Financial Stability in a Weak Global Environment[1]

At the outset, I extend a very warm welcome to Dr. Hans Genberg, Executive Director, the SEACEN Centre and all the participants of the 7th SEACEN High Level Seminar for Deputy Governors, Financial Stability and Supervision [DG (FSS)] and the delegates of the 7th Annual SEACEN DG Meeting (FSS). It is, indeed, a matter of great honour and privilege for the Reserve Bank of India to host this Seminar and the Annual Meet.

The theme of the seminar, "Financial Stability in a Weakening Global Economic Environment", is very topical and befitting, given the volatile recovery the world economy is experiencing. Even almost eight years since resorting to the extraordinary monetary and fiscal measures to counter the after-effects of the Global Financial Crisis, authorities are still left wondering about relationships between key parameters such as unemployment and inflation, as some of the time-tested tool kits have discernibly failed. The recent speeches by FED Chair and her colleagues are a testimony[2]. Against this backdrop, it is important to remain mindful of the uncertainties, stay as vigilant and as prepared with ex-ante institutional framework, policy measures and decisions as one can be, to tide against the possible forces of destabilisation.

Global Environment

1. To state that the world economy is in a fragile state would be an understatement. Whatever parameters one may look at - growth, inflation, employment, trade, etc., all point to weakness in one geography or the other. What, however, is really confounding is that the growth and inflation in the Advanced Economies continue to remain elusive despite the sustained easy money policy and relentless bond buying programmes pursued by the monetary authorities. The underlying premise of making abundant liquidity available at low interest rates to incentivise investments and consequently, to spur real economic activities

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[1] Address delivered by Shri S. S. Mundra, Deputy Governor, Reserve Bank of India at the 7th SEACEN High Level Seminar for Deputy Governors in–charge of Financial Stability and Supervision held in Mumbai on September 22, 2016. Assistance provided by Ms. Rekha Salilkumar and Shri Sanjeev Prakash is gratefully acknowledged.

[2] The Federal Reserve's Monetary Policy Toolkit: Past, Present, and Future – speech by Dr. Janet Yellen, Chair of the Board of Governors of the Federal Reserve System at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming on August 26, 2016

The "New Normal" and What It Means for Monetary Policy – speech by Governor Lael Brainard, member of the Board of Governors of the Federal Reserve System at the Chicago Council on Global Affairs, Chicago, Illinois on September 12, 2016 and to trigger the virtuous cycle of growth, employment and income generation and subsequent reversal of interest rate cycle, has failed. However, it would be imprudent to be completely dismissive of the accommodative monetary policy stance of the monetary authorities as initially these measures had helped to calm the financial markets and revive confidence. The flattening observed in the Phillips curve makes a case for relooking at the implied relationship between full employment and inflation. For instance, in the US, though the unemployment rates declined, the inflation continued to be below the target level of 2%.

2. The vast hoard of liquidity made available due to continued accommodative policy stance has drummed down the yield to the negative terrain. Markets and investors have appeared to respond to the prospects of the continued low interest rate environment by renewing their search for yield by moving into riskier assets, which has supported elevated valuations. That being the case, there is a strong possibility that any reversal of the rate stance by Fed Reserve would reverse flows away from the riskier asset classes, trigger sell-offs and cause market disruptions much as witnessed during the taper tantrum in summer of 2013. In a globally integrated world, these sell-offs would not remain restricted to the advanced economies alone, thus making reversal of policy rate by Federal Reserve as one of the important risk events that the world is looking at anxiously.

3. Similarly, Japan continues to be trapped in the decade long vicious cycle of "low-growth -low inflation -low inflation expectations". Growing sovereign and corporate debt levels as well as rising valuations in commercial real estate in many jurisdictions raise concerns amid growing signs of a downturn in the credit cycle. The recent runs on several large UK commercial property funds illustrate the risks associated with deteriorating real estate values in few entities with structural vulnerabilities. Further, there are also concerns around asset quality and profitability of large banks in many advanced economies, including in the euro area. The prospect of increasing non-performing corporate and real estate loans has potential to further erode valuations and impede raising of further capital by these banks. The protracted low interest rate environment would also have deleterious consequences for the pension funds and asset managers significantly eroding the capability of defined-benefit funds to meet their future liabilities. Though, the World has survived BREXIT as a risk event, but how it will manifest in the trade relations, investments and business sentiments going forward would be keenly observed.

State of Emerging Economies

4. Emerging economies present a more heterogeneous ecosystem, though growth here also has been relatively weak than the long term average. The interest rates are high due to persistently high inflation, but at the same time the higher yields have helped them attract the much needed capital flows from the advanced economies. Higher capital flows has strengthened their currency with the resultant weakening of exports and has triggered some sort of a race for competitive depreciation among these economies. 'Beggar thy neighbour' is the mantra they seem to be following. One, however, needs to be mindful of the risk of quick reversal of capital flows if these economies do not have strong fundamentals and a commitment to structural reforms. China has been trying to retrace its growth path, however, excessive corporate leverage, which has fueled excess capacity, casts doubt on its sustainability. The moderating economic growth and rising corporate debt levels have begun to put pressure on banks' asset quality and may force Chinese authorities to take appropriate measures to repair the fragile bank balance sheets. Any adverse development in the Chinese economy holds the potential for sending shock waves across other jurisdictions.

