growth remained firm and in positive territory, extending a run that began in May. Although overall imports declined in December, they recorded an expansion for Q3 as a whole on the back of the earlier rise in gold and non-oil non-gold items. As a consequence, the trade deficit widened in Q3 relative to the preceding quarter. The estimate of the CAD for 2014-15 is currently placed at lower than previous year's figure. The CAD has been comfortably

financed by net capital inflows, mainly in the form of buoyant portfolio flows but also supported by foreign direct investment inflows and external commercial borrowings.

Capital Flow Channel

22. Economies in emerging markets have been integrating with the global economy at a rapid pace. Integration is driven by current and capital account flows. Investors of capital are loyal only to assets and markets that promise the highest risk adjusted return. There is always a tendency to retrace quickly when the risk-reward equation changes. Despite a high domestic savings rate, India needs to import capital from abroad to support the second highest growth rate in the world. The current account has been opened though gradually over the last two and half decades. A more calibrated approach has been adopted towards fuller capital account convertibility and for promoting capital inflows. Foreign direct investments are permitted with an exception of a few sectoral caps in most of the sectors. Portfolio investments in G-sec and corporate bonds are subjected to macro ceilings which are subjected to modulation with evolving scenario. In debt flows, certain restrictions remain including the overall quantum of external commercial borrowings, cost ceilings, end-use restriction with focus on capex except a small window for general corporate purposes. As far as financing of CAD is concerned, net capital inflows are expected to be more than adequate in 2014-15.

Commodity Price Channel

23. Many EMDEs are dependent on import of commodities critical for their economic development. The prices of these commodities are often characterized by huge volatilities. In the Indian context, the largest contributor to CAD is oil imports and price of petroleum products is an important factor to reckon with as also its inflationary impact. As our economy grows, reliance on petroleum products has increased significantly and the increased demand has to be met by higher imports. Last fiscal, India imported about US$ 150 billion worth of crude which constitutes about 75 per cent of the total annual crude consumption. Thus, spillover impact of price volatility of commodity like oil has huge impact on EMDEs like India.

Confidence Channel

24. The impact of uncertainties of global financial conditions is evident through confidence channel. The first market segment in India to be affected is the equity market. Of all markets in India, equity is most accessible to foreign capital. For example, as per one estimate, as of December 2014, foreign portfolio investors (FPIs) held 23 per cent of the market capitalization and 47 per cent of the floating stock in the equity segment. Despite limits on investments FPIs have also shown keen interest in taking exposure in debt securities for higher returns. This could prove to be a major source of vulnerability. Global risk aversion triggered by the European debt crisis caused a large correction and rapid outflows from Indian equity, and more recently debt markets as was evident in the aftermath of taper talk in 2013. When international investors seek safe havens, the exchange rate markets are the next market to be impacted. Equity and debt market correction is compounded by capital outflows through demand for foreign currency. A downward spiral can ensue; thus, threatening overall financial stability.

25. Transmission of impact of global crisis is accentuated with domestic vulnerabilities. The impact of May 2013 announcement of the Fed Reserve was more pronounced due to domestic vulnerabilities. The CAD had increased from about one per cent of GDP in 2006 to nearly five per cent in 2013, real exchange rate had appreciated, fiscal deficit and inflation had gone up. The economy had slowed down although the level of foreign reserves was considered comfortable.

26. The confidence channel is also influenced by the credit rating action and outlook. Any adverse move by international credit rating agencies affects the borrowing costs of the corporates. It also affects capital flows and the exchange rate. Any resultant reversal in capital flows would lead to fall in asset prices and volatility.

Carry Trade Channel

27. The "carry trade" is the most popular trading strategy in currency markets. Traders borrow in currencies with low interest rates and invest in currencies with high interest rates profiting from the margin. Prior to the global financial crisis, carry trades in Yen and commodity currencies were common. In the recent past, with accommodative monetary policies and near zero interest environments in developed economies, currencies of EMEs have emerged as avenues of carry trade. The problem with currency carry trades is that they are inherently unstable. The initial buying of the high yielding currency has the perverse effect of pushing the currency higher, giving the impression of unidirectional bias and complicating policy for the country as the overvalued exchange rate dents the country's export competitiveness. In the event of unwinding of carry trades, which is generally sudden and vicious as, the leveraged positions head for the exit at the same time causing reversal of flows and depreciation of domestic currency. In the recent past, Reserve Bank had noticed trends of volatile FPI flows in the short-term debt market which were impacting the foreign exchange markets as well. In view of volatile FPI flows in the short term government securities market, the Reserve Bank restricted FPI investments in dated government securities earlier and corporate bonds recently to securities having residual maturity of three year or above. The objective was two-fold (a) containing the interest rate and exchange rate volatility and (b) developing the debt market by attracting long-term stable investments.

