Turmoil in Global Economy: The Indian Perspectives[1]

1. Shri Rajendra Kumar Das, Host Branch Chairman, Shri. Prashant Panda, Organizing Committee Chairman and the office bearers of the National & Branch Managing Committees of the Institute of Chartered Accountants of India (ICAI), Shri. Jugal Kishore Mahapatra, Principal Secretary, Finance, Government of Odisha, distinguished delegates from across the country, ladies and gentlemen. I am very happy to be invited to this important conference being organized by the ICAI in this picturesque temple city of Bhubaneswar which can also be called as God's Own City. I am thankful to the organizers for choosing such a topical subject for this session of the conference.

2. The last few years have been very challenging times for the policymakers, regulators and participants of the financial system. The crisis of 2007-08, now popularly referred to as the Global Financial Crisis (GFC), emanated from developed countries and considerably slowed down their growth and raised the unemployment to all-time highs. Due to various inter-linkages with the affected Advanced Economies (AEs), Emerging and Developing Economies (EDEs), including India, experienced the consequential impact by way of slowdown in trade, increase in risk perception and reversal of capital flows. The recent European sovereign debt crisis, fears of Chinese slowdown and the "Fiscal Cliff" of the US are having an adverse impact on the already fragile global economy. In short, the world and Indian economies are faced with new challenges to growth and stability which have emerged while some of the old impediments to sustainable growth persist. In my presentation today, I would attempt to delve into some of the issues related to the current global turmoil and provide the Indian perspectives on those issues using a '7 C' framework. For the sake of completeness, I would also like to touch upon the macroeconomic environment as the occasion demands and very briefly refer to the accounting and auditing issues since the gathering is predominantly of the accountants.

Challenges facing global economy

3. The recent slowdown of the AEs is both a cause and an effect of the sovereign debt crises in the Eurozone and the associated fiscal problems. The sovereign debt crisis in the Eurozone has not only aggravated the macroeconomic conditions of the countries of the Eurozone but also, in turn, has deeply affected the balance sheets of global banks having exposures to these countries. The political measures and announcements, co-ordinated initiatives of the Governments, and prolonged easing policies backed by unconventional measures of the central banks to provide a solution to the problems arising out of this crisis have not been able to evoke sustainable confidence in the financial markets. The fiscal austerity measures taken in response are further weakening the prospects of growth and employment in the affected European countries and, in turn, fiscal adjustment and repair of the national balance sheet are becoming an onerous task. The US continues

[1] Based on the address delivered by Shri Harun R Khan, Deputy Governor, Reserve Bank of India at the All India Conference 2012 on "Waves of Change: Ocean of Opportunities" organized by the Institute of Chartered Accountants of India in Bhubaneswar on August 18, 2012. The speaker acknowledges the contributions of Shri Jagan Mohan, Shri Anand Shankar and Shri Surajit Bose of the Reserve Bank of India.

to face high levels of unemployment, the consumer and business confidence remains shaken and the financial sector is still recuperating from the earlier crisis. The European Union and the US form the two largest economies in the world and are deeply inter-twined with each other even in such adversities. There is, thus, a felt need for concerted actions by the policy-makers across the AEs to save the global economy from falling into a downward spiral, rejuvenate the employment led recovery and pave the way for structural reforms required for sustainable and balanced growth not only in these economies but also in other economies including India.

Growth prospects

4. Economic growth around the world weakened significantly in Q2 2012 after being better than expected in Q1 2012. AEs and EDEs alike are experiencing moderation in growth. The numerous problems confronting the highly inter-connected global economy are reinforcing each other in retarding the pace and prospects of growth. Growth in the US has fallen during Q2 2012 while UK has been experiencing negative growth rates for three quarters now. GDP growth in the Euro area and Japan has been negative during Q2 2012. Economic growth even in the BRICS nations, which serve as an engine of growth in the developing world, has slowed down considerably. One of the other pressure points in the world economy, particularly the AEs, is the prevailing high unemployment. Unemployment in the US above 8 per cent has been persistently high. UK is also experiencing high unemployment of about 8 per cent and so is the Eurozone at around 11 per cent. Unemployment in the peripheral countries of Eurozone range between 15 per cent (Portugal) to 25 per cent (Spain). This obviously has implications for economic growth and the social fabric. China, a large contributor to the global GDP in the recent times, is slowing down too, much more than what was anticipated with growth rate for 2012 expected to below 8 per cent vis-à-vis trend rate of near double digit growth rate. This would have significant influence on the growth prospects of both AEs and EDEs.

Inflation prospects

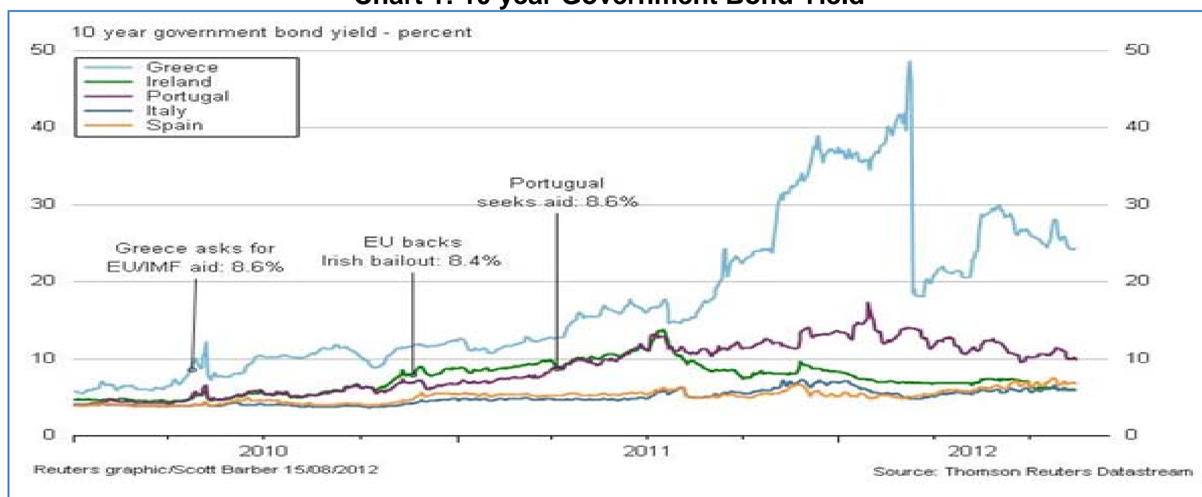
5. The risk of rising inflation globally is currently not high as demand softens and commodity prices decline. Bond yields across the maturities in the US, the UK and Germany, which are relatively stable AEs, remain low and do not portend higher inflation down the line. A key risk factor to benign inflation expectations is, however, brewing. The US is facing the worst drought in over half a century. There are fears that corn and soyabean crops could fail leading to an increase in the price of these crops. Since these crops also serve as animal feed and bio-fuels, there could be an eventual increase in price of animal products like meat, milk and milk products and bio-fuels due to fall in supply. The drought could have a bearing on the production of other crops which could potentially increase global food inflation. Massive liquidity injections by the central banks of advanced countries also have the potential, particularly through the financialization of the commodity price channel, leading to build up of inflationary pressures. In the face of falling growth, rising inflation could pose tremendous challenge for policy-makers who are fighting against heavy odds to maintain the growth-inflation equilibrium.