5. Brazil and Russia have also seen downturns due to sharp fall in commodity prices, especially oil. The uncertainty with regard to oil prices continue to persist as the demand supply dynamics have become mostly non-existent, leading to supply glut and plummeting prices.

Impact on Financial Stability

6. It is against this uncertain backdrop that we are discussing financial stability. The co-existence of very low interest rates and still lower economic activity in the advanced economies makes a strong case for revisiting the theory around transmission ability of policy rate and the efficacy of the transmission channels. Financial stability is characterised by a condition, in which the financial system functions normally, allocates the resources judiciously and undertakes intermediation between the financial sector and the real sector uninterruptedly. Most importantly, financial stability portends a situation in which the system would be resilient to shocks, if any, through a self –correcting mechanism. As central bankers with a direct/indirect mandate to preserve financial stability, our efforts, therefore, must be aimed at strengthening the financial institutions and markets and their ability to transmit and intermediate effectively through robust capital position, improved profitability and resilient systems and control.

7. The monetary easing pursued by the authorities worldwide in the aftermath of the crisis was ostensibly with the objective of tackling the freeze in the credit markets, driving growth and for tackling unemployment. Nevertheless, if near- zero/negative policy rates are not helping achieve the desired outcomes and only having a steroid effect on the financial markets, then the reversal of that stance seems inevitable. Under the circumstances, the timing and quantum of reversal must be as non-disruptive as possible.

8. The immediate reaction to the reversal of the rate cycle in the advanced world would be realignment of the capital flows and strengthening of dollar that can impact the already delicate exports and global trade, given the current political penchant towards protectionism. As yields harden, the rising debt burden would have fiscal implications. The resultant high cost of credit and higher cost of intermediation would adversely impact the overall growth and can push the economies back to the disinflationary mode.

Indian Experience

9. As I said earlier, emerging markets have different dynamics at play and they are rather dispersed across the spectrum than being a homogeneous group. Therefore, it is a bit difficult to discuss them as a class. Let me, however, use this opportunity to talk about India- how we are placed in the current environment and what are the specific issues/challenges that we are faced with.

10. While generally sharing the problem of high corporate leverage with most emerging markets and well as with the developed world, India presents some exceptions. These exceptions are in the form of moderately higher growth, favourable demographics and persistent inflation. The accommodative policy stance and other conventional and unconventional monetary and fiscal measures taken in the immediate aftermath of Global Financial Crisis have been long unwound. We have been fighting a battle against high inflation and have been on a tight monetary policy regime for some time. You may be aware that we have moved to a CPI-based Inflation targeting regime sometime back and our monetary stance and liquidity management is being calibrated accordingly. India also enjoys demographic dividend in form of a young, growing population and hence, the domestic demand is likely to continue growing for the foreseeable future. In fact, we need to grow at a higher pace consistently if the demographic advantages are not to be frittered away. India has been the beneficiary of the capital flows as it is seen as a promising investment destination and the Government and Reserve Bank of India are committed to continue to press the advantage by ushering in necessary reform measures.

11. While the economic fundamentals of the country are on a much sounder footing than three years ago, like the rest of the world we are also wary of the impending market volatility that could emerge from crystallisation of any of the risk events that I alluded to earlier. A significant area of concern for some EMEs, especially for us in India, is slowdown in inward remittances from non-residents. The depressed oil prices have created stress in the oil-exporting countries in the Middle East which has a significant population of migrant Indians. Already a feeble trend of decline in remittance is established and if the oil prices remain depressed for an extended period of time, immigrant population may lose their jobs, face retrenchment and the consequent repatriation may lead to social tensions back home.

12. The key goal that we have set for ourselves is to restore order and normalcy as soon as possible so that the financial system could continue to subserve the needs of the real economy on an on-going basis. The GDP growth of 7.1% (Q1 2016-17), the current level of oil prices and measures to contain gold import has helped us move towards current account surplus , the rupee has been reasonably stable and macros are more or less comforting.

13. In a dynamic environment, being in a relatively safe zone cannot be a reason enough for complacency. As I mentioned earlier, we hold potential for achieving still higher rates of sustainable economic growth. We are mindful of the need for more structural reforms to address issues relating to capital formation, infrastructure creation, low capacity utilisation, fiscal consolidation, subsidy management etc. As a bank dominated financial system, it is important for us that the banks have the ability to undertake intermediation in a productive and efficient manner. Hence, an efficient transmission of cuts in policy rate to end borrowers has also been on our active agenda. But the stress in the bank balance sheet has been a hurdle with provisioning for bad debts taking a toll on the bottom line. This is mainly on account of a RBI drive for balance sheet repair in the banking system resulting generally from corporate balance sheet distress. We firmly believe that once the banks have a healthier balance sheet, they would be ready for dispensing credit and aid growth.

