# Y V Reddy: India and the global economy

Speech by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Lal Bahadur Shastri National Academy of Administration, Mussoorie, Uttaranchal, 17 July 2004.

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Friends,

I am delighted to be here in the Lal Bahadur Shastri National Academy of Administration, Mussoorie. You are among the few that have succeeded in perhaps one of the most competitive and fairest examinations in the world. You have the additional advantage of having spent some time in the rural and semi urban areas of our country while in the districts. I chose the subject `India and global economy' precisely because during the next three to four decades that you will be serving our nation, the biggest challenges and opportunities for our country would be in the rural and semi-urban areas. An important driver of change in rural India would be the impact of integration of the Indian economy with global economy. It is a happy coincidence that the respected Chief Minister of Uttranchal, Shri N.D. Tiwari, who spoke to you in the preceding session today, urged you to closely follow the developments in the global economy even while you work in sub-divisions, districts and States. Mr. Mukesh Puri, your Course Director asked me whether the topic of my talk today was, indeed, 'India and the global economy' and not 'India in the global economy'. I clarified that it was 'and' and not "in" the global economy. Simply stated, till recently the issue had been how India would manage its growing integration with the global economy. Of late, there is some discussion on how the global economy would adjust to the successful global integration of India.

In the first part of the presentation, as a background, there will be a brief account of global economic integration and the role of public policy. This will be followed by a review of India's policies in regard to the external sector. The third section will mention what appear to be the current challenges for the global economy as India integrates with it. The fourth section would be in the nature of random thoughts on the public policy challenges in our country to manage the integration smoothly. The fifth section will elaborate on several issues in regard to financial integration. The issues include the special characteristics of financial integration and our policy in this regard including that for the banks.

### Global economic integration

The concept of globalisation, in the sense in which it is used now, can be traced to the phenomenon of nation states. In the distant past, there were just human communities. For much of human history, most people remained confined to their communities, villages or local areas. With developments in communication and economic activity, it has progressively become easier to move from the local to the regional and then from the regional to the national level, and finally across nations. Perhaps globalisation is a process that has been, in some sense, constrained by the authority of the nation states, particularly in the twentieth century. It may be useful to touch upon the role of the public policy of nation states, in the context of the concept of globalisation. After the emergence of the nation states, each nation state perceived that it was in its collective self-interest to promote or restrict involvement with citizens of other nation states. While developments in technology enabled and accelerated the movements of goods, people and services, the policies of many nations tended to impose restrictions. A nation state is presumed to put restrictions on its citizens in their involvement with other nation states only in the collective self-interest of its citizens. It is, however, not easy to define what is in the collective self-interest of all its citizens or of only a few at the expense of others. In the context of the public policy relating to globalization, a critical issue is the trade-off between individual freedom and the collective self-interest and also whether the onus of proof lies with the individual or the national authorities. It is difficult to resolve these issues but they must be appreciated in the context of public policy.

At a conceptual level, a distinction can be made between technology-enabled (or induced) globalization and public policy-induced restrictions or easing of restrictions. Globalization has several dimensions arising out of what may be called enhanced connectivity among people across national borders. Such enhanced connectivity is determined by three fundamental factors viz., technology, individual taste and public policy. Cross-border integration can have several aspects: cultural, social, political and economic. For the purpose of this presentation, however, only economic integration is

considered. Broadly speaking, economic integration occurs through three channels, viz., movement of people, of goods and, of finance or capital.

Firstly, on the aspect of movement of people, the most notable achievement of recent globalization is the freedom granted to many, if not all, from the tyranny of being restricted to a place and being denied the opportunity to move and connect freely. Secondly, in regard to trade in or movement of goods across the national boundaries, two types of barriers generally are described viz., natural barriers and artificial barriers. Of late, while the multilateral trade agreements are encouraging reduction in such artificial barriers, the developments in technology are also making it difficult for national authorities to enforce artificial barriers. The pace and nature of globalization will naturally depend on the combined effect of technology and the public policy, both at the national and the international level. The third dimension relates to capital movements for which also, the interplay between technology and the public policy becomes relevant. There have been, however, some special characteristics of capital flows in recent years mainly led by revolutionary changes in telecom and computing capabilities. These have highlighted the phenomenon of what is described as "contagion", which implies the risk of a country being affected by the developments totally outside of its policy ambit, though domestic policy may, to some extent, influence the degree of its vulnerability to the contagion. In any case, cross-border flows of capital have wider macroeconomic implications, particularly in terms of the exchange rate that directly affects the costs of movement of people as well as goods and services and, also in terms of the conduct of monetary policy and the efficiency as well as stability of the financial system. Capital flows, by definition, generate further liabilities or assets and could involve inter-generational equity issues. In this regard, it is useful to distinguish the extent of globalisation in respect of three different types of economic entities viz., individuals or households, corporate entities and financial intermediaries. It has been noticed that financial intermediaries impinge on the contagion effects impacting financial stability in the developing countries. Experience in Asia and Latin America has shown that the external liabilities of the private sector tend to devolve on national governments in the event of crises and hence, there is a role for the public policy in trying to prevent crises and creating capacities to meet crises, if and when they arise.

