*Financial Crisis and Beyond**

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Let me first take this opportunity to welcome Deputy Governor Dr. Delun and all members of the Chinese delegation to India.

2. I am very pleased to be present here today to inaugurate the third India China Finance Conference, 2009. The impact of the crisis on countries like India and China has reinforced the global heterogeneity in terms of the structure of financial systems. Both India and China are actively involved in bringing this heterogeneity to the table during discussions at various international policy fora such as the G20, FSB, BCBS, *etc.*

3. Economic and financial conditions have improved following the unprecedented and coordinated response to the crisis. There has been discernible improvement in the financial sector and financial markets in particular, though some concerns in regard to the real sector and the high levels of unemployment persist in many countries. There is greater appreciation of the divergent situations and pace of recovery in different countries and that the process of withdrawal from the accommodative policies will need to be nuanced by the specifics of each country *albeit* in a coordinated manner. This spirit was captured in the final communiqué issued after the meeting of the G-20 Finance Ministers and Governors which reflected the countries' commitment to "*to implement our plans flexibly, taking full account of variations in the pace of economic recovery and market conditions across countries and regions, and the complex interactions between different policy areas*"

Indian Banking Sector: An Overview

4. The modern economic system depends on a reliable flow of financing through

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intermediaries such as banks, insurance companies securities companies and mutual funds. Although India has a well diversified financial system it is still dominated by bank intermediation. Important components of the financial sector in India broadly fall into categories *viz.* banks, non-banking financial institutions and insurance sector. Commercial banks together with cooperative banks account for nearly 70 per cent of the total assets of the Indian financial institutions.

5. Significant financial deepening has been taking place in Indian economy over the years as seen from the credit-GDP ratios. A noteworthy feature discernible in the Indian context is that the rise in indicators of financial deepening takes place along with a noticeable rise in the domestic savings rate. This has to be seen in the backdrop of financial sector reforms, rise in total factor productivity and investment boom which has led to acceleration in the growth performance.

6. There are around 80 Scheduled Commercial Banks (SCBs) operating in India, including public sector banks, private banks and foreign banks. The banks have remained largely robust against the backdrop of global financial crisis, though there has been some slowdown in the growth of assets. The Capital to Risk-weighted Assets Ratio (CRAR) of banks in India has improved further to 13.2 per cent at end-March 2009 from 13.0 per cent at end-March 2008. The asset quality of banks has been improving over the past few years as reflected in the declining NPA to advances ratio. It is especially noteworthy that notwithstanding the pressures of a slowdown in the economy and an atmosphere of uncertainty, the net NPA to net advances ratio increased only marginally to 1.1 per cent as at end March 2009 from 1.0 per cent as at end March 2008. Significantly, gross NPA to gross advances ratio remained constant at 2.3 per cent. Thus, in terms of the two crucial soundness indicators, *viz.,* capital and asset quality, the Indian banking sector has exhibited resilience amidst testing times. It is noteworthy that contrary to the trend in some advanced countries, the leverage ratio (Tier I capital to total assets ratio) in India has remained high reflecting the strength of the Indian banking system. The growth rate of consolidated balance sheet of banks decelerated to 21.2 per cent in 2008-09 from 25.0 per cent in 2007-08. The growth rate was, however, higher than the nominal gross domestic product (GDP) (at current market prices) resulting in a higher ratio of assets of banks to GDP.

7. The growth rate of advances, which was as high as 33.2 per cent as at end-March 2005 has been witnessing a slowdown since then. During the year 2008-09, the growth rate decelerated to 21.2 per cent from 25.0 per cent in the previous year. During the current financial year, the growth has further declined to 4.3 per cent, which is significantly lower than the growth of 10.5 per cent in the corresponding period of last year. Several factors have contributed to the slowdown in non-food bank credit. One, overall credit demand from the manufacturing sector slowed down reflecting a decline in commodity prices and drawdown of inventories. Two, corporates were able to access non-bank domestic sources of funds and external financing – which had almost dried up during the crisis

– at lower costs. Three, unlike in the previous year, oil marketing companies reduced their borrowings from the banking sector as oil prices moderated. Four, a significant amount of bank finance has gone to the corporate sector through banks' investment in units of mutual funds. Five, banks have also reined in credit to the retail sector due to the perceived increased risk on account of the general slowdown. This credit retrenchment was more pronounced in the case of foreign banks and private banks.

8. India has already committed to fully move to a Basel-II environment from April 1, 2010. The enhancements issued by the Basel Committee in response to the crisis will also be made applicable to Indian banks, as applicable to standardised/basic approaches.

The Way Forward

9. The immediate task of repairing the global financial system in the aftermath of the crisis has seen considerable progress with a broad agreement on the general principles for strengthening the prudential and regulatory framework for banks, the need to develop macroprudential frameworks, tools to monitor and assess the build up of macroprudential risks in the financial system and take action to limit such risks. The challenge, going forward, would be for the respective national authorities to take appropriate actions within the broad contours of the international approaches. There would indeed be certain issues requiring a more nuanced approach depending on individual country's circumstances. I would like to touch upon the key policy challenges for countries.

