

Turmoil in Global Economy: The Indian Perspective



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**All India Conference- 2012
“Waves of Change: Ocean of Opportunities”
The Institute of Chartered Accountants of India
Saturday, August 18, 2012
Bhubaneswar**

Challenges facing global economy

Global growth considerably weaker

- * Moderation in growth outlook for advanced and developing nations
 - * World Bank projects global GDP to increase 2.5 per cent, 3.0 per cent and 3.3 per cent in 2012, 2013 and 2014 respectively.
 - * IMF projects global growth at 3.5 per cent in 2012
 - * Likely to be worst year since global financial crisis (GFC) of 2008-09
- * Spillover from European sovereign debt crisis
 - * All major EMEs to be affected

Challenges facing global economy

Unemployment problems

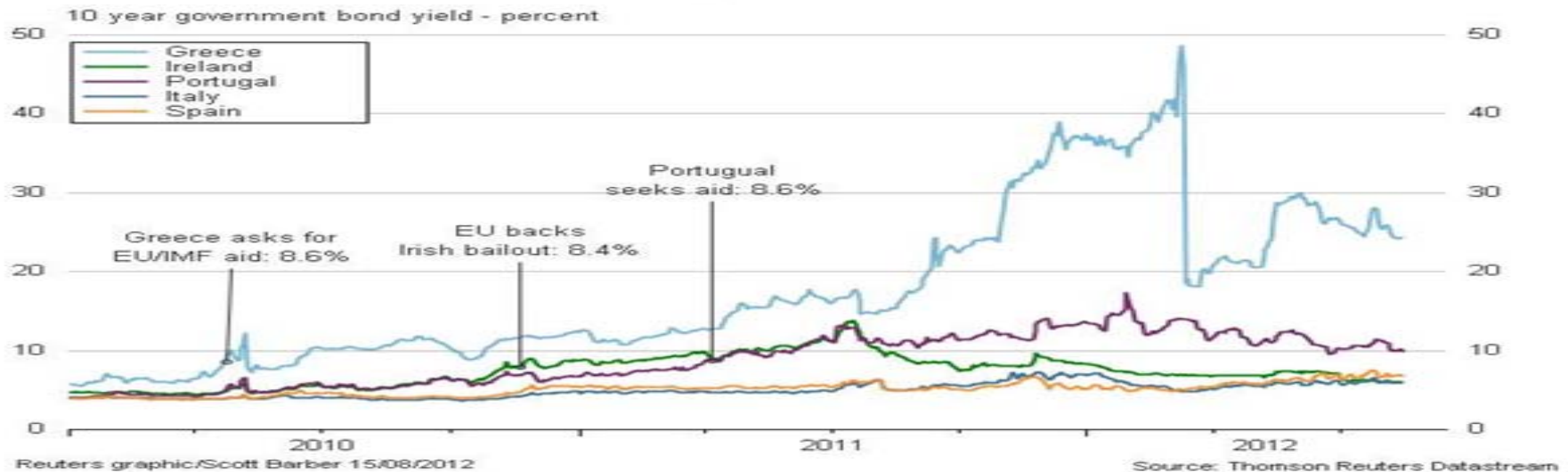
- * High unemployment in the advanced countries (e.g. US & UK above 8%, Spain is about 25%)
- * Any recovery in Europe and US not accompanied with higher employment may not be sustainable

Global inflation prospects

- * Weak demand conditions calls for benign expectations
- * Long term bond yields too do not portend higher future inflation
- * US drought, however, is a key risk for food inflation

European Sovereign Debt Crisis

- * Originated in Greece, moved to other “peripheral sovereigns” (PIIGS) and now is threatening the “core countries”
- * 10 year government bonds in Italy and Spain are trading at about 5.8% and 6.7% respectively.
- * High cost of borrowing is unsustainable over a long period of time



- * Crisis has moved from sovereigns to banks and now threatens regional governments which are seeking bailouts (eg. Catalonia, Valencia in Spain)

US Fiscal Cliff and Chinese Slowdown

- * Risk of government spending in US abruptly falling on inability of US Congress to pass budget
 - * Could cause substantial decline in growth as government spending is keeping economy in positive territory
- * US Debt ceiling needs to be revised higher amid plans to return to long term fiscal prudence.
- * Asia and China in particular is slowing down too
- * Growth during the recent quarter in China was the lowest in three years.
 - * Fall in investment and export demand have contributed to growth slowdown.