14. Especially for augmentation of the capital in Public sector banks, we have been closely engaging with the government. Several measures have been taken by us to deal with the asset quality issues in the banking system. A centralised repository of large credits has been operationalised which enables to have a correct picture of indebtedness of large corporate houses. Several other tools like JLF/ SDR/ 5:25/ S4A[3] etc. were brought in to help

[3] Framework for Revitalising Distressed Assets envisages a corrective action plan that incentivizes early identification of problem cases, timely restructuring of accounts considered to be viable and taking prompt steps by banks for recovery or sale of unviable accounts. All lenders of a consortium are required to form a Forum named Joint Lenders Forum (JLF) to plan for resolution of a stressed borrower as soon as a defined stress parameters is reported by any lender.

5/25 Scheme

To enable banks to offer finance for long-gestation projects in the infrastructure/core industries sector, they have been allowed to extend structured long term project loans with periodic refinancing option.

Strategic Debt Restructuring (SDR)

The SDR guidelines enable banks to effect change in ownership where the existing promoters are found to be wanting. At the time of restructuring, lenders are required to incorporate an enabling clause to convert their loans into equity if the borrower fails to achieve the viability milestones/critical conditions. Subsequently, the banks may bring in a new promoter to turnaround the borrower company.

the banks for revitalization of stressed assets on their books. A framework for enhancing credit supply for large borrowers through market mechanism has also been unveiled recently with the underlying aim to limit concentration risk of large borrowers while facilitating access of borrowers to funds from the bond market. In order to curtail exposure of banks to large corporates, the single and group exposure norms have been made stricter and made more expensive beyond a limit. These measures are meant to implicitly facilitate better credit flow to micro, small and medium enterprises (MSMEs) and retail sector.

15. In sum, there is realisation that the banking sector needs to be declogged and a multitude of options must be made available for better and efficient credit dispensation. Measures have also been taken to enhance resolution mechanisms, strengthen the existing payment and settlement system and to leverage technology to achieve greater financial inclusiveness. A set of differentiated banks have already been licensed for better penetration of financial services and to meet requirements of specific sectors. The framework for non-bank financial companies has been strengthened and work is currently in progress to study the entire gamut of regulatory issues relating to Fin Tech in view of the growing significance of Fin Tech innovations and their interactions with the financial sector as well as the financial sector entities. Talking of fintech, I am also reminded of Cyber Risk which has emerged as a major vulnerability for the financial institutions across the world as the trend has shifted from targeted attacks on individuals to institutions. Cyber-attack on Bangladesh Central Bank is a case in point. Regulation of Peer to peer lending platforms is another item on RBI's active agenda, which can potentially bring complementarity to banking services.

Conclusion

16. Before I conclude, let me raise a couple of issues which can be worthy debating during the course of the seminar.

a) While we have been assiduously pursuing implementation of the regulatory reforms set out in the wake of GFC, have we convinced ourselves fully about the unintended consequences for the emerging markets eg. availability and cost of credit for smaller

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Scheme for Sustainable Structuring of Stressed Assets (S4A):

S4A scheme is meant to strengthen the lender's ability to deal with stressed assets and converting part of the debt into equity without necessarily changing the control of the company. The existing debt is to be segregated into 'sustainable' and 'unsustainable portions'. Sustainable debt should not be less than 50 percent of current funded liabilities and capable of being serviced with existing cash flows without changing tenor and interest rate on the loan. Unsustainable portion can be converted into equity / convertible preference shares / optionally convertible debentures.

entities, contraction in operations by foreign banks having implications for specialised high end products like derivatives, withdrawal of correspondent banking relationships etc.?

b) How far is imposing risk weight on sovereign exposures of banks currently being discussed by standard setting bodies actually justified in jurisdictions where the large part of the banking sector itself is publicly owned and required by statute to hold government securities in their investment portfolio? It is also important to note here that most of the sovereign debt in our jurisdiction is issued in home currency.

c) Since the reversal of policy stance in the US has potential to create global market disruptions, it would be appropriate to take that decision keeping the global context in view rather than in the domestic context.

d) Pace and timing of some of the reform measures are apparently disproportionate to the stage of development of the markets in EMEs. The stiff deadlines set out for adoption of reform measures pertaining to OTC derivatives and resolution of CCPs are cases in point.

e) Some jurisdictions are overlaying parallel policy prescriptions on top of the multilaterally agreed reform measures which undermine the effectiveness of collaborative framework.

The above posers lead one to ask a broader question: “whether the reform measures have plugged the vulnerabilities and created a more stable financial system or have they created new vulnerabilities and fragilities for the system?” I think only time can answer that question.

17. To conclude, howsoever confident we might feel of various endeavours made by us to build strong systems and processes, their ultimate test would only happen during the times of turbulence. The base we build by putting in place well-thought out institutional framework and policy measures will provide the bulwark against forces of disruption. More importantly, irrespective of the global environment, we must keep revisiting and reorienting the framework and mechanics at periodic intervals so that the risk events can be managed with minimal damage. I once again welcome you to India and wish you an enjoyable stay in Mumbai and fruitful deliberations during the seminar.

Thank you!