In managing the process of economic integration that is driven by several forces, developing countries face challenges from a world order that is particularly burdensome on them. Yet, it is necessary for the public policy to manage the process with a view to maximizing the benefits to its citizens while minimizing the risks; but the path of optimal integration is highly country-specific and contextual. On balance, there appears to be a greater advantage in achieving a well-managed and appropriate integration into the global process, which would imply more effective - but not necessarily intrusive or extensive - interventions by governments. In fact, while there are some infirmities in interventions by government, markets do experience market-failures and cannot exist without some externally imposed rules and prescriptions of the public policy. As the poor, the vulnerable and the underprivileged continue to be the responsibility of the national governments, there is relevance of national public policy - particularly as it relates to global economic integration.

### External sector policies: a review

It is useful to outline the major developments in external sector policies since our independence as a background to enable an appreciation of the current and future challenges. During the first three decades of planned development, successive plans emphasized the need for financing development largely from resources mobilized domestically. Firstly, Indian planners shared the export pessimism then pervading the developing world. Secondly, the existence of a large domestic market provided scope for internalising forward and backward linkages. Thirdly, development strategy hinged upon a programme of industrialization to break through the vicious circle of backwardness. Fourthly, the availability of foreign exchange was a major constraint, especially after the running down of the Sterling balances during the 1950s and 1960s. Export pessimism permeated the policy stance throughout the early decades of our planning. Accordingly, exports were regarded as a residual, a vent-for-surplus on those occasions when such surpluses were available. Import substitution was the principal instrument of trade policy and was regarded in the early years as not only the correct strategy but also inevitable in a continental economy like India.

It may be of interest to note that the objective of self-reliance did not find an explicit commitment in the second and third five-year plans which were mainly concerned with generating the foreign exchange resources required for the plans. The third plan reflected the first signs of rethinking in the policy strategy by dedicating itself to 'self-sustaining growth' which required 'domestic savings to

progressively meet the demand of investment and for the balance of payments gap to be bridged over'. The fourth plan contained an articulated approach to achieving self-reliance. While an export growth of seven per cent per annum was considered an essential element of the strategy, it was envisaged that the dependence on foreign aid would be halved during the course of the fourth plan (1969-74). It was in the fifth plan (1974-79) that self-reliance was recognised as an explicit objective. The sixth plan (1980-85) emphasized the strengthening of the impulses of modernization for the achievement of both economic and technological self-reliance. The seventh plan (1985-90) noted the conditions under which the concept of self-reliance was defined earlier, particularly in the preceding plan. It conceptualized self-reliance not merely in terms of reduced dependence on aid but also in terms of building up domestic capabilities and reducing import dependence in strategic materials. The concept also encompassed the achievement of technological competence through liberal imports of technology. The gulf crisis and its impact on India provided several lessons for us, and one of them was that a relatively closed economy does not provide immunity from a foreign exchange crisis. Incidentally, India excelled in managing the crisis and emerged as one of the very few countries in the world, amongst both the developed and the developing, to have never defaulted on its external obligations.

In the aftermath of the Gulf crisis, policy actions were initiated as part of the overall macroeconomic management well coordinated to simultaneously achieve stabilization and structural change. External sector policies designed to progressively open up the Indian economy formed an integral part of the strategy for structural reforms. In this context, the Report of the High Level Committee on Balance of Payments (Dr. Rangarajan Committee, 1993) recommended improvement in exports, both merchandise and invisibles; modulation of import demand on the basis of the availability of current receipts to ensure a level of current account deficit consistent with normal capital flows; enhancement of non-debt creating flows to limit the debt service burden; adoption of market-determined exchange rate; building up the foreign exchange reserves to avoid liquidity crises and elimination of the dependence on short-term debt. It is evident that the external sector policies of the 1990s, based on the Report, paid rich dividends in terms of growth and resilience to a series of external and domestic shocks.