Accounting Issues Emerging from Global Financial Crisis (GFC)

- * Widespread criticism that certain accounting standards and auditing practices either contributed to or exacerbated the severity of the GFC
- * Failure to deal with illiquid markets and distressed sales
- * Issues from GFC
 - * **Procylicity:** Certain aspects of accounting frameworks tend to amplify business cycles, affecting both the credit expansions and contractions
 - * **Disclosure:** Weaknesses in public disclosures by financial institutions damaged market confidence. Public disclosures were inadequate and unclear of risks associated with their on- and off-balance sheet items.
 - * **Recognition of impairment:** Loan loss provisions were based on an incurred loss approach rather than approaches that consider expected losses. This resulted in the level of provisions being “Too little Too late” in case of many banking institutions.

The World is a Village - An Interlinked One

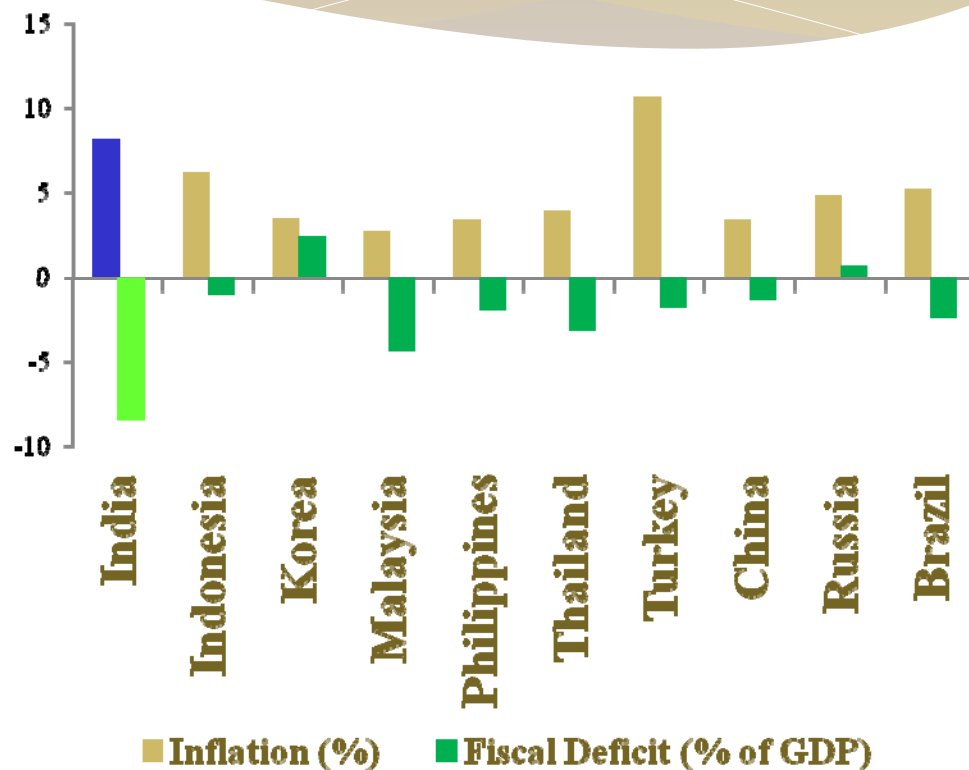
- * Globalization – double edged instrument
 - * It has both benefits & costs
- * India has benefited from greater integration with world economy and global financial markets
- * Belief in some quarters that India and EMEs in Asia had ‘decoupled’ and could grow indefinitely - GFC proved that it was a myth
- * Globalisation has extracted its costs now
- * European debt crisis and global slowdown are serious headwinds to our own recovery

