V K Sharma: The international financial crisis and India – the impact, response and outlook

Address by Shri V K Sharma, Executive Director of the Reserve Bank of India, at the Conference on "Doing Business with India", jointly sponsored by the Confederation of Indian Industry and The Indian High Commission, Johannesburg, 23 July 2009.

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His Excellency the High Commissioner of India Mr. Bhatia, Mr. Navdeep Suri, Consul General of India, Mr. Hari Bhartia, Vice-President of CII, Dr. Guma, Dy. Governor, South African Reserve Bank, Mr. Rudolf Gouws, Chief Economist, Rand Merchant Bank, distinguished invitees and delegates,

First of all I would wish to thank His Excellency the High Commissioner of India for giving me the opportunity and privilege to address this distinguished and august audience. Second, I must congratulate and compliment the High Commissioner of India and his very passionate team as well as the CII for having taken the bold initiative in conceptualizing and organizing this conference with a very imaginative theme of "Building partnerships when the chips are down."

The current global financial crisis was caused primarily and fundamentally by extended structural global macro economic imbalances. These global imbalances were reflected in current account surpluses of China, Asia and EMEs and current account deficits of the USA, in particular. These large and persistent imbalances represented "unearned" prosperity for deficit reserve currency countries and "unshared" prosperity for surplus countries. Such a global economic order was inherently unsustainable and unstable from the word go. In other words, the only sustainable and durable global economic growth model would be where growth and prosperity are both "earned" and "shared". In fact, the whole thing can be likened to cosmic balance/equilibrium/harmony where stars, suns, planets, all orbit within the inviolable discipline of their elliptical orbits which do not permit deviant behaviour beyond the shortest and the longest distance from the suns and stars of the orbiting planets! Any deviant behaviour/conduct, inconsistent with the cosmic harmonious balance and equilibrium, will invite and inflict extremely retributive backlash; the more severe and prolonged the disequilibrium and imbalance, the more wrenching and excruciating will be the resulting pain as is currently being experienced.

In refreshing contrast, India ran modest current account surpluses to modest current account deficits with only the latest current account deficit at 2.6% of GDP due to the impact of the ongoing global recession. Thus, in the post-economic reforms period, through its macro economic policies, India demonstrated that it is committed to, and believes in, "earned" and "shared" prosperity in our economic relations with the rest of the world through sustainable and balanced current account.

The current global economic recession, the worst since the Great Depression, was caused by the apocalyptic global financial melt down and not the other way round which traditionally has so far been the case, where typically it was economic recession that preceded and precipitated financial crises. At the risk of being repetitive, it must be noted that even if global imbalances and accommodative monetary policy provided an enabling environment for excessive leverage and risk taking, it was still the responsibility of regulators and supervisors to have taken appropriate macro-prudential measures, pre-emptively and proactively, rather than reactively. But unfortunately broad spectrum and generic regulatory and supervisory failure worldwide, especially in the West, precipitated the current unprecedented global financial crisis. This regulatory and supervisory inertia to unprecedented build up of risk globally, typical and characteristic, of the hunky-dory and gung ho financial environment of the pre-crisis days, is most graphically epitomized by what Mark Twain said 100 years ago:

"It ain't what you don't know that gets you into trouble; it is what you know for sure that just ain't so!" In refreshing contrast, in India, we have had remarkable financial stability, not fortuitously, but thanks to pre-emptively and pro-actively delivered prudential measures like increase in risk weights for exposures to commercial real estate, capital market, venture capital funds and systemically important non-deposit accepting Non Banking Finance Companies (NBFCs). These pre-crisis prudential regulatory measures of Reserve Bank of India represented what now are famously known as "countercyclical capital measures" and have been strongly commended for adoption by various recent Working Groups/Committees of international regulators. Indeed, in the aftermath of the global financial crisis and resulting economic recession, these countercyclical capital measures have been rolled back to cushion the adverse impact of the crisis to considerable beneficial effect to the Indian economy.

However, for all the positives about the Indian economy, the fact still remains that in view of the growing integration of the Indian economy and the financial system with the rest of the world, it cannot be the case that Indian economy should have remained unaffected. The Indian economy was collaterally affected primarily through two channels: the Capital account and the Trade account. While India continued to experience substantial net capital inflows, the situation changed for the worse in September/October 2008 in the wake of Lehman Brothers' bankruptcy, with substantial net capital outflows and this, in combination with widening trade account and current account deficits resulted in the decline of foreign exchange reserves of about USD 60 billion, from USD 316 billion in May 2008 to about USD 255 billion now. The trade deficit widened to USD 120 billion (10% of GDP) and current account deficit widened to USD 29 billion (2.6% of GDP).