Policy Challenges – Short-term

A. Exit from supportive policies

10. In line with the discernible improvement in the economic outlook globally as also in India, attention has shifted from managing the crisis to managing the recovery. But the issue here is that given differences in prospects, monetary policies may begin to diverge considerably between the advanced and emerging economies. While the design of exit strategy, especially its timing in each country will largely depend on the respective macroeconomic and financial market conditions, factors like strong aggregate demand conditions and a well-functioning domestic banking system may pave the way for early, yet gradual, exit from the expansionary policy. There is, however, no doubt that given the level of integration among the economies, each country will also have to take into account the external factors.

11. It is, however, important to recognise that the exit debate in India is qualitatively different from that in other advanced and emerging economies because of the unique features of its macroeconomic context, for the following reasons:

i. Most of these countries do not face an immediate risk of inflation, whereas India is actively confronted with an upturn in inflation. As per the latest information available, wholesale price index (WPI) inflation, on a y-o-y basis for the week ended October 17, 2009 was at 1.51 per cent largely on account of the base effect of sharp increases in prices recorded a year ago. However, there are emerging signs of underlying inflationary pressures. The inflation based on different CPIs continues to remain stubborn at double digits and the prices of food articles and essential commodities in WPI increased substantially on year-on-year basis. The momentum of WPI since end-March 2009 indicates that the WPI has increased by 5.9 per cent indicating emerging inflationary pressures.

ii. India has the challenge of reviving domestic consumption and investment demand - the traditional dominant drivers of our growth. Households, firms and financial institutions in India are not struggling with impaired balance sheets unlike those in advanced economies.

iii. India has traditionally been a supply constrained economy in contrast to advanced economies which are demand starved. The supply constraints, which remained subdued during the crisis period due to weak demand, will re-emerge and may indeed become binding.

iv. India is one of the few large emerging economies with twin deficits – fiscal and current account deficits.

12. The precise challenge for the Reserve Bank is to support the recovery process without compromising on price stability. This calls for a careful management of trade-offs. Premature exit will derail the fragile growth but a delayed exit can potentially engender inflation expectations. The balance of judgment at the current juncture is that it may be appropriate to sequence the 'exit' in a calibrated way so that while the recovery process is not hampered, inflation expectations remain anchored. Accordingly, conventional monetary policy tools *viz.* the policy rates were left unchanged but certain special liquidity support measures were withdrawn.

- The statutory liquidity ratio (SLR), which was reduced from 25 per cent of demand and time liabilities to 24 per cent, has been restored to 25 per cent.
- The limit for export credit refinance facility, which was raised to 50 per cent of eligible outstanding export credit, has been returned to the pre-crisis level of 15 per cent.
- The two non-standard refinance facilities: (i) special refinance facility for scheduled commercial banks (available up to March 31, 2010), and (ii) special term repo facility for scheduled commercial banks (for funding to MFs, NBFCs, and HFCs) (available up to March 31, 2010) have been discontinued with immediate effect.

13. Going forward, fiscal consolidation would be a major challenge for the Government of India. In order to make up for the deceleration in private consumption and investment demand, it has become necessary for the Government to resort to countercyclical public spending and temporarily suspend the provisions of FRBM. This has, in a large way, insulated the economy from the worst impact of the crisis. The case, however, for return to a path of fiscal consolidation, when there are convincing signs of recovery, need not be overemphasised.

B. Managing capital flows

14. The sudden change in the external environment that started around mid-

September 2008 led to an adverse situation characterised by global liquidity squeeze and increased risk aversion on the part of international investors. In India, there were large capital outflows by portfolio investors in the third quarter of 2008-09. While FDI flows exhibited resilience, access to ECBs and trade credits was rendered somewhat difficult. In fact, the capital account balance turned negative during the third quarter (October-December) of 2008-09, the first time since the first quarter of 1998-99, mainly due to net outflows under portfolio investment, banking capital and short-term trade credit. This trend continued during Q4 of 2008-09. Net capital inflows at US$ 9.7 billion (0.8 per cent of GDP) were much lower in 2008-09 as compared with US$ 109.2 billion during the previous year. However, capital flows revived in Q1 of 2009-10 with the capital account clocking a positive balance of US$ 6.7 billion (US$ 11.1 billion in Q1 of 2008-09).

15. Capital flows have resumed on the promise of India's growth prospects. Under this backdrop, problems associated with a synchronous tightening of monetary policy, *viz.*, exit from the expansionary policy earlier than others can be especially relevant for emerging market economies like India. Here again one has to manage the trade-off between the costs and benefits to the economy and that of preserving financial stability.