European sovereign debt crisis – new challenges

6. The European debt crisis, which originated in Greece, spread initially to other “peripheral” sovereigns and has now moved to the bigger “core” European

countries, such as, Spain and Italy. As is expected, when a sovereign is stressed, its banking system is likely to get embroiled and this is exactly what happened in this case also. The European banking sector was tested during the onslaught of the global financial crisis and was found to be seized with less than optimal assets amidst a stagnating economy and high unemployment level. With aggravation of the sovereign debt crisis, it was observed that these banks with fragile balance sheets could not lend to the sovereigns. On the other hand, the affected sovereigns have been finding it increasingly difficult to borrow to re-capitalise the banking sector as borrowing costs have increased due to perception of high risk associated with sovereigns. In fact, the borrowing costs in Spain and Italy are inching towards unsustainable levels of 7 per cent and 6 per cent respectively (Chart 1).

Chart 1: 10 year Government Bond Yield



7. It is important to note that a large number of banks in the Eurozone stand to suffer significant losses in the event of further escalation of sovereign debt crisis which may put many banks on the verge of bankruptcy and trigger a worldwide credit crunch. Another equally important aspect to reckon is the fund availability of the European Financial Stability Facility (EFSF) is likely to be over-stretched if bigger economies like Italy and Spain require bail-out funds. The latest twist to the story is news of regional governments in Spain facing insolvency. Recently, Catalonia and Valencia regions in Spain sought bail outs from the Spanish central government. This has made the job of policymakers even more challenging. Business confidence continues to remain weak and the Keynesian "animal spirits" have long been absent. Any further escalation of the European problem would possibly lead to a deeper crisis with a potential recessionary impact not only in those economies under sovereign debt distress but also on other economies across the globe.

The US "Fiscal Cliff" and the Chinese slowdown

8. Another potential crisis on the horizon is the "fiscal cliff" in the US. There is a risk that government spending could fall abruptly in the US by as much as 4 per cent of GDP in 2013. The political deadlock over the budget could potentially harm the economic growth if it leads to severe fiscal austerity. With the huge unemployment rate unlikely to fall soon, the already shaken confidence of the households and businesses could be further depressed and possibly intensify the stressed housing sector, leading to foreclosures which, in turn, would put the United States banking sector at risk again. Obviously, this has implications for global growth and financial stability. It has therefore

been suggested that the policy-makers in the US must take steps to avoid the fiscal cliff and also raise the debt limit while devising plans to return to long term fiscal prudence – a medicine long prescribed by them to the others.

9. China, according to the IMF, is the most “central” trading power in the world, based on its extensive trade links with other economies that are themselves tightly interwoven. It is the largest trading partner for 78 countries. This makes the IMF to classify China as a member of the so-called S5, or Systemic Five, a group of economies subject to extra IMF attention. Given its systemic importance, the recent slowdown in growth of China led by fall in investment and export demand has dampened the hopes that China could make up for weak demand from the debt-crippled Europe and the United States. Accordingly, the IMF has projected very low growth rate of 3.5 per cent in 2012. The World Bank has projected global GDP to increase modestly by 2.5 per cent, 3.0 per cent and 3.3 per cent in 2012, 2013 and 2014 respectively. This year is, thus, shaping up to become the worst year in terms of global growth since the GFC of 2008.

Accounting and auditing issues emerging from GFC

10. Allow me to now turn to some issues related to accounting and auditing as most of the participants are Chartered Accountants and would be in a better position to appreciate the issues. The GFC has forced various market participants to re-examine their accounting standards and auditing practices. Though several detailed analysis has been done to determine the root causes of the crisis, the role of extant accounting standards and auditing practices in exacerbating the GFC have also been highlighted, particularly the approach dealing with illiquid markets and distress sales. As a result, a number of G-20 led initiatives on global regulatory reform process alongwith various regulatory/standard setting bodies, such as, the Financial Stability Board (FSB), the Basel Committee of Banking Supervision (BCBS), and the International Accounting Standards Board (IASB) have been taken.

11. Some of the key issues related to accounting which were considered to have contributed to the crisis were (i) *Procylicality:* Certain aspects of accounting frameworks and capital regulation tend to enhance the natural tendency of the financial system to amplify business cycles, affecting both the degree of credit expansion in normal conditions and the degree of credit contraction in the downturn phase, (ii) *Disclosure*: Weaknesses in public disclosures by financial institutions damaged market confidence during the turmoil. Public disclosures by financial institutions did not always make clear the type and magnitude of risks associated with their on- and off-balance sheet exposures, & (iii) *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.

12. Auditing related issues like role of external auditors in conduct of audit with professional integrity as per the applicable statutes to impart credibility to the opinion expressed on the reliability, transparency and usefulness of the financial statements have also been raised in the context of the GFC and many other accounting controversies relating to financial and non-financial firms. It is expected that international and national initiatives being taken up to bring about desired revisions of the accounting standards, their convergence

across the jurisdictions under the IFRS framework and improve the transparency of financial reports without jeopardising financial stability would yield the desired results sooner than later.

