*Financial Globalisation, Growth and Stability: An Indian Perspective**

Y. V. Reddy

Financial Sector Reforms

In India, reforms to improve efficiency and soundness of the financial sector started early in the reform cycle that commenced in 1991 - in some ways anticipating the gains that would accrue from the resultant flexibility in product and factor markets. However, the process of strengthening of the functioning of the financial institutions in terms of prudential framework, operational efficiency and regulatory/supervisory regimes has been gradual. It was also calibrated with the development of money, forex, government securities and equity markets. At the same time, the pace and content of reforms in banking, financial and external sectors are closely aligned with the progress in reforms in the real and fiscal sectors and in the public sector as a whole, considering in particular that the banking sector in India is dominated by the public sector. Our attempts to align the financial sector with the global best practices do take into account progress achieved in public policy in regard to similar alignments in related areas, especially the real sector flexibilities, fiscal health and overall governance standards.

In the Indian context, considerable weight is currently accorded by the Reserve Bank of India (RBI) to price and financial stability while recognising its twin objectives of growth and stability. The large segments of the poor tend to reap the benefits of high growth with a time lag while the rise in prices affects them instantly. Further, we recognise the limited capacity of the poor to bear risks that may occur in the real sector by virtue

* Remarks of Dr. Y V Reddy, Governor, Reserve Bank of India at the International Symposium of the Banque de France on Globalisation, Inflation and Monetary Policy, held in Paris on March 7, 2008

of developments in the financial sector, in the absence of social security mechanisms and public safety net.

Let me illustrate with two examples of emphasis on stability in relation to financial institutions and financial markets. First, the centrality of the banking sector, especially the retail deposit base and credit disbursement, is maintained while gradually expanding the practice of diversified universal banking. Second, in regard to financial markets, in view of a persisting, though moderating, high combined (*i.e.*, federal and provincial debt together) public debt to GDP ratio of over 70 per cent, coupled with current levels of fiscal deficits, almost the whole of sovereign debt, mostly at fixed interest rates, is denominated in domestic currency and is held almost entirely by residents. A small component is open to Foreign Institutional Investors and multilateral / bilateral agencies. At the same time, the government securities market is well developed and is paving the way for the healthy development of an expanding corporate bond market.

Capital Account Liberalisation

Liberalisation of the capital account has been a gradual process with a distinction being made between households, corporates and financial intermediaries, along with the recognition of a hierarchy of preferences for capital flows. The equity markets are more liberalised, relative to debt markets. Experience has shown that investment in equities, especially in terms of foreign direct investment, may bring in collateral benefits such as technological and organisational know-how. There is, therefore, considerable openness in regard to equity along with active management of external debt.

While the policy readily recognises the benefits of liberalisation of trade, it constantly weighs the risks and rewards based on both domestic developments and global conditions in regard to management of capital account. Thus, the process of liberalisation of the capital account reckons the pace of concomitant developments in domestic financial sector, fiscal health and flexibilities in the real sector.

Capital Account Management

It is possible to argue that just as 'stabilisation funds' take care of current account shocks, capital account management and market interventions are justifiable to take care of cognisable capital account shocks.

A continued focus on financial market development and its sophistication would, no doubt, mitigate the challenge of capital flows in the medium term. However, it is important to recognise that maturation of financial markets takes time. Hence, sometimes capital flows may have to be managed through other instruments in the short term, while continuing to work on development of the financial markets.

Increase in absorptive capacity of the economy could be a mitigating factor in the context of large inflows. It is not easy, however, to develop absorptive capacity of an economy in the short run and in any case it is very difficult to calibrate the absorptive capacity of an economy to match capital flows if they happen to be volatile. Furthermore, the level of current account deficit in respect of emerging market economies that is generally considered as sustainable by the global financial markets may be lower than the sheer volume of capital inflows in these economies.

It is sometimes suggested that encouraging outflows would be a good solution to manage surging inflows. While there is some merit in this approach, liberalising outflows may not be of great help in the short run because a more liberalised regime generally attracts higher inflows. Hence, such a policy has to be combined with other measures which could help to effectively manage the flows.

