Speech

EMERGING CONCERNS AND STATE OF INDIAN ECONOMY*

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On this occasion, I propose to address the limited issue of identifying the emerging concerns on the state of economies of emerging markets with particular reference to recent developments and place before you a factual account of the current scenario in the Indian economy.

The Recent Crisis

The recent crisis has many unique features which are worth relating as a backdrop to the current concerns.

First, it was unexpected, by almost all concerned i.e., Governments, multilateral institutions, rating agencies and market participants.

Second, it is unusual since its origin is not of low economic growth or low savings or high Government deficit or financial repression but in a way failure of the market mechanisms or private sector.

Third, it is pervasive since it is a crisis of currencies, corporates stocks and banking.

Fourth, it is the most contagious so far, with an impact, initially on neighbours, then other developing countries and soon developed world also.

Fifth, it is still, by and large inexplicable though the immediate cause appeared to be sudden confidence erosion and global scale herding by market participants.

Sixth, the response of the official policy makers and the international financial community seems to have been often delayed and pretty much behind events - following or reacting to events rather than shaping them.

Seventh, it is not only pervasive and widespread but also deep - say the extent of depreciation of some currencies.

Eighth, while there are some similarities between the directly affected countries, there are significant dissimilarities.

Ninth, similarly while there are some internal causes (i.e. domestic situation or excessive short-term borrowing and lending to non-productive sectors) there are also some external causes (i.e., global factors such as

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developments in Japan and China, including in particular excessive lending from major financial centres.)

There are three important aspects of the crisis which we need to note.

Firstly, it appears to be a case of unrealistically high expectations and disappointment on the part of participants.

Secondly, there is still some lack of consensus on the appropriate response, as also the role of relevant institutions.

Thirdly, and most important to all this, there is a widespread agreement that the concerned economies will bounce back but the issue is, how soon and at what cost, even if they are transitional. Also, bounce back will necessarily be different for different affected countries.

Areas of Concern

It is not, therefore, surprising that there are new concerns expressed, or what may be called emerging concerns. These relate not only to the state of economy or policies of each of the emerging markets but also the broader role of Government, aspects relating to market failures in both capital exporting and importing countries, sovereignisation of private debt, financial sector liberalisation especially regulation of banks, volatility of capital flows, pace of capital account liberalisation, regulatory systems in major financial markets, exchange rate management, international bankruptcy procedure, role of multilateral agencies, and of course international lender of last resort, etc.

Emerging Concerns and Indian Economy

Broadly speaking, there are five major areas of concern today, whenever one analyses an emerging economy. These relate to macro-economy, external sector management, regulation of the financial sector, the state of corporate sector and the broader issue of transparency in the system. More important, the specific aspects of concern in each are different now compared to say a year ago. Without entering into a debate on the appropriateness of such concerns or the differences about what should be a concern or what magnitude should engage attention, I will address clearly identifiable areas currently being looked at by market participants and the present status of Indian economy in respect of each of these.

Macro-Economy

The annual growth rate of Gross Domestic Product has been in the range of 7 to 7.5 per cent during the last three years (i.e., fiscal years 1994-95 to 1996-97). For the current year, estimates range between 5.0 to 6.0 per cent. Investments as a percentage of GDP has also been reasonably steady in the period at around 26 per cent on the average.

The current account deficit as a per cent of GDP has been consistently in the range of 1 to 1.8 per cent, and has averaged 1.3 per cent, and the current year's position would not be very different.

Fiscal deficit of Government of India as a percentage of GDP had come down gradually from 6.1 per cent in 1994-95 to 5.5 per cent in 1995-96 and 5.0 per cent in 1996-97. Though there are some fiscal strains, it is hoped that there would be no directional change.

The annual rate of growth in Broad Money (M_3) was 22.3 per cent in 1994-95, but dropped subsequently, pulling down the annual average growth rate between 1994-95 and 1996-97 to 17.3 per cent and in the current year it should be around 15.5 per cent. There is a similar pattern in regard to inflation, which averaged 7.4 per cent between 1994-95 and 1996-97 and the Wholesale Price Index this year is estimated to be around 6 per cent, less than last year's 6.9 per cent.

Finally, non-food credit growth has averaged 21 per cent per annum in the last three years and this year it is expected to be around 20 per cent including investments in PSU and corporate bonds, debentures and commercial paper.

As you may be aware, the latest CSO estimate places GDP growth of 1996-97 at 7.5 per cent and net capital inflow from abroad for the last two years has been placed at 1.86 and 1.15 per cent of GDP at market prices.

External Sector

On the external front, in SDR terms, exports have grown at 13.6 per cent and 16.7 per cent during 1994-95 and 1995-96 while imports have grown at 18.0 and 23.7 per cent. Last year (1996-97), there has been a deceleration to 9.6 and 10.6 per cent, respectively. This year, during April-December, growth of exports was 9.1 per cent and that of imports 13.5 per cent, both in SDR terms.