Challenges for the Indian economy

- * Growth deceleration not accompanied by lower inflation
- * Outlook for growth lowered by almost all including RBI
- * Lower private consumption demand
- * Reserve Bank's estimates suggest trend growth (non-inflationary) has fallen to 7.5% from 8%.
- * Weak monsoon feeding into food inflation worries
- * Currency depreciation could lead to imported inflation
- * Already high fiscal deficit reduces maneuverability
- * India is an outlier in many respects, particularly with respect to high fiscal deficit and persistent high inflation.
- * Current account deficit at 4.2% in 2011-12 is above comfort levels

Domestic Fiscal Deficit – Facts

- * Large fiscal deficit and persistent inflation limits fiscal and monetary space for further stimulation.
- * The centre's gross fiscal deficit (GFD) higher at 5.8 per cent in 2011-12 against 4.9 per cent in 2010-11.
- * Subsidies to GDP ratio – budget proposed cap of 2%
- * Our peers seem to have better fiscal fundamentals than ours
- * Even our inflation is one of the highest among peers



Note: Inflation and fiscal deficit are IMF estimates for 2012
Source: IMF

Current Account Deficit

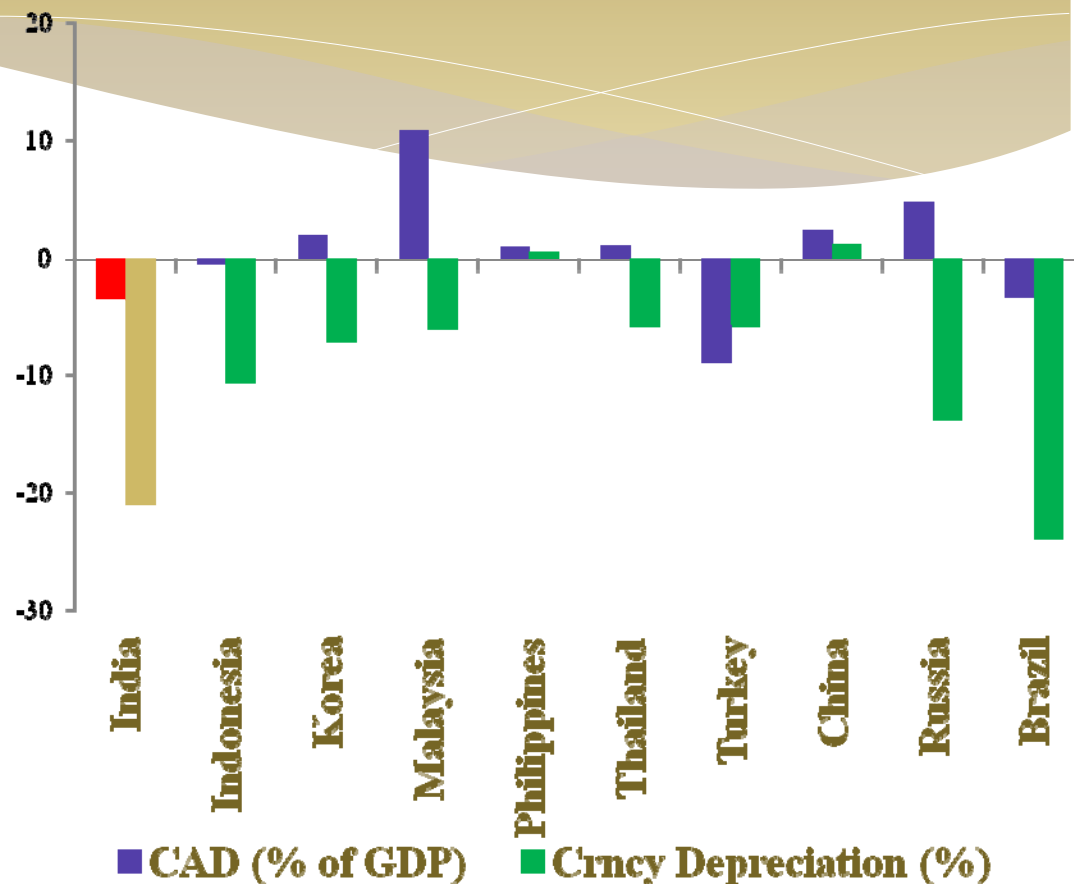
* Current Account Deficit (CAD) at 4.2% of GDP in 2011-12 is outside the comfort zone

