Readers Interview[1]

(Dr. Duvvuri Subbarao, Governor, Reserve Bank of India, answers questions from beyondbrics readers on currency wars, rural development, house prices and the deepening of capital markets. Interview published on ft.com/beyondbrics on November 18, 2010)

Dr. Duvvuri Subbarao, the Governor of the Reserve Bank of India, is at the forefront of economic policy making it the world's fastest growing large economy after China. He has taken questions from beyondbrics readers on currency wars, rural development, house prices and the deepening of capital markets. We will publish the Q&As in a series of three posts today. The first is after the break.

India's central banker (1): currency wars and hot money

Rupee strength

beyondbrics reader: Why is the RBI opposed to rupee appreciation? With billions of people, an increase in purchasing power enabled by a strong rupee could do wonders, rather than surrendering to handful of export industries. Since poverty is a serious problem in India, don't you think a stronger rupee could help them?

Duvvuri Subbarao: RBI is not opposed to appreciation or depreciation of the rupee. What RBI is typically concerned about is volatile movements in the exchange rate. Both large depreciation and appreciation could have significant costs, particularly in terms of inflation (with depreciation) and loss of external competitiveness (with appreciation). This is all the more so if appreciation, as in recent times, is due to volatile capital flows.

The argument that a stronger currency has an anti-poverty impact by softening inflation is quite persuasive. However, the beneficial impact depends on the extent [to which] the exchange rate [passes] through to prices. Empirical research shows that, in the Indian context, the pass through is quite low - in the range of 0.4-0.9 per cent.

Our exchange rate policy is not guided by a target or a band. Our policy has been to intervene in the market only to manage excessive volatility and prevent disruptions to the macroeconomic situation.

QE2's impact on India

beyondbrics reader: How will the new US round of quantitative easing (QE2) affect India? Would you welcome it as a good source of cheap money to finance the infrastructure investments that India badly needs?

DS: India needs to raise its investment by a quantum step if it has to realize its aspiration of a double digit growth. We certainly need to augment our domestic resources with foreign savings. For obvious reasons, we have a preference for long-term funds over short-term funds, for equity over debt and for FDI over portfolio flows.

Experience shows that capital flows into EMEs [emerging market economies] are influenced by pull factors and push factors. The typical pull factors are the promising growth prospects, the declining trend rates of inflation and improved governance in

EMEs. The push factors are the abundant liquidity in the global system and the interest rate differential between the advanced economies and the EMEs. It is the push factors which trigger volatile capital flows.

A possibly unintended consequence of the new round of quantitative easing could be an added impetus to the push factor - increased volatile capital flows into India, just as into other EMEs, in pursuit of higher returns which come at an acceptable risk. Our current account deficit, both in absolute terms and as a proportion of GDP, is expected to be wider this year than it was last year. To that extent, we can absorb larger capital flows.

Nevertheless, we have concerns about the deficit being financed by volatile capital flows. Should capital flows exceed our ability to absorb by a wide margin, we will calibrate our capital control instruments to manage the flows just as we did in the past.

Our infrastructure investment needs are huge. Foreign investment certainly helps. The concern though is that infrastructure, by its very nature, needs long term finance, and volatile flows chasing short-term returns do not meet the need. In order to support infrastructure investment, we have made, and are making, efforts to deepen the corporate bond market. We had also enhanced the limits for FII investment in corporate bonds.

Foreign exchange reserves

beyondbrics reader: Should India continue to accumulate USD and follow US interest rate policies? In the name of earning export dollars, maybe we are selling our resources and services for a currency of diminishing value.

DS: To deal with sudden stops and reversals of capital flows, a certain level of foreign exchange reserves is necessary. However, India does not have a policy of actively accumulating reserves as a measure of self-insurance. Any accumulation of reserves is partly an incidental byproduct of our exchange rate policy which is to check undue volatility in the foreign exchange market so that the exchange rate reflects the underlying macroeconomic fundamentals. Incidentally, the increase in our reserves also reflects valuation changes.