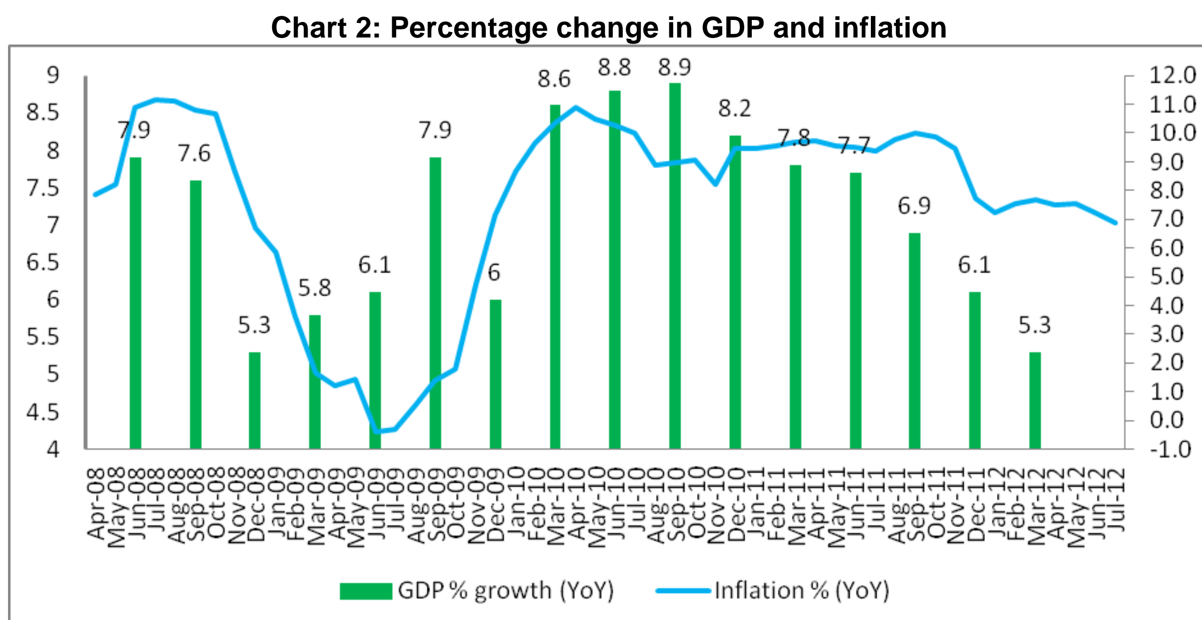
Challenges facing Indian economy

13. India has benefited from greater integration with the world economy and global financial markets. There was a belief in some quarters that India in particular and the EDEs in Asia have 'decoupled' from the AEs and could grow indefinitely. The experience gained during the GFC, however, proved that the decoupling theory was only a myth. It is also been realized that no doubt there are numerous benefits of globalisation it also entails huge costs. As has been seen over the years India's globalization indicators have been going up; for example, the current and capital account receipts and payments as a percentage of GDP has been around 110 per cent in the last two years. The European debt crisis and global slowdown are creating serious headwinds for the Indian recovery and posing major challenges for the economy. On the domestic front, the large twin deficits, viz. current account deficit (CAD) and fiscal deficit, pose significant risks to macroeconomic stability and growth sustainability. Financing the huge fiscal deficit from internal domestic savings would potentially crowd out private investment, thus lowering growth prospects. This, in turn, deter capital inflows, making it more difficult to finance the increasing CAD which in a sense is a result of global slowdown.

Decelerating growth and persistence of high inflation

14. Growth deceleration in India has not been accompanied by lower inflation (Chart 2). This obviously complicates policy making.

Chart 2: Percentage change in GDP and inflation

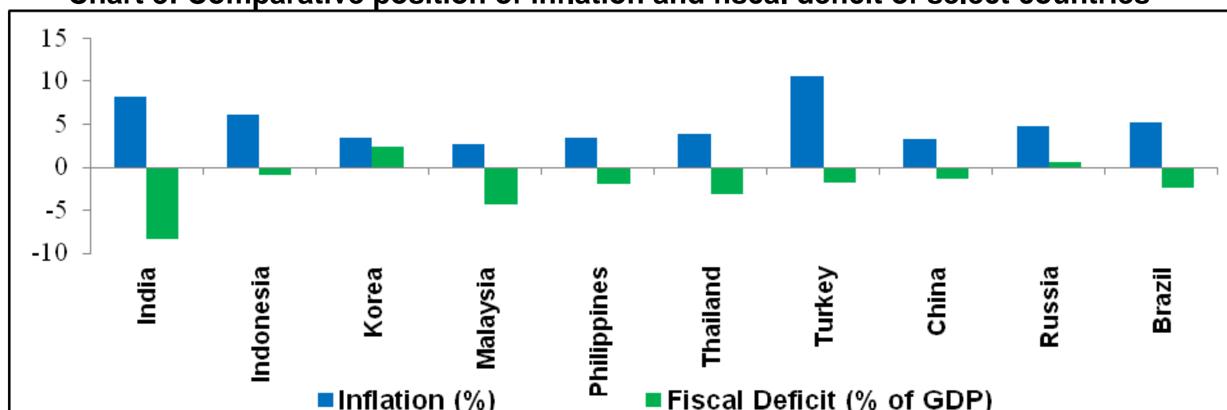


Source: Bloomberg

15. The latest GDP growth number of 6.5 per cent for the year 2011-12 is the lowest in the last nine years. Further, the growth outlook for 2012-13 has been lowered by almost all stakeholders including the Reserve Bank with its current projection of growth rate of 6.5 per cent for 2012-13. Lower private consumption demand in face of a slowing economy is compounding the

slowdown. Reserve Bank's estimates suggest non-inflationary trend growth rate has fallen to 7.5 per cent from 8 per cent. Further, a weak monsoon is feeding into food inflation worries. This coupled with sharp currency depreciation could lead to imported inflation. When compared to our peers, India is an outlier in many respects, particularly with respect to high fiscal deficit accompanied by persistent high inflation (Chart 3). India, for instance, now ranks at 151 out of 180 countries in respect of the inflation level as against a rank below 100 few years back. Such high fiscal deficit and inflation in India limits the policy maneuverability for providing support and stimulus by the Government and the Reserve Bank.