The Foreign Direct Investment (FDI) flows continue to rise and are US $ 2.5 billion during April-December 1997-98 as against US $ 2.7 billion during the whole of 1996-97. More important, the policy framework and the procedures ensure that most of the value of FDI flows to infrastructure and productive sectors.

FII investments during the current year so far are less compared to US $ 1.9 billion for the entire 1996-97; but it is expected that it would be at least US $ 1 billion during this year. The flows on account of external aid last year, commercial borrowings and non-resident deposits are positive on a net basis, and broadly as per expectations at the beginning of the year.

The invisibles have also been on track and as a result, the foreign currency reserves as on February 6, 1998 are higher at US $ 24.4 billion compared to US $ 22.4 billion at the beginning of the financial year.

More important, some mention about external debt management and magnitudes would be in order. The RBI controls by a process of approval of each case, the total short term debt, including trade related credit beyond 180 days. Our short-term debt as a per cent of our reserves is around 27 per cent, while as a per cent of total external debt, it is about 7 per cent. Each external commercial borrowing, including maturity, interest terms etc., has to be approved by the Government/ RBI. In fact, a micro level productive use of such external debt is ensured during the approval process. In fact, our volume of external debt has been generally on the decline and during 1993-97 total external debt was reduced by one billion US Dollar, while there was accretion to reserves of the order of US $ 16.6 billion. Indeed, strict control over external debt is the cornerstone of our external sector liberalisation.

Sometimes, the issue of forward liabilities of the Central Bank is raised. We have been very cautious by generally limiting such aggregate outstanding liabilities and rarely does it exceed 10 per cent of reserves. Of course, there is no rigid rule. We observe great prudence in these matters while exercising flexibility. We publish all such operations from time to time. Finally, the exchange rate is flexible but volatility has been and is being checked by the Reserve Bank of India.

Financial Sector

As most of you may be aware, we have adopted international standards of capital adequacy for banks, and their non-performing assets are closely monitored with a view to bringing them down. In particular, I would like to emphasise some major features. First, our banks' total exposure to assets of Asian and East Asian countries was less than US $ 500 million, and foreign liabilities are well below 10 per cent of total liabilities.

Second, lending to property is frowned upon and is generally restricted to housing finance.

Third, lending to stocks is also severely restricted and there is a ceiling of 5 per cent of incremental deposits for this purpose. Actually, very little of this facility has been used.

Fourth, by virtue of close monitoring and approvals required and in the absence of derivatives etc., off-balance sheet items of banks are minimal and closely monitored.

Fifth, the banks are permitted to borrow or invest abroad only up to 15 per cent of their net unimpaired capital.

The authorised dealers (apart from a few money changers) on foreign exchange are almost always banks, whose exposures, open positions etc. are closely monitored.

Sixth, the non-banking financial companies have been brought under tight legislative, regulatory and prudential framework recently.

Corporate Sector

The debt of corporates as a percentage of equity, on the basis of annual surveys audited by the RBI indicates that corporate debt of 1730 selected non-financial public limited companies was 76.5 per cent of the extent of equity in 1993-94 and it has come down to 57.9 per cent in 1995-96.

Also, as a percentage of total debt, external debt was about 10 per cent in respect of large corporates and less than 2 per cent in respect of all corporates covered by the study in respect of 756 selected companies.

At the present juncture, therefore, corporate sector of India as a whole is not overexposed to external liabilities.

Transparency

On all areas of public interest involving RBI's operations, press releases on a daily basis are common. The Reserve Bank releases a Weekly Statistical Supplement which is virtually a balance sheet of the RBI and captures monetary, fiscal and external sector developments. In addition, the monthly Bulletin of the RBI gives a wide array of information, including for instance forex operations of the Reserve Bank. One can note all the forex transactions of the RBI, including outstanding forward liabilities in the monthly Bulletin. The formal statements of Governor, especially on monetary and credit policy developments clearly express a view of monetary and credit developments. The Annual Report on Trend and Progress of Banking in India contains a wealth of authentic information and the latest issue gives bank-wise ratios relating to performance. The Parliamentary oversight and occasional recourse to judiciary by affected parties ensure that an acceptable degree of transparency is maintained.

Conclusion

In brief, we ensure sustainable current account deficit, restrict reliance on short-term external debt; limit access to external debt and emphasise productive use of such debt. We encourage Foreign Direct Investment as the main source of non-debt creating capital inflows. Also, exchange rate is market determined though the RBI closely monitors and occasionally intervenes to avoid volatility as also ensure orderly conditions in forex markets. We undertook financial sector reforms, especially banking reform as a prelude to liberalisation of some capital account transactions in the external sector. We discourage banks' investments in real estate and stock markets. Non-banking financial companies are currently subject to regulation. Corporates' exposure to debt, especially external debt is within reasonable limits, though growing. There is transparency in operations of the Reserve Bank of India - whether it is forward market or whether it relates to performance of banks. In fact, the RBI takes initiatives in the orderly development of money market, Government Securities market and foreign exchange markets. We hold constant formal and informal consultations with market participants on these issues. To conclude, we believe that market participants should note these features of current state of our economy in assessing our prospects - both short and medium-term.