In this context, it is also important to note that our foreign exchange reserves comprise not just dollars but also other hard currencies such as the euro and the sterling pound [and] also gold.

Managing volatile capital flows

beyondbrics reader: What is the RBI's view on taming the disparity between speculative capital inflow ("FII") and real investment ("FDI")? To me the Indian markets are looking volatile and this could have serious ramifications on the rupee as well as domestic asset prices should the fund flow reverse (which is easy in FII)? Are there any steps planned to balance this?

DS: It is true that FII flows are volatile and could pose policy challenges during both surges and sudden stops. But it is also difficult to identify, especially in real time, the permanent and temporary components in the capital flows.

Our approach to managing capital flows, therefore, is calibrated to respond to both domestic and global developments. We are quite agnostic towards the several available options. We deploy both quantity and price instruments as well as end use restrictions.

Our FDI policy is fairly liberal. Foreign investment in a vast majority of sectors is approved under an automatic route. In fact, government approval is required for foreign investment only in a few select sectors. FII investments, on the other hand, are allowed both in the debt and equity markets. We have typically used control levers on the debt side.

An important factor in managing capital flows is the absorptive capacity of the economy. Despite large FII inflows in recent months, the rupee has not appreciated much because of our widened current account deficit. Nevertheless, we are carefully monitoring the size and nature of flows and will take measures as and when needed.

India's central banker (2): rural growth and capital reform

In the second post in a three part series on beyondbrics, Duvvuri Subbarao, India's central bank governor, says that *festina lente* - making haste slowly in Latin - is a motto close to the RBI's heart. He answers readers' questions on the financial inclusion of India's masses as well as capital account convertibility and a possible south Asian currency union.

Development and entrepreneurship

beyondbrics reader: What can the RBI do on its part to engender development in rural India? How can the RBI encourage entrepreneurship there so that we can reduce urbanization and decentralize India's growth story?

DS: From the very beginning, the Reserve Bank has been in the forefront of pioneering development initiatives. In the 1970s, we introduced the priority sector lending scheme mandating banks to direct a minimum proportion of their overall lending to sectors with a large welfare impact such as agriculture, medium and small sized business and exports. We introduced the Lead Bank Scheme (LBS) after the banks were nationalized in 1969-70 thereby assigning banks a monitorable obligation for local development particularly in rural areas. Our aim all along has been to encourage banks to have a positive bias towards agriculture, employment generation consistent with their business models and comparative advantage.

Large sections of the population and certain regions, however, still remain outside the formal banking structure. Our main focus today is on financial inclusion as it is a necessary condition for sustaining equitable growth. There are few, if any, instances of an economy transiting from an agrarian system to a post-industrial modern society without broad-based financial inclusion.

We all know from personal experience that economic opportunity is strongly intertwined with financial access. Such access is especially powerful for the poor as it provides them opportunities to build savings, make investments and avail credit. Importantly, access to financial services also helps the poor insure themselves against income shocks and equips them to meet emergencies such as illness, death in the family or loss of employment.

In order to further financial inclusion, the Government and the Reserve Bank are pursuing several initiatives. The Finance Minister, in his last budget, announced that every village in the country with over 2,000 people must have access to banking services by March 2012. We have asked every domestic commercial bank - public and private sector - to prepare its own Financial Inclusion Plan (FIP) and have it approved by its Board.

Our aim in this respect is two-fold. One, each bank should have ownership of its FIP. Two, we want each bank to build on its comparative advantage. We want banks to be innovative and entrepreneurial and try out their own models and experiments consistent with their business models.

Even as the brick and mortar branch presence will expand, there will be a big emphasis on branchless banking based on the business correspondent (BC) model and leveraging on technology. In order to facilitate this, the Reserve Bank has also enlarged the types of entities that can be engaged as BCs.

Third, the Government of India has set-up two funds - the Financial Inclusion Fund for meeting the costs of developmental and promotional interventions towards financial inclusion, and the Financial Inclusion Technology Fund for meeting the costs of technology adoption. Each of these funds is worth Rupees 50bn.