Chart 3: Comparative position of inflation and fiscal deficit of select countries

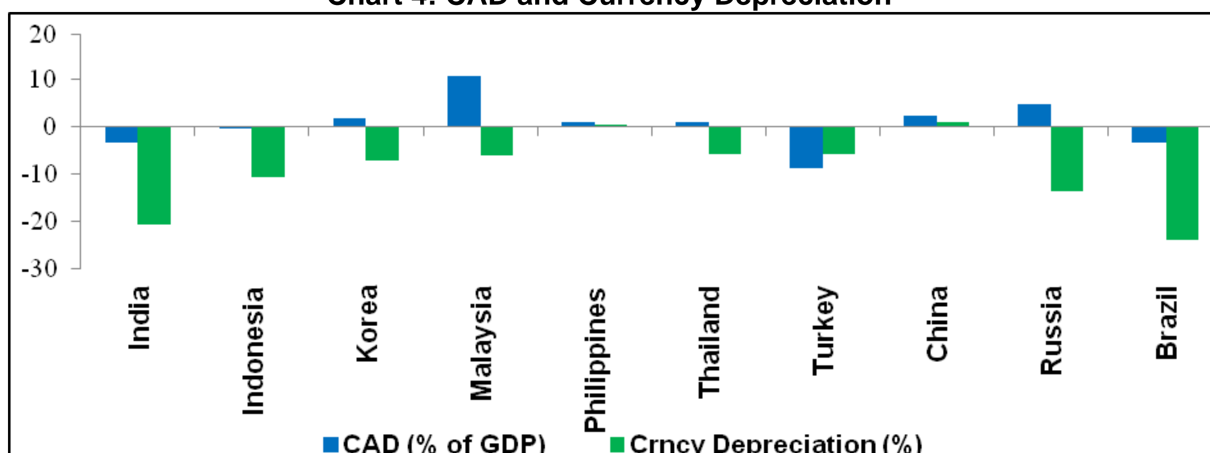


Note: Inflation and fiscal deficit are IMF estimates for 2012 Source: IMF

Currency depreciation and current account deficit

16. The high current account deficit (CAD) at 4.2 per cent in 2011-12 is much above the country's comfort level. India's CAD is also relative higher than its peers and the Indian currency has depreciated by about 20 per cent, year on year. In fact, currencies of other countries with CAD have also depreciated in the last one year since the US sovereign rating downgrade. The depreciation of Indian Rupee has been broadly at the same rate *vis-à-vis* the BRICS nations but higher than Asian economies (Chart 4).

Chart 4: CAD and Currency Depreciation



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

17. With recent global developments contributing to a significant rebalancing of portfolios as a result of rapidly changing risk perceptions and appetites, the Indian macroeconomic environment has looked turbulent during the past year or so. It has been noted that Indian growth slowdown during 2008 crisis was more due to global developments while in the current phase of crisis it is due to a combination of both domestic and global factors. Taking up the latter, it is almost axiomatic that in a world that is highly globalised, developments in developed economies are bound to have considerable direct and indirect influence on our domestic economy and the financial system. Against this background, I intend to highlight the impact of global developments on the Indian economy by using a **7 C** framework under which I will analyse their influence through the seven channels – **C**ommerce, **C**ommodity price, **C**apital flows, **C**urrency rates, **C**ontamination, **C**onfidence and **C**redit rating channels. I will also highlight the measures that have been taken as also further measures that need to be taken to contain the impact of these global headwinds alongwith the challenges that lie ahead.

Commerce channel

18. India, notwithstanding its strong domestic consumption and investment drivers for growth, has witnessed concomitant integration into the world economy over the last decade. Whenever one thinks of globalisation, the first things that comes to mind is integration of trade around the world. Over the years there has been substantial improvement in India's trade openness. Further, services have come to account for a major contributor to our export earnings. A number of factors have aided this process. Services that were considered to be non-tradable increasingly became tradable due to innovations in Information Technology and led to the export of Information Technology Enabled Services (ITES) and the business processes. Currently, total trade in goods and services, for example, accounts for over 55 per cent of the GDP (Table 1).

Table 1: 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 & imports of goods & services	55.8
Remittances	3.6
Current receipts	28.7
Current payments	32.9
Current receipts & current payments	61.5

Note: Figures are for 2011-12 and as per cent of GDP

19. The GFC and the European sovereign debt crisis has slowed down the global growth and trade and this would impact our exports both in merchandise and services. The recent decline of Indian exports (during April – June 2012, merchandise exports have contracted by 1.7 per cent) is a clear indication of this. Given the projections of the IMF that during 2012 world trade would grow

only at 3.8 per cent as against 5.9 per cent in 2011, Indian exports are certainly in for turbulent times.

20. It may, however, be noted that strong and sustained growth in merchandise exports witnessed in the recent years has been accompanied by structural shifts in the commodity composition and product and market diversification. Over the years, technology intensive engineering goods, such as, machinery, transport equipment, manufacture of metals and iron and steel, and petroleum products have emerged as the drivers of India's exports in place of traditionally predominant items, such as, gems and jewellery, textiles and textile products. In addition, India's exports have witnessed geographical diversification as well. India's major export markets have shifted from developed regions in the European Union and the US to diversified markets, such as, Asia, OPEC and African countries. All these developments have provided space for maneuverability for India's exports. Besides rationalization of many procedures, various policy measures have also been undertaken to boost exports. Some of the recent significant policy measures taken by the Government include more coverage under the Focus Market and the Focus Product Schemes and the interest subvention scheme. Reserve Bank of India has also taken quite a few steps like allowing elongated period for realization of export proceeds, increasing export credit refinance limits from 15 to 50 per cent of the banks' outstanding Rupee export credit, increasing spread in respect of FCNR(B) deposits which would provide source for foreign currency denominated export credit to Indian exporters and deregulating interest rate on export credit in foreign currency so as to incentivize the banks to extend more foreign currency export credit.

21. There are many opportunities for India to sustain its export momentum. India could encourage and build capacity in the export of the **3E**s – **E**ngineering, **E**lectrical and **E**lectronic goods as India's presence in these goods is rather insignificant and there is a huge scope for improvement. India could tap into the African market and encourage exports to other EDEs. Invoicing of trade in local currencies, which has received fillip with the Reserve Bank of India permitting hedging facility to the non-resident importers in respect of Rupee invoiced exports, could also help reduce reliance on the US Dollar and the vagaries of the movement in the US dollar. Bi-lateral and regional trade blocks could be promoted and used to invoice trade in local currencies. The steps already taken and further steps that could be taken to explore and establish new markets and augmenting manufacturing base to increase the export capacities could be leveraged when tides turn and would provide us the opportunity to balance our trade account.

22. With trade across the globe closely interlinked with the products and markets of different countries, developments in the world economy will also influence the Indian economy with greater intensity. While on the one hand our exports may fall, our imports may not moderate commensurately, thereby posing problems for India on the trade account front. Besides slowing global demand, excessive volatility in the exchange rate along with uni-directional movement bias witnessed during the last one year, persistence of high inflation accompanied by wage pressure which erodes export competitiveness, and infrastructural bottlenecks have emerged as major challenges for Indian exporters.

