40th Annual Convention, Department of Business Economics, University of Delhi South Campus

October 7, 2013

Certain Uncertainties, Uncertain Certainties: India in an interconnected world

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Outline

- **Metrics of India's growing interconnectedness with the global economy**
  - challenges posed to the policy making due to the growing integration
- **Challenges following announcement of imminent tapering by the Federal Reserve Bank of the United States**
  - the Indian experience and
  - policy measures to counter the headwinds from the global economy
- **Way forward internationally and domestically to "embrace" the uncertainties engendered by an interconnected world**
- **Certain uncertainties, uncertain certainties**

India – increasing interconnectedness

- **Metrics of globalisation for India increased between 1972 and 2011**
  - **Ratio of external trade to GDP** up four times (8% to 37%)
- **Financial integration deeper than trade integration**
  - **Ratio of two way flow of goods and services and finance** up eight times (14% to 109%)
- **Other indicators**
  - **Gross capital flows** at about 60% of GDP though net capital flows lower at about 4%
  - **CAD** growing (nearly 6.5% in Q3 of 2012-13) though it improved thereafter
  - **Net International Investment Position** deteriorating - US$ 309.4 billion in March 2013 (US$ 250 billion in March 2012). Some improvement in June 2013 to US$ 296.9 billion

An increasingly interconnected globe

- **World trade, as a percentage of global GDP**
  - rose from about 20% of GDP to over 30% in the years leading up to the crisis

- **Cross border capital flows, as a percentage of global GDP**
  - rose from about 5% in the mid-1990s to about 20% in 2007
  - ratio fell sharply as the crisis emerged but global capital flows have recovered since

- **International financial openness**
  - measured by the sum of countries' external assets and liabilities to GDP
  - more than doubled from 150% of world GDP in mid 1990s to 350% in 2007

- **Increase in international banking activity and rise in share of cross-border ownership of financial institutions**
  - Value of external assets and liabilities of banks doubled as a share of world GDP - from about 30% of world GDP in 1990 to about 60% in 2007, with most of this increase taking place in the 2000s

Growing interconnectedness: trends & features

- **Advanced Economies (AEs) dominated cross border flows**
  - increased investment opportunities in EMEs; substantial reduction in home bias in AEs
- **EMEs also joined the fray**
  - outflows from EMEs mainly driven by reserve accumulation
- **Growing globalisation was accompanied by widening global imbalances**
- **Financial integration deeper than trade integration**
  - resulting in financial flows completely swamping trade flows
- **Policy focus shifted, rightly to gross capital flows**
  - gross capital flows typically several multiples of net flows
  - risks from gross flows similar to net flows but magnitude higher
- **Even as globalisation deepened, economic policies remained largely national**
  - leading inevitably to spillovers and sub-optimal responses

EMEs: Living in an integrated world

- **Trends and features of globalisation reduce degrees of freedom for the conduct of financial sector policies**
  - Spillovers from monetary and exchange rate policies of AEs significant
  - "Exogenous" spillovers managed through domestic policy response
- **Further challenges posed by the pattern of capital flows**
- **Did EMEs import risky capital while exporting safe capital?**

Ordinary laws of physics say that water ought to flow downhill. The parallel in economics is that money is supposed to flow from rich countries to poor countries, and risk is supposed to be transferred from the poor, who are least able to bear it, to the rich. But in the world today, things are moving in the opposite direction…. Meanwhile, the poorest countries in the world are left to bear the risks of interest rate and exchange rate volatility

- Stiglitz (2006)

India: An illustration of these challenges

- **India with a persistent CAD, needed net inflows of capital**
  - but what the country has experienced is surges and sudden reversals due to factors not related to the fundamentals

- **Movement of capital flows**
  - dominated domestic liquidity management
  - provided excess volatility to the exchange rate
    - a sharp post-global-crisis depreciation of the rupee, followed by significant appreciation, and then depreciation again