I must stress is that financial inclusion is not just a public good; it is also a merit good. It empowers poor people in diverse ways. If there is to be ‘inclusive growth', financial inclusion is the next big idea, as it promotes growth and equity.

Capital account convertibility

beyondbrics reader: What is your view in respect of the timetable and progress towards fuller capital account convertibility, which determines the ease with which investments can be moved into and out of India?

DS: Our goal has been, and remains, to traverse towards capital convertibility along a gradual path - the path itself being recalibrated on a dynamic basis in response to domestic and global developments. Capital account liberalisation also has to keep pace with reforms in other sectors.

The second Tarapore Committee provided a roadmap for fuller capital account convertibility [and included] fulfilment of certain pre-conditions such as fiscal consolidation, lower inflation and a stronger financial system. Our approach to capital account liberalization has been what the Romans say, *festina lente* - make haste slowly. Our forward movement has been calibrated by the macroeconomic conditions, the state of financial sector development, the risk management capabilities of financial institutions, the depth of the financial markets and global developments. In certain respects, we have moved ahead of the Tarapore Committee recommendations. Illustratively, non-resident foreign corporates and foreign institutions enjoy currency convertibility going farther than the Tarapore recommendations.

Currency union in south Asia

beyondbrics reader: Viewed from an economic standpoint (beyond any existing diplomatic rifts) would a common currency with Pakistan, Bangladesh and Sri Lanka, be useful to India?

Duvvuri Subbarao: From an economic point of view, a common currency should certainly be beneficial for regional trade and be cost effective too. However, for benefits to accrue, intra-regional trade has not only to be large but has to constitute a significant proportion of each country's global trade. This is not the case presently. We are nevertheless actively exploring regional financial arrangement (RFA) options like the Chiang Mai Initiative (CMI). Economic co-operation among SAARC nations is based on our shared aspiration for growth and poverty alleviation. The Asian Clearing Union (ACU) settlement arrangement between the member central banks, which facilitates regional trade, is also an example of co-operation.

India's central banker (3): house prices, markets and banks

In the final post in a three part series on beyondbrics, Duvvuri Subbarao, India's central bank governor, answers readers' questions about house prices, steps to deepen India's financial markets, and the future of the banking sector, including the role of foreign banks.

Rising house prices

beyondbrics reader: Why does a house in India cost more than three to four times what it used to cost in 2003-04? Did any significant changes in affordability happen in the last seven years ... ? What do you say to people like me for whom a mortgage now looks out of reach, especially with inflation now in double digits?

Duvvuri Subbarao: It is true that the cost of a house is higher now than it was in 2003-2004. House price indices suggest that prices in Chennai, Mumbai, Delhi and Kolkata have more than doubled since 2007. This is also the case in some of the non-metro cities like Bhopal and Lucknow. But this price increase has happened in pockets and cannot be generalized to the all-India level.

The increased price level of houses in India is a function of many factors - growth from a very low base for housing, better access to financing and some speculative build up. As per the Wholesale Price Index, the general price level of all commodities has gone up by about 45 per cent since 2003-04. House prices have risen faster than this. Some factors that explain this are increased raw material costs, rising incomes and hence a demand for better quality housing, urbanisation in the face of limited land availability and improved access to institutional financing.

In the Reserve Bank, we are sensitive to the financial stability implications of rapid build up in house prices. We have had quite a credible record of preemptive regulatory tightening to prevent unnatural asset price build up. In our latest policy statement on November 2, we capped the loan to value ratio (LTV) at 80 per cent, increased the risk weight for residential housing loans of Rs. 7.5m and above to 125 per cent, and increased the standard asset provisioning by commercial banks for housing loans with teaser rates from 0.4 to 2 per cent.

Deepening capital markets

beyondbrics reader: Are there plans to create deep liquid markets for fixed income, commodity and currency trading so banks can hedge their risks?