* Currencies of countries with CAD have depreciated more in the last one year since the US sovereign rating downgrade

* India's CAD is high relative to its peers

* Indian currency has depreciated 20% (y-o-y)

* Broadly at the same rate vis-à-vis BRICS nations but higher than Asian economies



Note: Currency Depreciation is for the period 1 August 2011 until 13 August 2012, CAD is IMF estimate for 2012
 Source: IMF, Bloomberg

Impact of global developments on India

- * The current & evolving economic and financial system is a product of both domestic and external factors
- * Slowdown in India in 2008 was more due to global developments
- * Current slowdown is combination of global and domestic factors
- * Global developments have considerable direct and indirect influence on our economy and financial system through various channels - 7Cs



Commerce Channel - I

- * Global financial crisis and European sovereign debt situation has slowed the pace of global trade.
 - * IMF projects world trade growth at 3.8 per cent in 2012, down from 5.9 per cent in 2011. Indian exports declined 5.1 per cent this year (April-July) so far.
- * Services are a major contributor to Indian forex earnings
 - * Growth in services may fall due to global slowdown
- * Oil and gold together constitute a substantial portion of our trade deficit.
 - * May remain constant/increase due to their relatively inelastic character
 - * Both factors could worsen the CAD
 - * Moderation in gold imports has been witnessed recently

Commerce Channel – II

Steps taken

- * Substantial improvement in trade openness
- * Services, considered non-tradable, turned increasingly tradable mainly due to off-shoring led by rapid innovations in information technology
 - * Information Technology-enabled services (ITES) and Business Process Outsourcing (BPO)
- * Diversified list of trading partners
- * Diversified product basket
- * Lower tariff and non-tariff barriers
- * Increased coverage of Focus Market and Focus Product Schemes for exports
- * Interest Subvention
- * Improvements in Export Credit/Refinance Facilities

Trade Openness Indicators

Goods Exports	16.8
Goods Imports	27.1
Export & Imports of Goods	43.8
Goods & Services Exports	24.5
Goods & Services Imports	31.3
Export and Imports of Goods & Services	55.8
Remittances	3.6
Current Receipts	28.7
Current Payments	32.9
Current Receipts & Current Payments	61.5

Figures are for 2011-12 and as % of GDP

Commerce Channel - III

Opportunities

- * Export growth prospects in **3Es** - Engineering, Electricals and Electronics
- * Africa remains relatively untapped
- * Trade flows among the EMEs
 - * Reduction of reliance on the US and Europe
- * Invoicing in local currencies
 - * Bilateral and regional trade blocks

Challenges

- * Shrinking export markets on account of falling growth abroad
- * Controlling inflation and anchoring inflation expectations to improve competitiveness
- * Containment of volatility in the exchange rate
- * Reducing our reliance on commodity imports like oil and gas over time
- * Focusing on greater manufacturing capacities to expand exports further
- * Discouraging gold imports as they are unproductive diversion of savings

Commodity Prices - I

- * High reliance on commodity imports
 - * Oil (70% of demand) and gold (100% of demand)
 - * These imports are to a great extent inelastic
- * Demand-supply imbalance is propelling commodity prices into ever higher ranges – prices are sticky on the way down
- * Impact of higher commodity prices
 - * Expansion of CAD and
 - * Fuelling inflation expectations
- * Lower US agricultural output (US drought) could have implications for food inflation in India
- * Impact of financialisation of commodities needs more careful study and analysis
- * Monetary easing by central banks of advanced countries aids gold price rise

Commodity Prices - II

Opportunities

- * Increase domestic exploration (oil and gas)
- * Increase domestic agricultural production and productivity by optimally exploring 32 agro-climatic zones of the country

Challenges

- * Discouraging gold imports through financial education about alternate financial products
- * Containing the impact of exchange rate volatility
- * Moderating the impact of volatility of global prices
- * Containing the impact of high global prices on domestic macro-economy
- * Moderating the increasing trend for financialisation of commodities globally
- * Pass through of global oil prices for the domestic consumers