- **Levels of FX reserves are comfortable but under stressful conditions, market perception of reserve level could be different**

- **Global headwinds affected the real economy with growth slowdown**
  - part of the slowdown was attributable to a host of domestic factors

- **Emerging pattern of "Perception" interconnectedness**
  - challenges posed by "herding" behaviour of capital flows – all EMEs are the same!
  - but the post crisis normal will likely veer towards a more discerning approach

Unconventional Monetary Policies

- **As the global financial crisis exploded, central banks slashed policy rates to zero or near zero and embarked upon unusual policy activism**
  - objectives were to restore stability to financial markets; restore the functioning of key market segments; act as market maker of last resort (?); revive growth
  - but the policies were found to be insufficient and central banks found themselves constrained by the "***zero nominal bound***"

- The response was a slew of unconventional monetary policy measures – encompassing ***forward guidance*** of continued low policy rates over extended policy horizons and ***large-scale asset purchases***
  - the quantum of operations was very large;
  - unprecedented relaxation in collateral standards;
  - there were attempts by the central banks to directly affect long term interest rates

Unconventional Monetary Policies…2

- **Objectives of the unconventional monetary policies**
  - the initial set of measures were aimed at providing liquidity and reviving dysfunctional segments of the financial markets
  - the follow up measures were aimed at reviving credit offtake, incentivising long term investment and fostering economic growth

- **Impact of the unconventional monetary policies**
  - policy rates in major AEs remain at zero or near zero
  - balance sheets of central banks in advanced economies burgeoned
    - Central bank balance sheet of major AEs currently stands at over 20% of GDP as compared to around 10% in 2007
  - the expansion accompanied by a significant lengthening of the maturity profile of central banks assets

Unconventional Monetary Policies…3

- **Risks from a prolonged unconventional monetary policies**
  - policies may not work if transmission is impaired or accommodation is not adequate
  - policies may work too well; then it may become new normal

- **In any case, unconventional monetary policies distort markets over time.**
  - postponed balance sheet adjustments
  - incentives for risk taking and increased leverage
  - risk of distorting the functioning of financial markets

- **Risks from exit**
  - risks of large losses of banks, financial institutions and reserve managers
  - associated credit risk, funding challenges
  - spillovers to the global economy

Early musings on exit: The fallout

- **On May 22, 2013, Chairman Bernanke announced that the improvements to the US economy could prompt a tapering in its asset purchase programme before the end of the year;**

- **The fallout:**
  - **large capital outflows from EMEs**
    - rough estimates place the outflows from EMEs between May 22 and August 30, 2013 at around US$ 44 billion
  - **EMEs witnessed heightened volatility and a sharp sell-off in key markets**
    - Emerging market equities went down by almost 11% between May 22 and August 30, 2013, significantly underperforming their mature market counterparts (which went down just 1% during that period)
    - currencies of capital recipients, especially those with large current account deficits, came under pressure
    - exchange rate overshooting with severe micro and macro consequences
    - tighter monetary policy in the face of capital outflow with impact on growth

Early musings on exit: The fallout…2

- **The impact on Indian financial markets was one of the most severe amongst emerging markets**
  - Between May 22 and September 4, 2013
    - currency depreciated by 17.3%;
    - equity market fell by 7.9%;
    - 10 year interest rates shot up by 123 basis points.
  - Net FII disinvestment from Indian debt market between May 23 and August 30, 2013 was US$ 10.4 billion (net investment of US$ 5.6 billion between January 1 - May 22, 2013)
  - Net FII disinvestment in equities between May 23, 2013 and August 30, 2013 was US$ 2.8 billion (investment of US$ 14.35 billion between January 1 and May 22, 2013)

The volatility in financial markets spread like a contagion through the interconnectedness in markets with the rupee depreciation weighing on the stock market, foreign outflows from the debt market further aggravating the FX markets and impacting yields as also the equity markets