DS: The Reserve Bank regulates the government securities (G-Sec), money, credit and currency markets and their derivatives. The commodities market is outside its domain.

Facilitating the emergence of a robust market is an evolutionary process. The markets in India have already witnessed far reaching developments. We already have an active government securities market where primary issuance is at market-determined rates and there is reasonable trading across the yield curve. The government securities market also has sound infrastructure for trading and settlement as well as for dissemination of trade information. For hedging interest rate risk, we have exchange traded interest rate futures (IRF) and a liquid and vibrant interest rate swaps (IRS) market.

The foreign exchange market in India is deep and liquid and is expanding rapidly. The market facilitates conventional risk management instruments such as forwards, swaps and options and also a few structured products in options to enable economic agents to manage their exposure to the Indian rupee. We have also introduced currency futures and options which enable both hedging and view-taking. While basically the OTC market is based on an underlying exposure with enough flexibility for risk management, there are products on the exchanges available for hedging or for purely view taking.

In the Reserve Bank, we continuously explore the scope for introduction of new products with a view to enhancing the efficiency of the financial markets without compromising financial stability.

beyondbrics reader: Does the RBI plan to increase the scope of the corporate bond market in India?

DS: The development of the corporate bond market is one of the focus areas for the RBI as we recognize [it is critical] for the development of the financial system. At the current stage, it is true that the market is not active. The following are some of our recent initiatives to develop the market:

Putting through a robust settlement mechanism including Delivery-versus-Payment (DVP) and a flexible settlement period.

Disseminating price information to the market on real time basis for improving transparency and facilitating efficient price discovery.

Introducing repos in corporate bonds to enhance liquidity in the secondary market.

With a view to widening the market, the limit for investment by FIIs [foreign institutional investors] has been further enhanced recently to $20bn. Though the market is yet to become robust, it is important to note that the secondary market volume in corporate bonds has grown nearly four-fold between 2007-08 and 2009-10. We are also in the process of introducing credit default swaps.

Banking

beyondbrics reader: Where do you see the banking sector in India in 10-20 years from now?

DS: Though the Indian economy is bank-centric, the penetration of the banking system is smaller than in many countries including some of the Asian countries. The credit to GDP ratio is just about 55 per cent.

In 20 years time, I would envisage the following scenario. The credit-GDP ratio will go well beyond 100 per cent. Indian banks will have penetrated the entire country and have covered every household with a functional bank account. By ‘functional' what I mean is that the access of low income households extends beyond just savings and remittances to other services such as credit and micro insurance.

Indian banks will have come up with some world-beating business models and innovations to make financial inclusion meaningful and also an effective business model.

Banks will have adopted and adapted the best of world technologies so as to provide real time or near real time data/ information which would enable them to have sophisticated risk management capability and, the ability to handle much more sophisticated products to meet the risk management needs of the real economy.

I expect the underwriting standards to improve significantly with the setting up of strong credit information bureaus which will considerably reduce the information asymmetries. Banks will also be much more efficient due to substantial increase in productivity both of human capital as well as due to leveraging of technology and, therefore, able to operate on thinner margins and at lower cost to borrowers.

In terms of architecture, I foresee the emergence of four to five large banks having strong international presence with a larger number of smaller domestic banks having all-India reach. I also foresee a stronger presence of foreign banks. The more sophisticated risk management and superior technology that foreign banks bring in will diffuse to Indian banks and bring our banking system close to the global best practices.

Rural cooperatives, Regional Rural Banks and urban cooperative banks would be stronger with higher standards of corporate governance and stronger balance sheets. They will be an important vehicle for financial inclusion.

Mortgages

beyondbrics reader: Do you see Indian banks offering a true fixed rate mortgage that can be easily refinanced by the consumer?

DS: The Reserve Bank has not issued any specific regulatory guideline to banks with regard to fixed rate mortgages. Banks are free to design products, fix interest rates on them and offer them to customers after getting them approved by their boards.

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