

*Lessons from the Global
Financial Crisis with
Special Reference to
Emerging Market
Economies and India**

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1. Since the collapse of the leading US investment banks in August-September 2008, there has been a breakdown of trust in inter-bank and inter-institutional lending. Given that this kind of extreme risk perception will be reversed only slowly, the full resolution of the crisis will inevitably take time.

2. Additionally, there is the problem of contagion - across markets, across institutions and across countries. Each day, there is news of the crisis spreading to a newer part of the world or to a newer institution. What we are going through is an unprecedented crisis; and we will be failing the world if we do not draw lessons from the crisis to prevent its recurrence. It is on these lessons that I want to focus.

3. First, financial supervision has drawn widespread critique. The stereotype perception is that risk management and supervisory practices lagged behind financial innovations and emerging new business models. The present crisis underscores the need for regulation staying ahead of the curve, and for continually upgrading the skills and instruments for financial regulation and supervision. However, there is need for a note of caution here. There is a distinct risk that in trying to stay ahead of innovation, regulation may get so stringent that it stifles innovation. This is a risk we must guard against.

4. The second lesson relates to the inter-agency coordination. The origins of the current crisis can be traced to both

* Statement of Dr. D. Subbarao, Governor, Reserve Bank of India, and Leader of the Indian delegation at the International Monetary and Financial Committee Meeting, at the International Monetary Fund, Washington DC, on October 11, 2008.

the build up of macro-global imbalances as well as the mispricing of risks in the financial system, which in turn, was encouraged by prolonged easy monetary policy and excess liquidity. We endorse the IMF view that the respective roles of central banks, regulators, supervisors, and fiscal authorities regarding financial stability needs to be revisited. Central banks should play a central role in maintaining financial stability and should have the necessary informational base to do so effectively. This implies close co-operation among all the agencies entrusted with the task of maintaining financial stability.

5. The third lesson is that the large scale bail-out packages will have implications for the regulatory architecture of the financial system and for the fisc of countries. Besides, the rescue packages offered by one country could have ramifications for other countries, even when they are far from the epicentre of the crisis. A relevant issue in this context is the efficacy and coverage of deposit insurance. What should deposit insurance cover? How are small deposits to be defined? Apart from small deposits, should we, in a crisis situation like this, consider extending guarantees to the money markets and mutual funds?

6. Fourth, the unfolding crisis has revealed the weaknesses of structured products and derivatives in the credit markets. This throws up questions about the appropriateness of various structured product like credit derivatives and their financial stability implications. Are

exchange traded derivatives superior to over the counter (OTC) derivatives? Do we need to focus on prescribing and instituting appropriate clearing and settlement practices even for OTC products? In what way can we eliminate the shortcomings of the "originate-to-distribute" model?

7. Finally, the near meltdown of the US financial sector is seen by some as evidence that markets and competition do not work. This is clearly the wrong lesson to draw. The right lesson to draw is that markets and institutions do succumb occasionally to excesses, which is why regulators have to be vigilant, constantly finding the right balance between attenuating risk-taking and inhibiting growth.

8. Let me now make a brief comment on India.

9. India, with its strong internal drivers for growth, may escape the worst consequences of the global financial crisis. Indian banks have very limited exposure to the US mortgage market, directly or through derivatives, and to the failed and stressed financial institutions. The equity and the forex markets provide the channels through which the global crisis can spread to the Indian system. The other three segments of the financial markets - money, debt and credit markets - could be impacted indirectly. Risk aversion, deleveraging and frozen money markets have not only raised the cost of funds for Indian corporates but also its availability in the international markets. This will mean additional demand for

domestic bank credit in the near term. Reduced investor interest in emerging economies could impact capital flows significantly. The impending recession will also impact on Indian exports.

10. To sum up, even EMEs which do not have direct or significant exposure to stressed financial instruments and troubled financial institutions are experiencing the indirect impact of the financial crisis, and this impact is by no means insignificant or trivial. Indeed, it could intensify in the months ahead.

11. It is heartening that there is coordination among developed countries

in the management of the crisis. That is welcome and necessary, but not sufficient. In as much as emerging and developing economies are likely to be increasingly impacted by the crisis, going forward two things are necessary. First, in managing the crisis, the implications of that management for emerging and developing economies should be explicitly factored in. Second, emerging and developing economies should be taken into confidence and consulted whenever the policies and actions of the developed countries have implications for them.