In implementing a calibrated process of liberalisation of capital account, co-terminus with developments in other sectors, there are several issues that are addressed in regard to managing capital flows in the short run. These are: (a) whether the capital flows are judged to be large and lumpy; (b) whether they are assessed to be temporary; (c) the limits to effectiveness of interventions if the exchange rate movements are unidirectional; (d) the desirable extent of sterilisation, considering costs and the available instruments; and (e) above all, the likely impact of the relevant policy stance and procedural measures on the exchange rate expectations. Needless to say, monetary and exchange rate and reserve management are rendered complex in the context of the well known 'trilemma', especially in the current global environment.

Monetary Policy

Monetary policy recognises the growing importance of global factors but the domestic developments play a dominant role. No doubt, the structural transformation underway and the continued significance of public sector in financial sector as well as notable prevalence of administered interest rates make the tasks particularly complex. While there has always been a dual mandate of the Reserve Bank, it has, in recent years, successfully articulated a self-imposed tolerance limit of five per cent on headline inflation. The tightening of monetary policy commenced in October 2004 and there have been seven increases of 0.25 per cent in the repo rates till March 2007, to address early signs of possible overheating during the period. To meet the challenges of excess liquidity on account of surge in capital flows, the cash reserve ratio in regard to banking system has been increased in ten instalments since September 2004 till date, aggregating three hundred basis points. Currently, there are acute policy dilemmas arising from global food and energy prices as also from financial market turbulence that need to be factored-in in evolving appropriate policy responses.

Supervision of Banks

In recent years, partly reflecting the buoyant economy, credit growth has been very high, particularly, in select segments and the asset prices have been accelerating. The Reserve Bank made it clear that while it does not have a view on the market valuations, it would like to sensitise the banking system to the potential risks of rapid escalation in prices. The actions taken since December 2004 to address these issues include increase in risk weights in respect of housing loans and sensitive sectors *viz.*, commercial real estate and capital market exposure. Further, since November 2005, provisioning requirement for standard advances, except for agriculture and SMEs, were increased while the increases in respect of sensitive sectors were steeper. Several procedural & suasive measures, and supervisory review processes over select banks were also undertaken to sensitise them in this regard. In particular, the RBI's concerns about credit quality in the expansion phase of credit, the recourse to non-deposit resources to fund their assets, the uncomfortable loan-to-value ratios and excessive reliance on wholesale deposits were repeatedly expressed, and this has been followed up with interactions with select banks, as needed. As a result, overall credit growth as also advances to sensitive sectors have since moderated. The Reserve Bank has been urging the banks to also monitor carefully larger unhedged foreign exchange exposures of their corporate clients.

In view of the tendency of some of the banks to utilise non banking financial companies as conduits to channelise funds leading to regulatory arbitrage and discomfort, limits on both direct and indirect exposures were imposed and transparency in their relationship with banks was insisted. Further, supervisory review process has been undertaken in regard to the few banks that rapidly expanded their off-balance sheet exposures so as to secure supervisory comfort.

As regards complex financial products, the structured credit market is in its infancy. Both mortgage-backed and asset-backed securities are in vogue, but in the light of differing market practices and concerns relating to accounting, valuation and capital adequacy treatment of such products, the Reserve Bank issued guidelines on securitisation of standard assets in February 2006. Permitting introduction of credit derivatives, currency futures as well as interest rate futures with modified product design in India are under active consideration and the process of extensive consultations with market participants is underway.

Regulatory Focus on Liquidity

The overall liquidity in the system is actively managed by the Reserve Bank mainly through the operation of Liquidity Adjustment Facility on a daily basis in addition to sterilisation through several instruments.

While the Reserve Bank has prescribed prudential guidelines for asset liability management by the banks and they have flexibility in devising their own risk management strategies as per Board-approved policies, subject to regulatory limits on mismatches prescribed for short-term time buckets, the Reserve Bank has taken steps to mitigate risks at the system level as well.

The Reserve Bank had, early on, recognised the risks of allowing access to the unsecured overnight market funds to all categories of entities and, therefore, restricted the overnight unsecured market for funds only to banks and primary dealers.

Like other supervisors, the asset liability management guidelines for dealing with overall asset-liability mismatches have been issued by the Reserve Bank. Since excessive reliance on call money borrowings by banks could cause systemic problems, prudential limits in relation to net worth have been stipulated on both lending and borrowing in call money market in addition to those on inter-bank liabilities.