Contamination Channel

28. In 2013, the Rupee had experienced huge quantum of volatility primarily due to the external factors and fall in the risk appetite of the external investors. Following indications of QE tapering by the Federal Reserve on May 22, 2013 and growing concerns about high CAD, exchange rate depreciated sharply by about 15 per cent to Rs 63.75 in September 2013 over March 2013, touching an all-time low of Rs. 68.85 against dollar as on August 28, 2013. Subsequent policy actions undertaken both by the Reserve Bank and the Government, however, augured well for Rupee stabilization as it gradually appreciated to Rs 60.10 by end-March 2014. For Q2 2014-15 as a whole the Rupee depreciated against the US dollar *albeit* with some appreciating bias during the second week of August to first week of September 2014. During periods of higher volatility, Indian firms get affected by such sharp currency movements by way of transaction, translation and economic exposures with serious implications for their bottom line and future business capabilities.

29. Large scale reliance on borrowings abroad in foreign currency by Indian corporates entails huge interest rate and exchange rate risks. The not-so-happy experience of redemption of foreign currency convertible bonds (FCCBs) highlights the risk for the corporates in issuing such foreign currency bonds on the uncertain premise of ever increasing equity prices. Large unhedged forex exposure of corporate is not only a potential threat to the balance sheets of the corporates but also to financial stability. Reserve Bank has been highlighting the need for sound risk management culture of our corporates. Reserve Bank has have been cautioning participants from taking too many bets in one direction. It is essential for the banks to rigorously evaluate unhedged exposures of the clients by adequately pricing in the risk premia. In the last few years, Indian corporates have gone for establishment/acquisition of overseas companies, often at the cost of their capability to meet the domestic business needs and without proper assessment of the risk-return trade-off. When global situation turned stressful, the viability of these overseas entities impact domestic balance sheets. As a result, there have been disinvestments at large losses.

Central Banks' Actions & Communication Channel

30. Central bank actions in the developed economies have an impact on emerging markets. These spillovers have been the subject of debates in academic and policy forums. Monetary policy actions pass through interest rate, exchange rate, capital flow and the asset price channels. The large scale asset purchase programme of the Federal Reserve depressed the yields on US fixed income securities and the value of the US dollar until recently. QE announcements by the Bank of Japan and the European Central Bank may also have similar consequences though the magnitude could be different. The Swedish Riksbank's announcement of a negative repo rate and its decision to purchase SEK 10 billion of government bonds and the sudden move of the Swiss National Bank to abandon the EUR-CHF floor had sent the financial markets into a tizzy. As the interest rate differential between the developed economies and the emerging markets widens, more capital flows into EMDEs in search of yield. But when easy monetary policy is sought to be reversed, emerging markets face a "sudden stop" or even a reversal in capital flows as witnessed in the summer of 2013. EMDEs need to be prepared for a rapid rise or fall in asset prices and exchange rate volatility arising from policy action of dominant economies. True, every central bank is bound by its own mandate for domestic policy imperatives but there are unintended spillovers that impact other economies, which Governor Rajan has been highlighting in different international fora. Fortunately, the spillover effect is beginning to be recognized now. In its latest monetary policy statement, the Federal Reserve has stated that their assessment of economic conditions will take into account a wide range of information, including international developments. The President of the European Central Bank, too, acknowledged this when he said that the European Central Bank was keeping an eye on risks stemming from volatility in emerging markets.

31. Post 2008 global financial crisis, central banks have sought to enhance transparency in their policy thinking and action through communication. 'Forward Guidance' is now a part of monetary policy tools of many central banks. There has been a sea change in the way central banks view the role of communications in monetary policy (Paul Jenkins, 2001[7]). The

[7] Communicating Canadian monetary policy: towards greater transparency: Paul Jenkins, Deputy Governor, Bank of Canada, May 2001

challenge in central bank communication lies in how best they communicate in a language that provides clarity and not further confusion to the public discourse. The Federal Reserve, in its last couple of meetings of 2014, had indicated that it would be "patient" before raising the interest rates. This was seen as a way of preparing the markets for gradual reversal of low-interest rate and accommodative cycle and prevent sudden-shocks in the markets. The markets are, however, divided in their interpretation of the term "patient" and its qualification or elimination in the minutes of the next meeting. In other words, forward guidance is emerging as a challenge for the central banks viz-a-viz the markets as has been experienced by the Bank of England and now possibly, by the Federal Reserve. Thus, the communication of policy stance by the Central Banks of the advanced economies can be a cause of market volatilities and may have spillover impact on EMDEs like India.