Recent fiscal and monetary policy measures

Because of the integration with the rest of the world, fall in export demand for Indian merchandise and services, the GDP grew by 6.7% in 2008-09 compared with an average growth of 9% plus in the previous 3 years. Thus, it will be seen that the Indian economy was much less adversely affected, primarily due to being driven by domestic demand which again had a very strong rural demand component. Significantly, even now the rural demand continues to remain robust, especially for autos, two wheelers, tractors and FMCGs. This was all made possible because of public spending under National Rural Employment Guarantee Programme, Rural Self-Employment Programme and Rural Road Construction Programme under flagship Government sponsored schemes. Indeed, as a critical complement to this effort, financial inclusion initiative driven by leveraging smart card and bio-metric technology, also played a pivotal role. Besides, going forward, with 400 million odd mobile phone subscribers in India, mobile banking has tremendous potential for spreading banking and financial services to rural and semi-urban areas and further economic empowerment of the rural sector.

Inevitably, the fiscal policy had to respond commensurately and Government delivered three fiscal stimulus packages, as a result of which the fiscal deficit rose from 2.7% of GDP in 2007-08 to 6.2% of GDP in 2008-09 and is projected to rise to 6.8% in 2009-10. But, this is not a cause for concern primarily because we need to look at fiscal deficit not in isolation but in conjunction with current account deficit. Thus, even though the fiscal deficit is 6.2%, the current account deficit at 2.6% is below 3%, a level which is considered sustainable. The underlying idea is that current account deficit subsumes fiscal deficit in the sense that high fiscal deficit essentially connotes high public sector dis-saving which can be offset by private sector and house hold sector savings. It is significant in this context to note that Indian economy has been characterized by increasing domestic savings rate financing investment, with domestic savings rate reaching a high of about 38% of GDP in financing investment of 39% of GDP in 2007-08.

Both the Government and the Reserve Bank of India responded to the challenge in close coordination and consultation. The main plank of the government response was fiscal stimulus while the Reserve Bank's action comprised monetary accommodation and counter cyclical regulatory measures.

Monetary measures

The monetary measures have comprised three elements: Monetary easing by cutting policy rates, provision of rupee liquidity, forex liquidity and ensuring availability of credit for productive purposes.

Reduction in key policy rates

- The repo rate was reduced by 425 basis points from 9.0 per cent in October 2008 to the current rate of 4.75 per cent. Similarly the reverse repo rate was reduced by 275 basis points from 6.0 per cent to 3.25 per cent.

Provision of Rupee liquidity

- The Cash Reserve Ratio (CRR) was reduced from 9% to 5% of Net Demand and Time Liability (NDTL). The cumulative reduction in the CRR by 400 basis points since mid-September 2008 released Rs.1.6 trillion of primary liquidity. ($32 billion)
- Unwinding, redemption and de-sequestering of Market Stabilization Scheme (MSS) has released primary liquidity of Rs.1.44 trillion. (approx $29 billion)
- Permanent reduction in SLR by 1.0% of NDTL has released Rs.400 billion. ($8 billion)
- An exclusive repo facility for supporting non-banking financial companies(NBFCs) mutual funds, and housing finance companies to the extent of Rs.600 billion. ($12 billion)
- Special Purpose Vehicle (SPV) set up for extending assistance to NBFCs to the extent of Rs.250 billion. ($5 billion)
- Refinance extended to Small Industries Development Bank of India (SIDBI) ($1.4 billion), National Housing Bank ($800 million).
- The actions of the Reserve Bank since mid-September 2008 have resulted in augmentation of actual/potential liquidity of over Rs.4.69 trillion ($ 93 billion)
- That liquidity is not a constraint is attested to by the fact that on an average, RBI has been absorbing through its Reverse Repo window roughly USD 25 billion worth of surplus rupee liquidity in the banking system.