Commodity price channel

23. Commodity price channel also serve as a major transmission mechanism of global developments to the domestic economy. India is highly reliant on imports, particularly oil imports. About 70 per cent of demand for oil is met by imports and almost 100 per cent for the demand of gold is met *via* imports. Therefore, any change in price of these commodities has implications for price of these goods in the Indian markets. Inherently, the demand for these goods is relatively price inelastic. Increase in price of oil and gold have thus little impact on the demand of these goods in India. Since they are largely imported, India's current account balance is adversely affected and could also influence inflation expectations, putting further pressure on the fisc by way of higher subsidies and on the monetary authority by way of suppressed inflation. Although slowdown and recession in the AEs and EDEs should moderate oil price substantially, monetary easing by major central banks and geo-political factors have ensured that the prices do not fall much. The other major commodity price channel which adversely affects the global and domestic prices is that of food. The current drought in the US is already showing the adverse impact in terms of higher prices for corns. Further, the impact of financialisation of commodities on their prices needs to be studied further as current level of demand-supply mismatch does not warrant persistence of such high prices.

24. Discouraging gold imports, containing the impact of exchange rate dynamics, moderating the impact of volatility of global commodity prices on domestic economy and moderating the increasing trend for financialisation of commodities pose serious challenges for India in the future. Increasing the domestic exploration of gas and oil, augmenting alternative source of energy in a planned manner and enhancing domestic agricultural productivity by optimally exploring 32 agro-climatic zones of the country, however, can mitigate risks arising out of adverse commodity price movements to some extent.

Capital flow channel

25. The major source of the transmission of external shocks to the domestic economy is through the movement of capital flows across borders. India has also benefitted from the flow of capital into the country and integration of financial markets across the world. The savings-investment gap in India has been met by capital inflows. India is structurally a current account deficit country; therefore, capital inflows play a very important role in financing the CAD. In the recent period, however, dwindling capital inflows have been a cause of concern and financing the CAD has become a major challenge. The general risk-off sentiment and deleveraging by the European banks against the back drop of the European sovereign debt crisis is affecting trade credit, infrastructure financing and external commercial borrowings (ECBs) of the Indian corporates. Capital flows are determined by, *inter-alia*, global investor sentiment *i.e.* risk-on - risk-off sentiment, investment climate in the destination country and its credit rating. Expectedly capital flows into India have slowed in the recent times; the figures of Q1 of 2012-13 except for non-resident deposit flows have particularly been very disappointing. (Table 2)

Table 2: 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
FIIs (net)	Apr-Aug*	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@	316,605	289,170

**upto August 10, 2012* *@ as on August 10, 2012*

26. A number of policy measures have been undertaken to augment the capital flows into India given the general risk-off sentiment prevailing the global markets. With deregulation of interest rate on NRE deposit schemes and increase in the spread for FCNR (B) deposits, greater non-resident Indian (NRI) deposit flows have been facilitated. 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. In addition, remittances facilities for Indian expatriates have been streamlined given the fact that India remains the largest remittance receiving country and such flows have huge beneficial impact for bridging the CAD. There has been calibrated enhancement in the investment limits for the FIIs in sovereign and corporate bonds. The limit on investment in G-Secs has been enhanced to US$ 20 billion from US$ 15 billion. Long term investors like Sovereign Wealth Funds (SWFs), multi-lateral agencies, endowment funds, insurance funds, pension funds and foreign Central Banks have now been permitted to invest in Government securities. The limit on investment in corporate bonds has been enhanced to US$ 45 billion from US$ 40 billion and the holding period and residual maturity requirements for bonds in the infrastructure sector have been reduced. A new scheme allowing the Qualified Foreign Investors (QFIs) to invest upto US$ 1 billion in corporate bonds has been introduced. A number of measures like increasing the limit for availing of ECB under the automatic route, increasing the limit for refinancing the Rupee loans out of ECBs, new US$ 10 billion scheme of ECBs for export earners, etc. have been taken to rationalize the regulatory framework for ECBs. All these measures are expected to augment capital flows into India.

27. Given the increasing vulnerability of the external sector reflected in increasing short term debt to total debt ratio, debt service ratio, fall in the import cover of our reserves and reserves to external debt ratio, the need is to encourage non-debt creating flows and discourage excessive debt creating flows. Finding funding sources other than the US and European banks is also a major challenge. Perhaps one of the most daunting challenges for India is to attract capital given the risk-off sentiment prevailing in the global markets and low investment and growth outlook in the country. Improving the investment climate in India has to be the priority area of focus both to retain the interest of Indian corporates in the country and attract foreign direct investment flows. This could perhaps be addressed by focusing on what can be called as deficits of the **7Ls** – Land, Linkages, Labour, Legal, Liquidity, Leadership and

Learning deficits. Let me spend sometime to briefly explain these seven deficits.

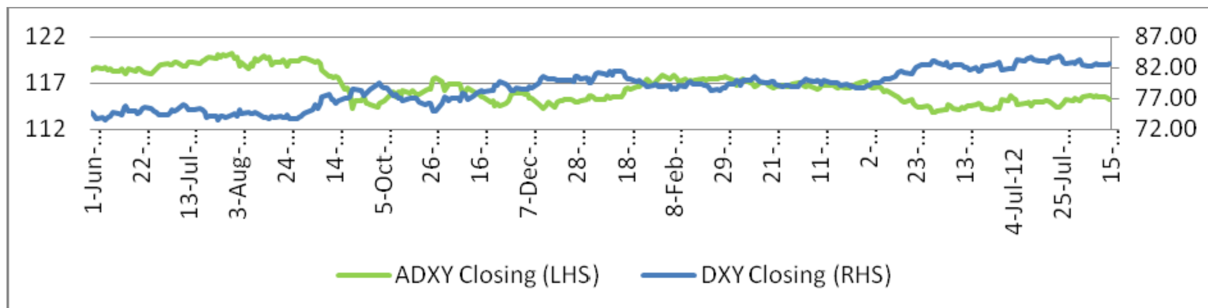
28. *Land:* Due to lack of clarity on land titles, incomplete land records, absence of their digitalization and weaknesses in the laws relating to land acquisition, investors find it difficult to acquire the required land. Further, given the population density and the type of land use in the country, the problem in land acquisition gets further aggravated due to social, cultural and political reasons. *Linkages:* The problem of non-availability of land at the right locations is compounded by the lack of required linkages with quality, infrastructure, backward integration with coal and power and other input sources. *Labour:* Despite huge unemployment, lack of employable people with right type of skills, inflexibility of the labour laws, growing signs of industrial unrest and rising wage demand have resulted in labour related deficit. In knowledge intensive sectors, which need people trained in hard subjects like science and mathematics and quality engineers, also face problems in hiring required people.