Role of domestic structural factors

- **Deterioration in the India's external sector performance - high trade and current account deficit**
  - impact of global slowdown on exports
  - imports continued to grow despite domestic slowdown
  - net investment income reflecting lower interest/discount earnings on F_X reserves and rise in interest payments on growing foreign debt
  - growing proportion of short term non-stable flows to finance the CAD
- **Concerns about the impact of exchange rate depreciation on balance sheet of corporates and banks**
  - banks have limited direct exposure to exchange rate movements
  - but overseas indebtedness of corporates has risen off late
  - to some extent, such exposures are un-hedged
    - rendering corporate and (indirectly) bank balance sheets vulnerable to the sharp exchange rate movements
- **Size of fiscal deficit**
  - concerns about slippages from targets though GOI committed not to breach the deficit target

Risks and challenges

- **Maintaining financial stability amidst the recent global turmoil**
  – conduct of macro-economic and regulatory policy in interconnected markets
- **Vulnerabilities move between markets at lightening speeds**
- **Managing the capital account**
  – monetary policy independence in an integrated world?
  – a nuanced approach to capital account measures
  – opening up of debt markets needs to be approached with caution
- **Exchange rate management amidst global turmoil**
  – what level of FX reserves is adequate?
  – spillovers from Offshore (NDF) markets
- **Central bank communication, especially during volatile times, needs to be carefully nuanced**
  – greater risk of misinterpretation during periods of stress
- **Addressing structural vulnerabilities and enhancing resilience of the economy**

Silver linings

- **Recent measures mainly aimed at boosting exports, curbing imports and facilitating foreign capital flows**
  - have been reflected in a moderation in CAD in Q4 of 2012-13 which should be sustained in the coming quarters (despite a higher CAD in Q1 of 2013-14)
    - lower gold imports
    - recovering exports as global economy recovers
    - lagged impact of exchange rate depreciation

- **Foreign exchange reserves are comfortable with a reserve cover of over 35 months to the CAD**

- **The government has reaffirmed its commitment to fiscal consolidation**

- **Notwithstanding global risks, domestic growth is also expected to rebound given**
  - a still high saving rate; a good monsoon performance this year; other structural drivers of growth including measures being taken by the policymakers to boost investments and attract foreign flows

Way ahead

- **Commencement of tapering has only been postponed**
  - speculation about when the Fed would start the tapering - will it be October? December? Early 2014?
  - volatilities could soon return to markets

- **Uncertainty of recent fiscal face-off in the US**

- **Were recent events an over-reaction? A front-loaded reaction? A taste of what is to come?**

- **Interest of all countries aligned in ensuring a non-disruptive exit**
  - but unlikely that countries' policy needs will be perfectly aligned
  - no previous experience of an exit of this scale
  - need for international coordination and transparent communication

- **Global policy makers confronting tricky questions**
  - do and/or should countries sufficiently internalise spillovers?
  - should countries posing global systemic risks bear a higher share of the burden?
  - how do we avoid giving conflicting signals?
  - how much bilateral liquidity and swap arrangements can help?

- **Balancing national independence with international accountability!**

Certain Uncertainties, Uncertain certainties

- **We are living in a global economy which is closely integrated and interconnected**

- **There are benefits from globalisation….**
  - difficult to argue against the benefits of cross border flows but there are associated costs

- **… as also challenges**
  - the challenges are only accentuated by the uncertainties surrounding events and developments in the global economy

- **The only certainty is that uncertainties will remain but so will the uncertainties about the certainties**
  - we do know that the Fed will start tapering – that is certain!
  - when will it start? At what pace? – that remains uncertain!

- **We can only prepare ourselves to meet these certain uncertainties**
  - better infrastructure and more incentives for efficient hedging
  - strengthening national balance sheet with focus on growth and development
  - addressing structural vulnerabilities; building resilience to global shocks
  - while continuing to strive for global policy coordination

Thank you