Policy Challenges – Medium-Term

A. Reforming the regulatory framework for financial institutions

16. There is an agreed agenda of reform of the financial sector aimed, *inter alia*, at building higher and better quality capital, liquidity buffers, mitigating pro-cyclicality, addressing moral hazard posed by systemically important financial institutions, development of firm specific recovery and resolution plans, strengthening accounting standards, reforming compensation practices to support financial stability and strengthening infrastructure of OTC derivatives markets. The emphasis is on applying these consistently across countries. It has been agreed that standards for strengthening prudential regulation will be developed by end 2010 and will be phased in as financial conditions improve and the economic recovery is assured with the aim of implementation by end 2012. Some of the specific nuances that may need to be taken on board in this regard are:

- The trade-off between the pace of higher and high quality capital requirements and the costs in meeting the genuine financing needs of the economy; there will be need for an impact study before the standards are finalised.
- The considerations that need to be taken into account for identifying systemically important entities. In addition to size there is need to assess the interconnectedness and the complexity while calibrating higher capital and liquidity requirements.
- While the issue of leverage had been sought to be addressed for banks, there was an equally pressing need to address this in the larger context of leverage by non-bank entities through banks and funding markets, which may be currently out of regulatory oversight.

- Prudential frameworks will also need to address the concerns regarding intermediation in foreign currency through the financial sector which also posed systemic risk in the recent crisis.
- The critical issues in the current debate on the accounting standards, *viz.* fair valuation and provisioning based on expected losses are of particular relevance to bank based financial system such as ours. There is a need to reduce procyclicality in accounting in the case of fund based leveraged financial entities to reduce build up of systemic risk. For this purpose, accounting standards must promote provisioning based on expected loss basis *i.e.* permit a forward looking approach. On use of fair value, it must be recognised that this system depends on continuous availability of market prices and liquid markets. Changes in accounting standards should therefore not expand fair value measurement to all assets and liabilities.

B. Fiscal concerns

17. The quality of fiscal consolidation has to be given priority attention in view of the fact that even the post-FRBM improvements in key deficit indicators were possible primarily on account of the revenue buoyancy. On account of the FRBM Act, revenue deficit and fiscal deficit came down from 2.5 per cent and 4.0 per cent of GDP in 2004-05 to 1.1 per cent and 2.7 per cent of GDP, respectively, in 2007-08. These improvements in fiscal indicators were largely revenue led. The revenue buoyancy improved significantly as a result of higher economic growth during this period and also due to deliberate policy action towards improvement in tax administration through computerised information system and institution of tax information network (TIN). As against this, not only that expenditure compression had the lowest contribution to fiscal consolidation, but even the composition of increase in expenditure tilted against capital expenditure reflecting lack of focus on expenditure management in contributing to the quality of fiscal consolidation.

18. Therefore, going forward, bringing about quality of fiscal adjustment under the mode of fiscal consolidation would be a challenge both for the Centre and the States but it is necessary to give more room to both private investment and the conduct of monetary policy. In the medium-term fiscal policy statement, the Government has projected a fiscal deficit of 5.5 percent of GDP in 2010-11 and 4 per cent of GDP in 2011-12. It is projected to reverse the trend of increasing debt/GDP ratio witnessed in 2008-09 and 2009-10.

C. Framework for strong sustained and balanced growth

19. Global rebalancing of demand is considered critical for sustained healthy growth over the medium-term. At a broader global level, there has been a widely shared perception now that "Developing Asia" could become the major economic hub over the medium-term. Already, its share in world GDP has increased from 10.1 per cent in 1990 to 21.0 per cent in 2008 and its share of exports of goods and services has jumped from 5.3 per cent to 13.5 per cent over this period. This combined with the fact that Developing Asia is also the home

to more than half of world population (its share being 52.6 per cent in 2008), with very favourable demographic profile in most of the countries, translate into the fact that the prospect of future growth in these economies is very high. In this background, the higher incremental consumption and trade from Developing Asia combined with those from growing regions in Latin America and Eastern Europe may compensate for the permanent fall in consumption and trade from the US. However, there is a need to improve consumption in some of those countries by building appropriate social safety network.

20. The G-20 has launched the framework for strong sustainable and balanced growth. While countries will continue to provide support for the economy until the recovery is secured, the challenge lies in managing the transition to withdrawal of the extraordinary macroeconomic and financial support measures.

21. India has not contributed to any imbalances. We have also not had to support the financial sector with extraordinary support. Our challenges are slightly different as articulated earlier.

Conclusion

22. While the worst may be over and world seems firmly on the road to recovery, the path is strewn with many challenges, as outlined above. The crisis has given us a unique opportunity to not only deal with the immediate task of reverting the economy to a high growth path, but also to make tangible progress in terms of fiscal and financial reforms in the long-run.

23. For us the challenges are not so much the repair of the financial system or the excessive growth of financial sector unrelated to the growth of the real sector. The level of penetration in India are presently low which can provide a medium-term structural growth driver for banks in India. Today's conference has very appositely identified the themes for various panel discussions – rural banking and microfinance, infrastructure finance and broader regulatory approach for financial sector. For emerging market economies, these are precisely the issues which need to be addressed to achieve balanced and sustainable growth over the long-term. These countries can take this opportunity to learn right lessons from the crisis for development of a robust financial sector with a sound systemic oversight framework. Such a financial sector with right focus and objectives would be instrumental in maintaining the optimum balance between the real sector and the financial sector. Leveraging such a framework would be critical in effectively meeting the financing and risk management needs of a growing economy in a manner which does not increase systemic risks. Stability in the financial sector is our best bet to provide a necessary buffer to undertake the task of financial empowerment in the true sense.