29. *Legal deficit*: Difficulty in enforcing contracts in a timely manner, absence of proper liquidation laws, absence of reforms and certainty in tax laws and uncertainty about interpretation of laws, as evident from some recent cases, are legal impediments for investments. Need for obtaining multiple regulatory approvals, which is reflected in very low global position of India in "Doing Business Ranking", compounds the problems of the entrepreneurs. *Liquidity:* At the system level, crowding out of resources from the banks due to huge government borrowings because of large fiscal deficit pre-empts resources for private sector investment. In the current context of declining asset quality and loan-deposit mismatches, banks are found to be risk averse in lending for private investment. Absence of a vibrant corporate debt market and the dearth of IPOs as seen recently in the capital market further compound the problems of funding investments. The Reserve Bank has of course been conducting the open market operations to ease the liquidity deficit in the system beyond its comfort level; recently to direct flow of resources to the private sector for productive purposes, it has reduced the Statutory Liquidity Ratio (SLR). *Leadership*: Although India has traditionally taken pride in its entrepreneurial class, the recent decades have brought to the fore the fact that not many new dynamic entrepreneurs have emerged. Some studies in fact indicate that India has a large number of well entrenched billionaires in comparison to the peer group countries. Absence of effective political and executive level leadership at the local, state and the central levels have also been seen as obstacles to investment in the recent years. *Learning deficit:* Learnings in the form of Research & Development (R&D) inputs form an integral part for laying a strong foundation for industrial growth. Given the quantum of resources and investments required, corporates tend to compromise on the R&D or depend on reverse engineering to manufacture cheaper alternatives. For achieving a greater share in world trade of quality products, corporates need to create or tap resources which will provide original ideas through R&D. Declining number of Ph.Ds in the country in a way shows how innovation and creativity deficits could affect quality investment efforts.

Currency rate channel

30. Movement in exchange rates both in India and abroad is primarily conditioned by the movement in the US Dollar due to the '*Exorbitant Privilege*[2]' that the currency enjoys. Firstly, a significant portion of world trade is denominated in the US Dollar. Secondly, during times of global risk aversion, capital flows back to the US and the US dollar strengthens (Chart 5) - a phenomena witnessed immediately after the US downgrade by the Standards & Poor's (S&P).

Chart 5: Movement of DXY[3] and ADXY indices



Source: Bloomberg

31. Thirdly, the US Dollar is the '*numeraire* currency' of official reserves around the world. All these factors have led to the strength of the US Dollar *vis-a-vis* other currencies of the world. Economic health of resident entities is often affected by developments in the US, Europe, US, China, etc. markets and is transmitted *via* changes in the currency rates. Transmission of developments in the global economy to the domestic economy takes place *via* movement in the exchange rates. More particularly, although exchange rates are influenced by domestic economic and financial conditions, rates are also influenced by the global currency rates due to integration of the Indian financial system and markets with the rest of the world. One such illustration is the recent movement in the US$-₹ rate which has been found to mirror the Euro-US$ movement. (Chart 6)

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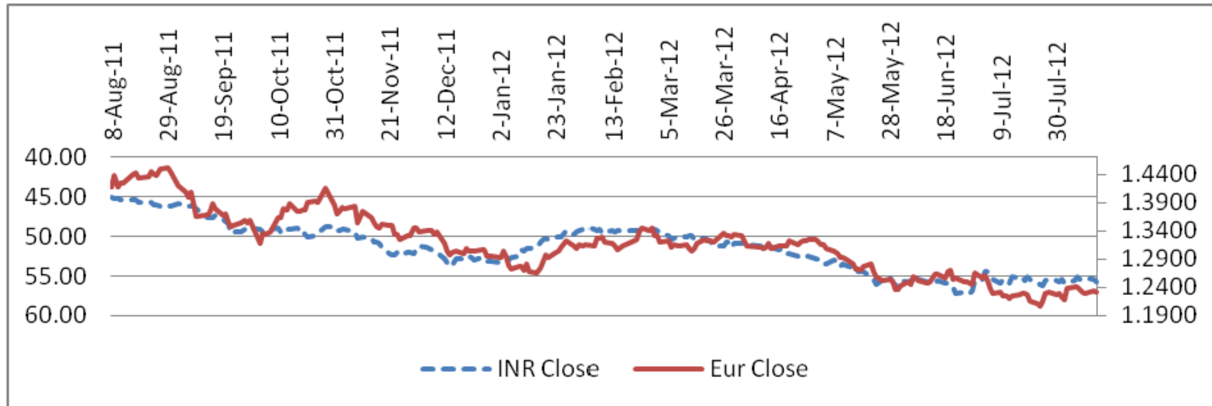
[2] The term was coined in the 1960s by Valéry Giscard d'Estaing, then the French Minister of Finance. The term got popularized with the release of the book titled "Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System" written by Barry Eichengreen.

[3] DXY Index: The US Dollar Index is a geometrically-averaged calculation of six currencies weighted against the US dollar and contains six component currencies: the Euro (57.60%), Japanese yen (13.60%), British pound (11.90%), Canadian dollar (9.10%), Swedish krona and Swiss franc. ADXY Index: The Bloomberg-JPMorgan Asia Currency Index is an U.S. dollar tradable index of emerging Asian currencies with Chinese Renminbi having a weightage of 36.76%, Korean Won 14.10%, Singapore Dollar 9.84%, Hong Kong Dollar 9.21%, Indian Rupee 7.90% and Indonesian Rupiah, Malaysian Ringgit, Philippine Peso, Taiwan Dollar and Thai Baht with smaller weightages.