E. India's External Sector Vulnerabilities

32. Let me now briefly touch upon India's external sector vulnerabilities now vis-à-vis the 1990-91 when the BoP crisis led to paradigm shift in our macro-economic policy framework. Between 1990-91 and now, trade deficit has deteriorated peaking at 4.8 at end-March 2013 but has recovered sharply to 1.7 as at end-March 2014; expectation is that for the year ending March 2015 similar range of lower CAD. Invisibles have been very steady and have lent support to the current account. Capital flows have not only financed CAD but have also added to our reserves. India's net IIP is (-) US$ 346 billion, up from (-) US$ 313 billion last year. Commercial debt is a dominant share of external debt as Official Development Assistance (ODA) has declined in recent years. The debt service ratio (repayments and interest as a proportion to current receipts) has also gone up from 5.9 per cent in March 2013 to 7.5 per cent in September 2014. Though some vulnerability parameters show some deterioration, we are much better placed now than in 1990-91 (Table). The external sector is, thus, in much better shape, and the country better cushioned against external shocks, than what it was in 1990-91.

Table: India's external vulnerability indicators (as at end March)

Indicators	1991	2001	2011	2014	2014*
1. External Debt to GDP ratio (%)	28.7	22.5	18.2	23.5	23.2
2. Ratio of Short-term to Total Debt (original maturity) (%)	10.2	3.6	20.4	20.2	18.9
3. Ratio of Short-term to Total Debt (residual maturity) (%)	15.8	10.3	40.6	39.6	NA
4. Ratio of Concessional Debt to Total Debt (%)	45.9	35.4	14.9	10.5	9.8
5. Ratio of Reserves to Total Debt (%)	7	41.7	95.9	68.8	68.9
6. Ratio of Short-term Debt to Reserves (%)	146.5	8.6	21.3	29.3	27.5
7. Ratio of Short-term Debt (residual maturity) to Reserves (%)	227	24.6	42.3	57.4	NA
8. Reserves Cover of Imports (in months)	2.5	8.8	9.5	7.8	8.1
9. Debt Service Ratio (%)	35.3	16.6	4.4	5.9	7.5
10. External Debt (US$ billion)	83.8	101.3	317.9	442.2	455.9
11. Net International Investment Position (IIP) (US$ billion)	-	-76.2	-207.0	-332.7	-353.7
12. IIP/GDP ratio*(%)	-	-16.5	-12.1	-17.7	-17.8
13. CAD/GDP ratio	3	0.6	2.8	1.7	2.0

(* end September 2014)

F. Foreign Exchange Reserves: the First Line of Defence

33. Foreign exchange reserve forms the first line of defence to calm volatility in the forex markets and provide adequate liquidity for “sudden stop” or reversals in the capital flows. Bilateral and multilateral safety nets are also helpful. One response to the global financial crisis was signing of bilateral swap agreements by the Federal Reserve with select central banks. Availability and adequacies of such bilateral/multilateral backstop arrangements is not an easy option during crisis times. The Asian crisis triggered a realization that large reserves are needed to face a crisis as a self-insurance policy.

34. Since 1991, the level of foreign exchange reserves has steadily increased from US$ 5.8 billion to about US$ 333 billion, an all-time high. India’s foreign exchange reserves are the end consequence of current account and capital account dynamics. Most of India’s foreign exchange reserves are held by the Reserve Bank of India principally foreign currency assets and gold, SDR allocation and Reserve Tranche Position in the IMF are held by the Government.

Major aspects of reserve management

35. Reserves are held essentially to instill confidence in the markets and investors, act as an insurance during periods of crisis and provide pool of resources for meeting the intervention needs during periods of extreme volatility and manage BoP mismatches. Reserve management is essentially the art of maintaining adequate liquidity, when required, ensuring safety of capital and generating reasonable returns under what is popularly known as the Safety, Liquidity & Return (SLR) framework. It, therefore, revolves around decisions involving trade-off between risk and return. The prolonged low interest environment, post the global financial crisis, has substantially affected the return on reserves, which in 2013-14 was 1.21 per cent. This has led to suggestions on the need to enhance returns by either diversification into non-traditional asset classes and currencies. Such strategies, however, have their own share of risks. For example, during phases of market turmoil, safe haven flows may result in losses in investments made in EMDE’s currencies and assets. The higher expected returns on non-traditional assets could be wiped out during periods of market turmoil.