Capital Flows - I

- * India has benefited from growing integration of financial markets and the world economy
- * The savings-investment gap in India met through capital inflows
- * External stress is causing capital outflows/moderation in inflows making financing of CAD challenging
- * Deleveraging by European banks is affecting trade credit, infrastructure financing and ECBs of the Indian corporates
- * Determinants of capital flows
 - * Global Investor sentiment (Risk on – risk off)
 - * Investment climate in destination country
 - * Credit rating of the country

Capital Flows in India during the year so far (in US\$ millions)

Component	Period	2011-12	2012-13
Inward FDI	Apr.-Jun.	12,172	5,639
Outward FDI	Apr.-Jun.	3,132	1,805
FII's (net)	Apr-Aug.10	2,201	728
ADRs/GDRs	Apr.-Jul.	298	154
Ext assistance (net)	Apr.-Jun.	388	-120
ECB Approvals	Apr.-Jul.	12,215	9,169
ECB to India (net)	Apr.-Jul.	5,394	- 409
NRI Deposits (net)	Apr.-June	1,153	6,532
Forex reserves	August 10 th	316,605	289,170

Capital Flows - II

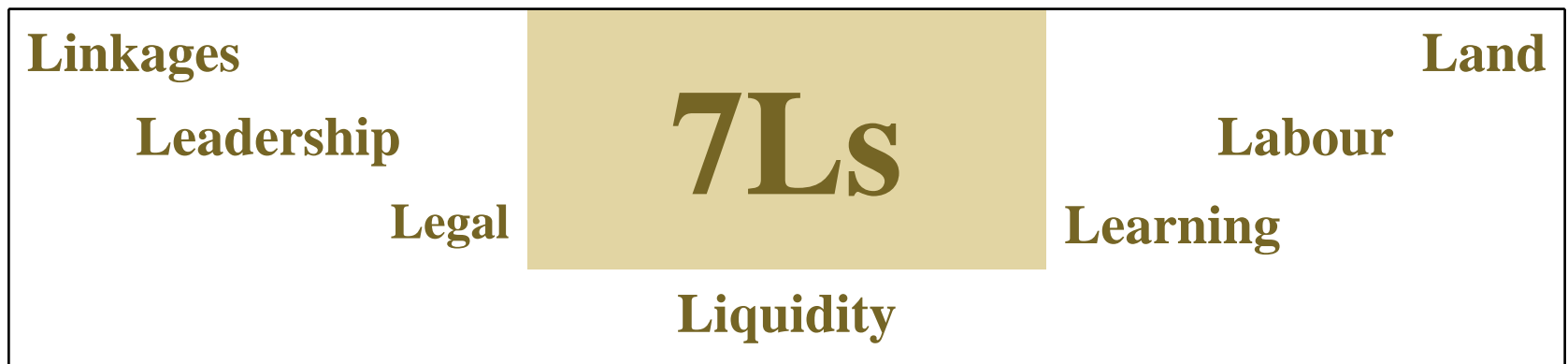
Steps taken

- * Rationalization of ECB norms and liberalization of NRI deposits facilities
- * Interest rate ceiling on FCNR(B) deposits raised and that on export credit in foreign currency deregulated
- * Facilitated greater NRI deposit flows
- * In 2011-12, NRI deposit flows witnessed a sharp rise of more than 200 per cent and stood at US\$ 11.9 billion as compared with an inflow of US\$ 3.2 billion in 2010-11
- * Improved remittances facilities for Indian expatriates
- * Calibrated enhancement in FII investment limits in bonds
- * The limit on investment in corporate bonds enhanced to USD 45 billion from USD 40 billion
- * New scheme of USD 1 (one) billion for QFIs for investment in corporate bonds
- * The limit on investment in G-sec enhanced to USD 20 billion from USD 15 billion
- * Long term investors like Sovereign Wealth Funds (SWFs), Multi-lateral agencies, endowment funds, insurance funds, pension funds and foreign Central Banks permitted to invest in Government securities

Capital Flows - III

Challenges

- * Avoiding excessive debt flows
- * Augmenting non-debt creating flows
- * Finding new sources of capital other than US and Europe based banks
- * Attracting capital flows despite general risk aversion
- * Improving the investment climate by addressing the problems of 7'L' deficits