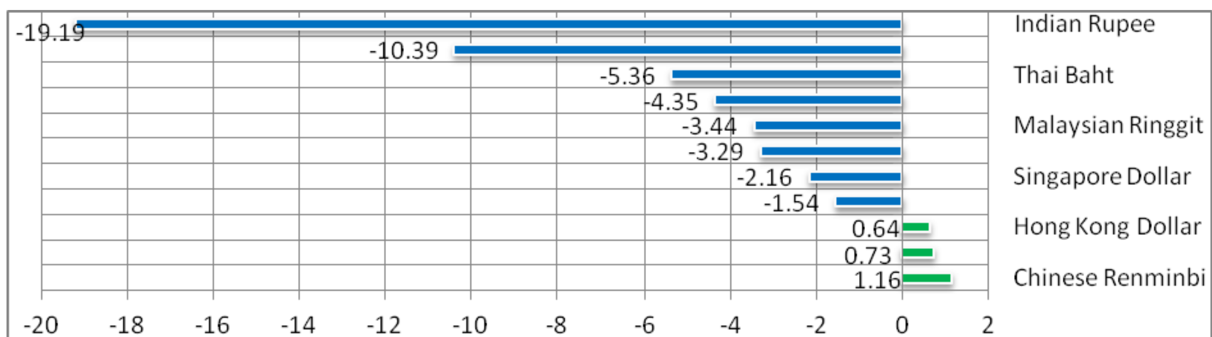
Chart 6: Trends in INR/US$ and Euro/US$ (closing) rates



Source: Bloomberg

32. The domestic forex market has witnessed a prolonged period of volatility with one-way bias over the last one year except brief periods of appreciation. While during 2010-11, the Indian Rupee saw an appreciation of 1.1 per cent, 2011-12 witnessed sharp depreciation of more than 12 per cent, much more than many Asian economy currencies (Chart 7).

Chart 7: Performance of Asian currencies against US dollar between August 8, 2011 and August 15, 2012



Source: Bloomberg

33. After touching 54.30 (all-time low till that point of time) on December 15, 2011, Rupee showed signs of recovery in response to the various policy measures aimed at encouraging capital flows as well as administrative measures taken to curb the speculative behavior of the market participants. Rupee has been trading in a range between 55.07 and 56.16 since early July. The level of Rupee exchange rate and its volatility, as mentioned, will, however, continue to be influenced both by the global currency rate movements and domestic developments.

34. A number of policy and administrative measures have been undertaken to mitigate the effects of unfavourable movement in the exchange rates. Steps have been taken to contain speculative pressure on Rupee and the Reserve Bank has, as a policy, intervened in the forex market to contain excessive volatility without of course targeting any level. Caps on banks' and corporates' ability to bring in or take out capital have been applied judiciously. Measures have been undertaken to attract capital flows to reduce supply-demand mismatch for the US Dollar. Trade invoicing in Indian Rupee and hedging of rupee exposures by non-residents has been permitted. All these strategic and

tactical measures are expected to reduce the effect of unfavourable movements of the global currency rates on the Indian currency. Level of CAD affects currency rates, thus, moderating the CAD by expanding exports and moderating imports is a challenge. Another challenge is the constant monitoring of the market by the Reserve Bank of India and review of the strategic and tactical tools available to it on an ongoing basis for handling excessive exchange rate volatility. Increasing the use of local currencies in trade starting with the neighbouring/emerging market countries could mitigate the effects of adverse movement in the US Dollar. Increasing the use of local currencies in trade, however, remains a challenge, particularly when such currencies have shown sharp volatility with downward bias.

35. Exchange rate is an important macro-economic variable which has significant impact on the real sector. Sharp unidirectional movements in this variable in a relatively short period of time can have serious financial stability implications. All the concerned regulators who have jurisdictional interest in the exchange rate have to adopt a coordinated approach to address market volatility. Credibility of central bank's approach to intervention and communication of its policy preferences remain a major challenge given the multiple pressure points of our external sector. Role of the Government is very important in building confidence in the economy, encouraging long-term non-debt creating capital flows and taking measures to promote exports and moderate avoidable imports for reduction in the CAD. At the same time, the market participants and end-users have a significant role and stake in market's early return to normalcy.

Contamination

36. Increasing integration of Indian economy with the rest of world has also made corporates vulnerable to external developments through the effect on their balance sheets. The recent sharp one-way movement of the Indian Rupee caught most people by surprise. The high levels of unhedged external borrowings of Indian corporate sector and other current and capital account linkages with the rest of the world exposed them to transaction, translation and economic risks from exchange rate movements. The Indian Rupee depreciation causes translation losses that need to be recognised on balance sheets in India to judge the true financial health of corporates. In addition, the use, and, on many occasions, the abuse of complex forex derivatives, added to the contamination of the balance sheets. The European sovereign debt crisis and consequent deleveraging by the European banks has increased funding pressures for our entities as the European banks are an important source of finance for Indian banks and corporates. In the recent period, Indian corporates have expanded abroad and, given the volatility in financial conditions the world over, their exposures by way of equity, loans and contingent liabilities like guarantees to the JV/WOS set up in stressed countries abroad could put pressure on the parent companies who maybe required to provide support to their overseas JVs/WoS. These developments pose major challenges as India Inc has been globalizing in a rapid pace.

37. Since the commercial banks are the major players in the domestic foreign exchange market in India, one would expect much higher responsibility from them. Keeping in view the need to keep "suitability and appropriateness" criteria in view, banks are expected to show restraint while offering forex derivative products to the corporates as the latter often enter into such

transactions without much understanding of the downside implications should the market move adversely. This could lead to enormous problems for the banks as also for the corporates. Therefore, Reserve Bank has been emphasizing that banks should insist on Board approved policy covering un-hedged foreign exchange exposure of all their clients including the SMEs. Further, while extending fund and non-fund based credit facilities to corporates, banks should rigorously evaluate the risks arising out of un-hedged foreign currency exposures of the corporates and price them in the credit risk premium.

38. Containing excessive reliance on foreign borrowings remains a challenge. As mentioned, managing the risks of leveraged fund based and non-fund based overseas exposures to the JV/WoS abroad is also an emerging issue. Adoption of sound risk management practices at home has also not been properly appreciated as domestic firms should focus on their core business rather than see forex transactions as profit centres. In addition, proper appreciation of the spirit of the accounting norms including the requirements of hedge accounting relating to forex exposures should also receive the attention of all the stakeholders.