36. We should also remember that holding reserves has a cost. This cost has a quasi-fiscal implication as the cost of sterilization is either borne by the Government or by the central bank itself. There are different approaches to measure the cost of maintaining reserves. The most common approach is to measure it as the opportunity cost of investment in domestic securities. It can also be looked at as cost-of-carry, being the difference between the cost of capital borrowed from outside minus the return on reserves. The cost of reserves, however, should be weighed against the benefits, such as, providing a stable exchange rate regime by smoothening extreme volatility. A stable exchange rate regime benefits market participants as it reduces uncertainty and hedging costs. But the benefits of adequate reserves are not easily quantifiable whereas the costs are more explicit. Therefore, any cost-benefit approach to reserve adequacy involves a judicious assessment of the risks of an economy that is on a path towards a more open capital account.

Adequacy of reserves

37. Traditional metrics of adequacy are import cover, ratio of short term debt/volatile capital flows to reserves and ratio of reserves to broad money. In the Indian context, import cover increased to 8.1 months as at end September 2014 from 6.6 months at end September 2013. Ratio of CAD to foreign exchange reserves has improved from 30.1 during 2012-13 to 10.6 in 2013-14.The ratio stood at 166.0 in 1990-91. Ratio of short-term debt to the foreign exchange reserves, declined from 34.2 per cent as at end September 2013 to 27.5 per cent as at end September 2014. Ratio of volatile capital flows (defined to include cumulative portfolio inflows and short-term debt) to the reserves declined from 97.2 per cent as at end September 2013 to 94.7 per cent as at end September 2014. India's net IIP has, however, been negative for a long time and has deteriorated from US$ 326 billion in March 2013 to US$ 353 billion in September 2014. Therefore, while some metrics indicate improvement in some aspects of our external sector vulnerabilities, there is no room for complacency as India is basically a current account deficit economy with large dependence on foreign capital flows which are susceptible to periodic phases of sudden stops and/or reversals.

G. The Challenges Ahead

38. The existing benign global economic environment could see some volatility in 2015, when some reversal of global liquidity, particularly, through the action of the Federal Reserve is likely. Reversal of monetary policy stance by the Federal Reserve is likely to be cushioned by continuance of easy policy of other major central banks. China's exchange rate policy in the context of ongoing slowdown also presents an external risk to Asian currencies including the Rupee. As economic slack diminishes with recovery in the domestic economy, the upturn in the investment cycle will require higher non-oil non-gold imports. Easing of norms for gold imports could lead to a widening of CAD in 2014-15. Even though international crude oil prices are projected to stay low as price war intensifies, the re-emergence of geopolitical risks, particularly in Middle-East and Ukraine, may keep oil prices relatively firm and thus may have implications for India's oil import bill. This may pose upward risks to India's CAD. Further, notwithstanding a modest recovery in exports and adjustment of the Rupee exchange rate in 2013-14, there are downside risks to exports due to uncertainty about the global growth outlook

39. Lower CAD, surge in foreign exchange reserves and exchange rate stability are signs of a more resilient external sector. Improvements in external sector indicators, however, do not warrant any policy complacency. Spillovers from renewed external pressures through the seven channels mentioned earlier may resurface and thus pose a challenge for India's external sector. External sector strength is a function of global developments, fiscal & monetary actions of advanced economies as well as domestic economy and policies. Given our limited role in influencing the global developments, the policy focus has to be on improving domestic macroeconomic fundamentals so as to minimize the impact of such spillovers. In particular, policy attention is required for redressal of sector-specific structural issues that affect growth, inflation, CAD, fiscal deficit and overall competitiveness of the economy, a conducive business environment to ensure a better mix of capital flows will focus on stable non-debt creating flows and improved governance. What gives confidence to India

watchers within & outside the country is that significant steps are being taken in the policy and execution space of the country.

H. Summing up

40. Financial crisis, as a phenomenon, has been recurring at frequent intervals – every crisis is new but the impact is, in many ways, similar. For India, external sector vulnerabilities are relatively lower than in the past but adverse spillovers of global macro-economic and geo-political developments on the domestic sector cannot be ruled out. Hence, it is necessary to remain focused on the structural and cyclical challenges arising through the 7C channels in the context of our increasing inter-linkages with the global financial landscape. Foreign exchange reserves act as a first line of defence but acquisition and holding of reserves has its own costs and challenges. While reserves provide us cushion to meet unforeseen market developments in the short run it is sound macro-economic management that is the best insurance in the long run. One takes heart from the fact that inspite of uncertain global environment, India is much better positioned now than before to seize what The Economist in its latest issue (February 21, 2015) calls " *a rare opportunity to become world's most dynamic big economy"*

Thank you all for a patient hearing.

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