Currency Rates - I

- * Integration of the Indian financial system and markets is leading to rupee increasingly getting affected by global currency rates
 - * Exchange rate is increasingly affected by currency movements abroad
 - * US\$/INR movements often mirrors EUR/US\$ changes
- * US dollar's 'Exorbitant Privilege'
 - * A significant amount of world trade is denominated in the US dollar
 - * During times of global risk aversion, capital flows back to the US
 - * The US dollar is the 'numeraire currency' of our reserves
- * Economic health of residents affected by developments in Europe, US, China, etc.

Currency Rates - II

Steps taken

- * Administrative measures to contain speculative pressure on Rupee
- * Intervention strategy to contain excessive volatility without targeting any level
- * Judiciously applied caps on banks' and corporates' ability to bring in or take out capital
- * Measures to attract capital flows to reduce supply-demand mismatch of USD
- * Permitted
 - * Trade invoicing in Indian Rupee and
 - * hedging of rupee exposures by non-residents
- * Swap arrangement with the SAARC countries

Currency Rates - III

Challenges

- * Containing CAD by expanding exports and moderating non-critical imports
- * Constant monitoring of the market and review of the strategic and tactical tools available for handling excessive exchange rate volatility
- * Increasing the use of local currencies in trade starting with the neighboring/emerging market countries
- * Nature and scope of forex market intervention by RBI
- * Need for intimate understanding of not just domestic factors but overseas developments in order to manage macro-economic variables like exchange rate

Contamination - I

- * The high levels of un-hedged external borrowings of Indian corporate sector exposes them to transaction, translation and economic risks from exchange rate movements
- * Recent sharp one-way movement has surprised most people
- * Use and abuse of complex forex derivatives
- * Indian banks and corporates used to rely mainly on European banks for such funding
- * European sovereign crisis and consequent deleveraging pressure on European banks has increased funding pressures for our entities
- * Rupee depreciation causes translation losses that need to be recognised on balance sheets in India
- * Increasing overseas operations of JV/WOS set up by Indian companies (Indian companies have invested over US \$ 100 billion abroad) in stressed countries could come under pressure requiring support from India

Contamination - II

Challenges

- *Containing excessive reliance on foreign borrowings
- *Monitoring and managing the risks of leveraged fund based and non-fund based overseas exposures through JV/WoS abroad
- *Adoption of sound risk management practices at home.
 - * Firms should focus on their core business rather than see forex as a profit centre
- *Addressing accounting issues
 - * Adoption of IFRS norms and hedge accounting

Contagion - I

- * Contagion or confidence channel arises from uncertainty in the minds of investors and other participants – due to both global and local factors
- * The impact of this channel manifests itself very quickly in the equity and foreign exchange market - falling equities and one-way movement of the rupee
- * Stock market sentiment often driven by FII activity (Risk on – Risk off)
- * Often the movements in one market reinforces movements in the other
- * Overall negative sentiments can quell investment plans of portfolio investors

Contagion - II

Steps taken

- * Call/money markets only for PDs/banks – not for NRs
- * Debt market insulated due to limited exposure of NRs
- * Intervention by RBI in currency markets to address excessive volatility
- * LAF borrowings and reduction of SLR
 - * Reduction of SLR expected to ensure that liquidity pressures do not constrain the flow of credit to the productive sectors of the economy
 - * Allowing banks to shift their portfolio in favour of the private sector

Challenges

- * Maintaining and improving confidence in India story – reduction in CAD & GFD, improvement in investment climate for both domestic and foreign investors
- * Maintaining foreign exchange reserve adequacy ratios
- * Monitoring of debt creating flows that increase external sector vulnerabilities
- * Realisation that financial sector solutions cannot address real sector problems