In the new millennium, however, there has been a dramatic shift in our approach to external sector management in tune with the changing circumstances. First, with the emergence of marginal current account surplus, it appears that the sustainability of current account deficit may not be a problem though the deficit on trade account persists and has been increasing. Second, the main contributors to the positive outcome in current account are workers' remittances and export of software, both being a result of process of global integration. Third, the exchange rate regime as well as external debt management served us well, especially the avoidance of sovereign debt through commercial borrowings. The policy regime helped us withstand several global crises while maintaining a respectable growth. Fourth, the management of capital account has acquired the primary focus rather than the current account. Fifth, a judicious integration with the global trade regime has imparted some competitive efficiency and confidence to the domestic industry and perhaps, even to commercial agriculture though to a limited extent. Finally, it has become evident that the management of the external sector is closely linked to the domestic sector and the major thrust of public policy now has to be managing the integration and not 'grumbling' as the Nobel Laureate Amartya Sen is reported to have said a couple of days ago. Integration of the Indian economy with the global economy and policies aimed thereat have to address domestic and external sectors in a holistic and harmonious way. In brief, we have moved from managing external sector to implementing an optimal integration of domestic and external sectors, and the global economy.

### Adjustments by the global economy

The debate in India has customarily been on the contours of the public policy in the context of increasing global economic integration. More recently, however, a debate in the rest of the world has been in evidence on the challenges likely to be faced by the global economy on account of progressively increasing global integration of the Indian economy. The emphasis is of course on successful integration which will no doubt depend on the appropriateness of our public policies and the private sector responses. Hence, there is a need to have an ongoing appreciation of how the global economy is responding to the challenges of our integration while we move forward with our own agenda of securing an optimal integration.

Currently, the major issue in the global economy appears to be the significant build up of current account imbalances. The current account deficit of U.S.A. has been rising and is around 5% of GDP, while current account surpluses are noticed in Asia and to some extent in Latin America and Russia. The external financing of the US deficit moved away from equity in the late nineties to debt in the recent years, possibly reflecting a perception of productivity growth in the former period and fiscal stress in the latter. The official reserves played a greater role than in the past in financing the US current account deficit in recent years. There is a perception that the US dollar is still relatively overvalued warranting a correction. Simultaneously, the unique combination of easy monetary policy and lax fiscal policy in major industrialised countries is set to end and the financial markets are already in a state of uncertainty. Even assuming that the transition of monetary policies to a more neutral stance is managed well and that trade gets to be more evenly balanced, associated with some corrections in the USA, the simultaneous emergence of China and India with significant competitive strengths in trade in goods as well as services will have to be accommodated by the global economy. Thus, the issue for the immediate future is that both, correcting current global imbalances and integrating the two Asian giants, may have to take place simultaneously in the global economy.

It is evident that China and India will have to give a high priority to generating employment and are poised for substantial increases in productivity. Consequently, the global economy will have to consider the implications of these developments on prices, exchange rates, wages and structures of employment in industrialised countries. Over the medium term, it is felt that outsourcing will grow in geometric progression, particularly to India, and may also cover high-end research and development. In manufacturing, China has emerged as a leader and India is poised to join the race. Though agriculture is heavily subsidised in major industrialised countries, such subsidisation could be difficult to sustain from a fiscal point of view, since many of the countries concerned are poised to meet the mounting pension liabilities not to speak of burgeoning health care costs of maintaining the changing demographics. One sector where the industrialised economies continue to show considerable strength and dominance is the financial sector, partly attributable to the confidence factor in financial markets that favours the industrialised economies and traditional international financial centres. It is essential for us to carefully monitor the developments in both real and financial sectors, and to modulate our policies in tandem with the global developments so that global integration continues to be a positive sum game for all the countries.

### Random thoughts on our policies

As mentioned, global economic integration is technology induced and, simultaneously, policy constrained or policy restrained - in other words, policy-managed. While the economic integration of India with the global economy will continue to take place, a successful integration, with due regard to the interests of a vast majority particularly, the poor in our country would be possible only through sound public policies - evolved and redesigned from time to time. The key phrases here are “successful economic integration”, and “sound public policies” - both involving processes spread over time and also interaction with global economies. If one were to make an informed guess on the prospects of such a successful integration of India, it may be said that upside and downside risks are evenly balanced with a short term bias towards upside risks - which would give us some time to work on mitigating the downside risks in the medium term. Indeed, the well publicised BRIC report[1] reflects considerable confidence in the future of the Indian economy, though it is necessary to see the fine print to realise that while India would be a super power in 2050, “if development proceeds successfully”, the per capita income would still not be at a high end. What is important to recognise is that the report leans on the demographic strength that India derives from its huge workforce. In order to harness the demographic advantages, the quality of labour force, (in terms of relevant skills which need to be sustained, reoriented and upgraded in a globally competitive era) and the physical health of the workforce become crucial. Education and health, therefore, provide the link between supply and demand for labour through increases in productivity. In this background, here are some random thoughts on the priorities for public policy to ensure successful economic integration of India with global economy.