The guidelines on securitisation of standard assets have laid down detailed regulations on provision of liquidity support to Special Purpose Vehicles (SPVs). It *inter alia* enables grant of liquidity facility, by the originator or a third party, to help smoothen the timing differences faced by the SPV between the receipt of cash flows from the underlying assets and the payments to be made to investors. The liquidity facility is subject to certain conditions to ensure that the liquidity support was only temporary and gets invoked only to meet cash flow mismatches and for absorbing losses. Any commitment to provide such liquidity facility is to be treated as an off-balance sheet item and attracts 100 per cent credit conversion factor as well as 100 per cent risk weight.

Select Issues

Keeping in view the Indian experience and recent global developments, I will venture to pose some select issues for consideration. First, arguably globalisation had helped to bring down inflationary pressures. An interesting issue would be as to whether globalisation of trade has contributed more to such a process than globalisation of finance or whether it is a combined effect. China's manufacturing industry and to some extent, India's services sector, have admittedly contributed to the downward inflationary pressures while more recent upward pressures on prices of food and fuel do not suggest significant role for finance relative to trade. The impact of extensive use of derivative instruments in respect of commodity trade on oil and food prices is still indeterminate.

Further, as illustrated by China and perhaps India, major contributors to the price moderation so far, consequent upon global integration, have remained relatively less open on capital account and have a moderately integrated financial sector.

Second, the link between open capital account and growth performance is not fully confirmed by the experience of the two largest emerging markets, though such a link is not entirely refuted either. In view of limited experience so far it is also useful to explore the link between movement in asset prices and financial integration *vis-à-vis* trade integration. In any case, the assumption that a managed capital account generates adverse sentiments in financial market is not fully borne out so far by the two aforesaid examples which experience large capital inflows. This points to the need for assigning greater weight to macro-economic fundamentals than to the state of capital account openness.

Third, recent turbulence in financial markets/institutions and the importance of harmonised and coordinated response of public policies indicate the significance of countercyclical fiscal and monetary policies. Is it possible to argue that similar harmonisation between monetary policy and prudential policies would be of some value as part of counter cyclical measures?

Fourth, in regard to regulation and supervision over banks, it is useful to explore whether the special status of banks in the financial system and the need for active coordination among regulators / supervisors needs to be reaffirmed. Further common persons in most of the societies would like to have a set of institutions where almost total safety of funds is assured and these traditionally are the banks. Hence, if the concept of reasonable expectation in public policies is accepted in regard to banks (as evidenced by the experience with Northern Rock), the pre-eminence of depositors' interests come out prominently. In this light, a reassessment of 'originate-to-distribute' models, off balance sheet items and liquidity requirements of banks may warrant a closer examination in regard to banks. Moreover, the debate on financial innovation and regulation has to be considered in terms of potential and systematic relevance of such innovations besides the capabilities for bringing them effectively under the regulatory umbrella. The extent of relevance of reputational risks in the conduct of the banking business relative to the past may also be worth considering.

Fifth, relative to trade in goods, externalities are more prevalent in regard to financial sector, especially the banking sector. Hence, some regulation is essential and it tends to be national. However, the financial flows are rapid due to modern technology and could be quite substantial, but in view of global scale, it becomes extremely difficult to identify or enforce the rules of origin in regard to financial flows. In this regard, the scope of and limit to global harmonisation of banking regulations in a convincing and enforceable manner may have to be continuously assessed so that the national regulators appropriately build into their regulatory regimes the requisite global requirements and domestic compulsions of reasonable expectation from the common person that ought to govern the public policy.

Sixth, currently there appear to be simultaneous challenges from several angles to the conduct of monetary policy emanating from recent financial turbulence. These relate to abrupt and large shifts in monetary policy measures of the major economies, major realignments in exchange rates within a short period and unprecedented inflationary pressures due to food and energy prices. These warrant significant and innovative ways of cooperation among the central bankers.

Finally, from a purely academic perspective, it may not be out of place to explore the issues concerning international policy coordination including the political economy considerations, in terms of interaction between governments and the financial sector, which may have been influenced by not only the growing importance of finance but also the cross-border linkages in the financial flows. Recent debates on the Northern Rock, Sovereign Wealth Funds and financial innovations being ahead of regulation, are symptomatic of this broader issue. If I recall, Prof. McKinnon and Prof. Jagdish Bhagwati, among others, had alluded to some of these aspects some years ago.