Provision of forex liquidity and inflow enhancing measures

- US$ swap lines of more than $10 billion for Indian banks with overseas subsidiaries and branches available up to March, 2010.
- Re-institution of special market operations to meet the foreign exchange requirement of public sector oil marketing companies.
- Prudential limit on overseas borrowing by banks doubled.
- Special refinance facility for EXIM Bank ($1 billion).
- Export credit refinance available to banks from RBI increased

- Increasing interest rate ceilings on Non Resident Indian deposits in rupees and foreign currency.
- Relaxation of External Commercial Borrowings (ECB) norms – ceilings on interest rates raised, end use restrictions which had been put in 2007-08 to deal with large inflows relaxed.
- The above various special refinance and other facilities have mostly remained unavailed of, underscoring the fact that lack of funding is not an issue; but they were provided preemptively, nevertheless, as a backstop.

Regulatory measures

- Risk weights and provisions in bank credit to certain sectors, such as real estate, which had been increased earlier, were rolled back to pre 2005-06 levels.
- To preserve productive value of assets otherwise viable, prudential regulations for restructured accounts were modified as a one-time measure for a limited period of time.
- With regard to their need to raise capital, NBFCs were allowed to issue perpetual debt instruments qualifying for capital.
- NBFCs allowed further time of one more year to comply with the increased Capital to Risk-Weighted Asset Ratio (CRAR) stipulation of 15 per cent as against the existing requirement of 12 per cent.
- Risk weight on banks' exposures to NBFCs which had been increased earlier, was rolled back.
- The restriction on commercial banks and all-India term lending and refinancing institutions who were not allowed to lend against or buy back CDs held by mutual funds was relaxed in the context of the drying up of liquidity for CDs and CPs.

Fiscal measures

- Three fiscal stimulus packages launched in December 2008, January 2009 , and February 2009
  - Tax relief to boost demand
  - Increased expenditure on public projects to create employment and public assets
  - Cost 3.5% of GDP – Rs.1.86 trillion ($37 billion)
  - Net borrowing during 2008-09 rose from budgeted Rs.1 trillion ($20 billion) to Rs.2.29 trillion ($46 billion)
  - Increase in fiscal deficit from 2.7% of GDP in 2007-08 to 6.2% of GDP in 2008-09
  - Net borrowing during 2009-10 budgeted at Rs.3.97 trillion (approx $80 billion)

Potential fallout of increased market borrowings and RBI's response

  - The increased market borrowing programme of the government has the potential to put upward pressure on interest rates with unintended consequences for growth as well as borrowing cost for the government. To mitigate this, RBI has been conducting Open Market Operations (OMOs).

From mid-February 2009 till date, RBI has purchased government securities worth Rs. 765 billion ($15 billion) as part of its open market operations.

These measures have had the desired effect of lowering deposit and lending rates of banks and increased credit flow to the real economy. Besides, recent quarterly figures of corporate earnings have been quite healthy and encouraging. Further, India has well developed liquid and efficient derivative markets like Interest Rate Swaps, Currency Futures, OTC Forward Contracts which afford businesses instruments to hedge their financial risks. Moreover, exchange traded Interest Rate Futures are due for launch shortly which will further increase the choices to market participants. Also, at USD 255 billion, foreign exchange reserves provide more than adequate comfort. Exchange rate of the rupee is market determined and RBI intervenes at the margin only to contain excessive volatility and to ensure orderly conditions in the foreign exchange market. Significantly, Indian foreign exchange market is very deep and liquid as reflected in bid offer spreads which compare with the major international currency pairs such as $-Euro, $-Sterling and $-Yen. In addition, as against the net outflow of portfolio investment in 2008-09, net Foreign Direct Investment (FDI) was substantially positive in 2008-09 at $ 18 billion underscoring the confidence of foreign investors in the growth prospects of the Indian economy. This was the consequence of liberal and transparent policy on FDI. Even the Overseas Direct Investment (ODI) policy is also very liberal which has resulted in an annual average ODI outflow during the last 3 years of USD 17 billion. Here again, we can discern the balance that I referred to elsewhere in my speech.

Last but not the least, the Indian Banking sector is very well regulated and well capitalized and has proved resilient to the recent global financial crisis as reflected in the following key parameters:

Total Assets: USD 1 trillion, CRAR: 13.18%, ROA: 1.03%; Gross NPA: 2.41%, Net NPA: 1.12%, NIM: 2.44%, Liquid Assets to Total Assets: 33%.

I do hope that the low-down that I have given on the current enabling and facilitating policy environment in India will appetise businesses both in India and South Africa enough to seize the complementary and synergistic investment and trade opportunities to consolidate and enhance the bilateral business relations to the common good of the people of our two countries.

With these words, I close my address and wish the conference all success that it deserves. Thank you all so very much!