Confidence channel

39. Confidence or contagion channel arises from uncertainty in the minds of investors and other economic agents due to both global and local factors. In general, one could relate the contagion channel to Keynes' concept of "animal spirits". The impact of this channel manifests itself very quickly in the equity and foreign exchange market-falling equities and one-way movement of the exchange rate. Even the stock market sentiment is often driven by the FIIs led activities based on their "risk on – risk off" approaches. Often the movement in one market reinforces movements in the other. Overall negative sentiments can quell investment plans of portfolio investors, deter long term direct investors to commit funds and can have negative effect on the financial markets.

40. Recognizing these issues the Reserve Bank had mandated that the participation in the call/money markets be limited to only domestic entities like primary dealers and banks without any role for non-resident entities. Even the debt market has been insulated due to limited exposure to the non-residents. The overall Indian approach has been to focus on active capital account management so that the domestic currency is not unduly affected by global factors unrelated to the local fundamentals. As discussed earlier, the Reserve Bank also intervenes in the currency markets to reduce excessive volatility. The Liquidity Adjustment Facility (LAF) available to the banks also acts as a safety valve during times of stress and reduction in the Statutory Liquidity Ratio (SLR) negates the impact of contagion as more resources are available for the private sector.

41. Contagion always poses challenges for the AEs and the EDEs alike. India is no different. Maintaining and improving confidence in India story remains a challenge. This obviously involves reduction in the twin deficits of CAD and the GFD and improvement in investment climate for both domestic and foreign investors. There is a need to realize that financial sector solutions can not address real sector problems. Maintaining foreign exchange reserve adequacy ratios in the current context of emerging vulnerabilities in our

external sector poses challenges for India. In addition, encouraging non-debt flows in a risk-off global environment is another big challenge.

Credit rating channel

42. Capital flows are often determined by the sovereign ratings. The outlook for India has been downgraded by a few Credit Rating Agencies (CRAs). India's sovereign rating was put under "watch-list" due to weak fiscal performance, uncertain investment environment, declining growth and governance related issues. According to S&P, India's rating currently is BBB^{-}. Any downgrade from the current rating will lead to a 'non-investment grade status and could have implications for capital flows. Cross-currency studies have revealed that downgrades cause depreciation of currencies and increases currency volatility. One can always argue whether the 'one size fits all' approach of the CRAs is the correct way to assess the country's macro-economic situation. Further, the credibility of CRAs has come into question in the recent past. Some quarters of the academia and policy makers often ask if the standards of the CRAs are poor. We have, however, limited choice in this regard. Changes in external ratings could affect the size or availability of capital flows in a significant manner in either direction. The cost of capital flows could also be affected by changes in ratings. Major rating agencies have recently sounded off warnings resulting in difficulties faced by both Indian banks and corporates in accessing overseas credit facilities mainly ECBs. Some FIIs like pension funds, endowment funds, sovereign wealth funds/central banks, etc. have a minimum investment rating criteria for their bond investments and if India falls below that rating, there could be an impact on capital flows.

43. There are many positives for India. India continues to be one of the fastest growing economies in the world and the relatively high levels of domestic savings and investment rates augur well for the future economic growth of the country. In addition, public debt is largely held domestically and is denominated in Rupees, insulating the country from adverse movements in exchange rates and contagion arising out of risk-off sentiment of the foreign investors. India's large and diversified economy along with educated workers and strong entrepreneurial class can go a long way in augmenting domestic growth and furthering India's long term growth story. There have been efforts to improve the general investment/business sentiment in the country. The Government has announced its commitment for fiscal consolidation and working towards a more transparent and stable tax regime. Improvements in supply side channels have been focussed to address the problem of inflation.

44. Meaningful engagement with CRAs, improving governance, removing bottlenecks in infrastructure projects in power, roads, ports & airports, improving the investment climate, providing a stable and clearer legal tax structure, easing regulatory rigidities in terms of approval for large projects, reducing high GFD which crowds out resources available to the private sector and adds to the inflationary pressure and quality spending by the Governments to crowd in investment could go a long way in bringing out positive reassessment of the country by the CRAs.

Concluding thoughts

45. In conclusion, allow me to summarize the issues I have highlighted. Global growth has slowed and uncertainties have increased. Unemployment remains

high in the advanced economies leading to lower demand. The Indian economy and the financial system have a unique set of strengths and weaknesses but like any other EDE it cannot fully protect itself from the global headwinds. Its resilience to overseas developments would be severely tested as domestic growth and inflation dynamics are affected by both global factors and local factors. Global factors affect the domestic economy through the 7C channels – **C**ommerce, **C**ommodity price, **C**apital flows, **C**urrency rates, **C**ontamination, **C**onfidence and **C**redit rating channels. The local factors, such as, the twin deficits of GFD and CAD, persistently high levels of inflation, deceleration in investments, infrastructural deficiencies, supply bottlenecks of industrial inputs like coal and electricity, deficient monsoon, hassles involved in execution of large projects, low business confidence and governance issues play an equally dominant role in toning down the growth expectations. From the global perspective, the major challenges facing India that need to be addressed are the falling demand for Indian exports and inelastic nature of our imports, mostly commodities with elevated prices, controlling inflation and inflation expectations, eliminating infrastructure bottlenecks, attracting non-debt creating foreign capital in the face of general risk aversion, containing knock-on effects of overseas developments on the exchange rate, encouraging firms to follow sound risk management practices to contain the impact of their foreign exchange exposures and taking measures to positively influence the assessment of the credit rating agencies.

46. In the context of current global environment characterized by slowdown and uncertainty on which we have little control, there are still leeways available for improving the domestic economy and the investor sentiments. The need of the hour is, therefore, to address the structural and cyclical impediments through appropriate domestic macro and micro-economic policies, credible action for fiscal consolidation, tax reforms and predictability and controlling inflation and inflationary expectations. There is also need to tone up our political – administrative - regulatory framework for improving our "Doing Business Ranking" given the fact that in 2012, India ranked 132 among 183 nations in terms of overall ease of doing business indicators as per a World Bank study. Although we have given a gobye to the so-called "licence-permit raj", the study finds that in terms of procedures to start a business and get all the permissions needed for a business to start India ranked 166th. This clearly indicates that we need to focus on the **7L** deficits – Land, Linkages, Labour, Legal, Liquidity, Leadership and Learning deficits - for boosting the investment climate for both domestic and foreign investors.

47. Finally, I believe each one of us can play a part in the globally turbulent and domestically challenging times by drawing inspiration from a prayer from the American theologian and public affairs commentator Reinhold Neibuhr who very aptly said :

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

48. Thank you once again for giving me this opportunity.