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[1] Wilson, D., Rupa Purushottaman, October 2003, 'Dreaming with BRICS: The Path to 2050', *Global Economics Paper No.99,* Goldman Sachs, New York.

First, pragmatic policies in the external sector, particularly in the management of capital account and exchange rate, have served us well by contributing to growth, resilience to shocks and an overall stability. There is merit in continuing the pragmatic, cautious and, gradual approach in this regard, subject to improvements in fiscal arena and the progress in strengthening the domestic financial sector.

Second, the management of financial sector has been oriented towards gradual rebalancing between efficiency and stability and the changing shares of public and private ownership. Enhanced competition among diverse players, including from branches of foreign banks, has been encouraged. Considerable improvements have taken place in prudential governance as also in moving away from administrative measures to market-orientation. Improvements in efficiency and stability are palpable and there is merit in continuing with such rebalancing while refocusing on consolidation, governance and moving towards Basel II - albeit gradually, as in the past.

Third, on the fiscal front, the ratio of public-debt to GDP is high in our country, but the structure of public-debt displays characteristics that make us less vulnerable than other countries with similar debt magnitudes. There is advantage in continuing the progress in public debt management keeping structural aspects in view. As we proceed with fiscal consolidation, clearly focussed in the latest Union Budget 2004-05, there will be greater flexibility in conduct of monetary policy and greater confidence for proceeding with financial sector reforms. Furthermore, an effective and qualitative fiscal adjustment would enhance the scope for a more successful integration with the global economy.

Fourth, in matters relating to trade, significant liberalisation of external trade has taken place smoothly, which has imparted competitive efficiency to the domestic sector. The apprehensions that existed till a few years ago of the adverse impact of such trade liberalisation, have abated and the business confidence in the country has improved. While the gradual approach with a commitment to a liberalised trade regime has enabled productivity increases - almost up to the global best standards in many of the sectors - there are signs of pick up in investment activity which could catalyse the needed demand for credit and create employment. There is one significant incongruity, however, which should be corrected sooner than later, viz., the continuing trade restrictions within the country even as there has been progress in liberalising external trade. There is incontrovertible, though generalised, evidence to show that persisting trade restrictions in a country are not in the public interest and hence, as many distinguished economists plead, most of the exceptions to Article 301 of the Constitution permitted on 'public interest' grounds perhaps need to be done away with. (Article 301 reads as `subject to other provisions of this part, trade, commerce, and intercourse throughout the territory of India shall be free’). This may warrant repeal of several legislations that restrict trade domestically in the “public interest”. To alleviate any adverse impact on vulnerable sections, a straight forward subsidy could be considered in favour of the poor. There is another well recognised distortion, vestiges of which still continue, in the form of reservation for small scale industries. With liberalisation of external trade, it is anomalous to persist with such distortions, even if on a reduced scale. Thus, there is still an unfinished agenda on trade reforms especially in regard to domestic trade and a policy commitment to remove such distortions in a defined short time frame would be ideal.

Fifth, it is interesting to note that the two sectors where India is globally most competitive, namely, software and pharmaceuticals, are not power intensive and do not require bulky transportation. The competitiveness of the manufacturing industry is admittedly a function of the availability of reliable power supply at reasonable cost. The budget of 2004-05 has rightly emphasised the importance of power, airports and seaports (apart from tourism, which has significant employment potential) but there is need for implementation at a pace significantly faster than we have ever witnessed in any sector so far.

Sixth, there is universal recognition of the need to improve both productivity and output in the agriculture and related activities to meet the objectives of growth and employment. Yet, despite the best of efforts and excellent results achieved in that direction, there will have to be a massive shift of the workforce from agriculture to non-agricultural avocations. While it is difficult to estimate at this stage, we should be prepared for a large-scale migration of the workforce to the tune of 10 million per year, from rural to semi-urban and urban areas. The quality of urban infrastructure even in the metropolitan cities is not conducive to globally competitive economic activity. The inevitable large scale redeployment of the migrating workforce would, therefore, need institutional arrangements, be they in public or private sector, for skill-imparting and skill up gradation. In these two matters relating to the workforce, some supply-led approaches appear to be in order, rather than waiting for the demand to be generated.