Credit Rating Channels - I

- * The outlook for India has been downgraded by a few Credit Rating Agencies (CRAs)
- * India's sovereign rating under "watchlist" due to
 - * Weak fiscal performance, uncertain investment environment, declining growth, governance issues
 - * CRAs have a 'one size fits all' approach
 - * Credibility of CRAs – are their standards poor?
 - * We have, however, limited choice
- * Changes in external ratings tend to affect
 - * Size or availability of capital flows in a significant manner – in either direction
 - * Cost of capital flows
- * Major rating agencies have sounded off warnings resulting in
 - * Difficulties faced by both banks and corporates in accessing overseas credit facilities (mainly ECBs)
 - * Some FIIs like pension funds, etc. have a minimum investment rating criteria for their bond investments
 - * India's rating at BBB⁻
 - * one notch downgrade will lead to 'junk status'
 - * Cross-currency studies reveal that downgrades cause depreciation of currencies and increases volatility

Credit Rating Channels - II

- * Large and diversified economy
 - * Large pool of educated workers and strong entrepreneurial class
- * India continues to be one of the fastest growing economies
- * Relatively high levels of domestic savings and investment rates
- * Public debt is largely held domestically in Rupees
- * Announced commitment for:
 - * Fiscal consolidation
 - * Capping subsidies to 2% of GDP
 - * Working towards more stable tax regime
 - * Improvement in supply side response for inflation control

Credit Rating Channels - III

Challenges

- * Meaningful and continuous engagement with CRAs
- * Improving governance – moving towards execution excellence
- * Removing bottlenecks in infrastructure projects in power, roads, ports & airports
 - * Easier regulatory regime in terms of approval for large projects
- * Reducing crowding out of private sector due to high fiscal deficit
- * Improving investment climate and quality capital expenditure by Government to crowd-in private investment.

Conclusions – I

- * Global growth has slowed and uncertainties have increased
- * Unemployment has remained high in advanced economies – lower global demand
- * Indian economy & financial system has a unique set of strengths and weaknesses
 - * Its resilience to overseas developments is being severely tested now
- * Domestic growth risks owing to
- * Global factors – 7 channels of influence (*Commerce, Commodity Prices, Capital Flows, Currency Rates, Contagion, Contamination, Credit Rating*)
- * Local factors
 - * High inflation
 - * Supply side response for persistent food inflation
 - * Fiscal deficit
 - * Monetary tightening
 - * Supply bottlenecks of internal inputs like coal and electricity
 - * Risk of deficient monsoon
 - * Lower business confidence
 - * Declining savings and investment rates³⁰

Conclusions – II

- * Domestic inflation risks owing to
 - * Structural/supply side pressures
 - * Wage pressures
 - * Incomplete pass through of oil prices
 - * Rupee depreciation in recent months
 - * Fiscal slippages
 - * Deficient monsoon

- * External inflation risk factors
 - * US drought
 - * Uncertainty in energy prices
 - * Monetary easing by advanced economy central banks

Conclusions – III

- * In general some of the challenges facing India are
 - * Addressing accounting issues arising out of GFC – Moving towards global convergence
 - * Falling demand for Indian exports and inelastic nature of our imports, mostly commodities with elevated prices
 - * Controlling inflation and inflation expectations
 - * Reviving infrastructure Spending
 - * Attracting foreign capital in the face of general risk aversion
 - * Containing knock-on effects of overseas developments on the exchange rate volatility
 - * Encouraging firms to follow good risk management practices for their forex exposures

Conclusions – IV

- * In the context of global slowdown and continuing uncertainty on which we have very little control, the need of the hour is addressing structural and cyclical impediments through
 - * appropriate domestic macro and micro-economic policies
 - * credible action for fiscal consolidation
 - * Tax reforms and predictability
 - * Inflation control and anchoring of inflation expectations - enhancing supply side responses
 - * Improving political and administrative framework for improving our **Doing Business Ranking**
 - * Today it is very low at 132 out of 183 countries (as surveyed by the World Bank)
 - * Addressing the ‘7L’ deficits (*Linkages, Leadership, Legal, Liquidity, Land, Labour and Learning*) for boosting investment climate for domestic and foreign investors

Conclusions – IV

A Final Thought....

“ God give us grace to accept with serenity things that can not be changed, courage to change the things which should be changed and the wisdom to distinguish the one from the other. ”

- Reinhold Neibuhr,
American Theologian and Public Affairs Commentator



Thank you