Seventh, improvements in institutional infrastructure in matters relating to administrative, judicial and other systems of governance are admittedly important. Needless to say, if we fail to record rapid progress in these critical areas, we will fail in everything, especially in economic arena.

Eighth, the quantity and quality of water, education and health care infrastructure are far from adequate, and are not even at the minimum level consistent with a modern society. These fall under the ambit of delivery of public services and the Prime Minister has already accorded a high priority to this issue. Any tangible reform in this area would require action on several fronts, i.e., legislative, executive and judicial and at several levels, Centre, State and local.

Ninth, there are regional inequalities in growth and several analysts have tried to find the causes and suggest remedies. Recognising that the next phase of reforms in most of the physical, social and institutional infrastructure, especially in the area of delivery of services, would fall within the realm of the States, one should hope that the demonstration effect of a few high-performing States will spur the other States, in the medium term, to compete for better governance and economic performance.

Finally, enhanced investment activity, particularly in the infrastructure area, would necessitate higher domestic savings, especially in the public sector coupled with efficient financial intermediation. In addition, foreign savings need to be attracted and absorbed with a strong preference to Foreign Direct Investment in all sectors though in some sectors like banking, a calibrated approach may be warranted. At the same time, our enterprises should be enabled to attain a strong global presence in all sectors. In brief, our global integration has to be a two way process, encompassing movement of people with some caveats, trade in a free and equitable manner and financial integration on a specially sequenced basis. Hence, it is necessary to elaborate on the financial integration.

**Financial integration**

From a policy perspective, there are three fundamental issues in regard to financial integration namely, “how does financial globalization help growth ?”; “how does it impact macro-volatility ?”; and “how can developing countries harness the benefits of globalization ?”. These three issues have been addressed comprehensively, in an IMF Occasional Paper[2] and the following extracts from the summary of the Paper do provide some answers:

> “There is some evidence of a 'threshold effect' in the relationship between financial globalization and economic growth. The beneficial effects of financial globalization are more likely to be detected when the developing countries have a certain amount of absorptive capacity”……… "International financial integration should, in principle, also help countries to reduce macroeconomic volatility. The available evidence suggests that developing countries have not fully attained this potential benefit”………. “A type of threshold effect appears here as well - reductions in volatility are observed only after countries have attained a particular level of financial integration”……….. “The evidence presented in this paper suggests that financial integration should be approached cautiously, with good institutions and macroeconomic frameworks viewed as important. The review of the available evidence does not, however, provide a clear road map for the optimal pace and sequencing of integration. Such questions can best be addressed only in the context of country-specific circumstances and institutional feature”.

The guidance for policy makers from the above is perhaps clear. Unlike in the case of trade integration where benefits to all countries are demonstrable, in case of financial integration, a “threshold” is important for a country to get full benefits. A judgmental view needs to be taken whether and when a country has reached the “threshold” and the financial integration should be approached cautiously with a plausible road map by answering questions in a country-specific context and institutional features. Fortunately, we, in India, have been adhering to a cautious and calibrated approach in our reforms so far and there is merit in adopting a 'road map approach' building on the strengths that we have already developed.

One of the major concerns for developing countries in proceeding with financial integration appears to be the financial stability. Hence, the role of cross-border linkages in this regard should not be ignored.

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[2] Prasad E., Kenneth Rogoff, Shang-Jin Wei, and M. Ayhan Kose, 2003, 'Effects of Financial Globalisation on Developing Countries: Some Empirical Evidence', *IMF Occasional Paper,* No.220, Washington DC.

It would be useful to draw upon the Introduction in an IMF Working Paper[3] on the subject which identifies four major trends in the financial economy of the past decades and mentions the following:

"Although these trends reflect important advances in finance that have contributed substantively to economic efficiency, they evidently have implications for the nature of financial risks and vulnerabilities and the way these affect the real economy, as well as for the role of policymakers in promoting financial stability. For instance, risk management and diversification techniques have, in principle, bolstered the resilience of the financial system, but the expansion of cross-sector and cross-border linkages implies more scope for contagion".

It is also necessary to recognise that financial integration complicates the conduct of monetary management. The growing cross-border integration of financial markets enables massive movements of capital, which quickly arbitrage interest rate differentials across national boundaries. This is reinforced by the ever-widening impact of the information technology revolution. Real long-term interest rates in industrialised countries have been converging since the late 1980s. Financial integration has also brought with it shocks common to several countries since the "confidence channel" transmits financial crises across countries swiftly. In a world of generalised uncertainty, monetary policy in several countries is faced with a progressive loss of discretion. For developing countries, in particular, considerations relating to maximising output and employment weigh equally upon monetary authorities as maintaining the price stability. In considering the pace of financial integration, the implications of a concurrent loss of a degree of autonomy in conduct of monetary policy of a country and the country context should not be lost sight of. The analytics presented in the *Report of the Committee on Capital Account Convertibility* (Tarapore Committee, 1997) are very relevant in this regard. In particular, they relate to what has been described as 'preconditions' such as fiscal consolidation and strength of the financial sector, and meeting such preconditions facilitates the conduct of monetary policy in a more open capital account regime.

It is also useful to recognise a close link between the extent of capital account liberalisation and the presence of foreign financial enterprises in a country. The nature of the link is best articulated in the following extracts from a recent book by Martin Wolf[4]:

> "It is impossible for such tiny markets to support competition among self-standing national players with realistic aspirations to world-class performance". (p.285)………… "For all these reasons, a symbiosis exists between both current and capital account liberalization and the contribution made by the presence of foreign financial enterprises in the economy. This is a second reason for aspiring to capital account liberalization". (p.286)…………… "For all these reasons, therefore, the elimination of controls on capital movement is a desirable objective. But it is one that also carries substantial risks. The right answer is not to avoid liberalizing for ever, but to carry it through in a carefully thought out and disciplined manner. In that way, it may be possible to achieve the objectives of integration without the crises that have, so often punctuated movement in that direction".(p.288).

Thus, one of the important considerations for encouraging the presence of foreign financial enterprises is to ensure adequate and healthy competition. The compulsion to expand foreign enterprises would thus depend on quality of competition that is already existing in a country. In any case, the consensus appears to be that process of liberalization in financial sector has to be carefully calibrated and sequenced.

## Banks and financial integration

The major risks in financial integration that emerging economies face relate to financial stability and in this regard the criticality of banks is generally acknowledged, but is worth reiterating in the words of Martin Wolf[5]:

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[3] Houben A., Jan Kakes, and Garry Schinasi, June 2004, 'Towards a Framework for Safeguarding Financial Stability', *IMF Working Paper*, No.WP/04/101, Washington DC.

[4] Wolf M., 2004, Why Globalization Works, Yale University Press, New Haven and London.

[5] Ibid.

> "Banks are the epicentres of financial fragility. The central role of banks in generating the financial feast and famine of the past three decades, particularly in relation to emerging market finance, is entirely predictable. If we are to manage a financially integrated world better than we have done so far, banks must be more effectively caged in the countries at the core of the financial system and those at the periphery". (p.298)………………."The fads and fancies of foolish bankers in the core countries have lain behind most of the financial crises of the past three decades. When elephants stampede, they trample down everything in the way. That is what happened to Latin America in the 1970s and 1980s and then East Asia in the 1990s. For this reason, Dobson and Hubauer have rightly argued that making the world safer requires changes at both the core and the periphery. They argue that not only the behaviour of the banks but even that of hedge funds is directly related to the frailty of banking". (p.299)

It would not be appropriate to conclude from the above that capital market integration should not take place. From a policy perspective, the concluding remarks of Mr. Martin Wolf are very pertinent, and the extract reads as follows:

> "But, for a host of reasons, emerging-market economies should ultimately plan to integrate into the global capital markets, with emphasis on the words `ultimately' and `plan'". (p.304).

### Foreign banks and financial integration

It will be useful to narrate the pros and cons of licensing foreign banks in the emerging economies by drawing liberally from two recent publications[6, 7]. The pros relate to (a) increasing and diversifying available funds; (b) enhancing banking competition and efficiency; (c) developing financial markets and market infrastructure; (d) helping with recapitalisation and wider diversification of banks; and (e) reducing sensitivity of the host country banking system to local business cycles and changing financial market conditions. The arguments against foreign banks' entry encompass (i) weakening infant domestic banks; (ii) servicing only the 'best' customers and neglect of Small and Medium Enterprises; (iii) likelihood of bringing instability; (iv) concerns that majority of banking assets will become foreign owned; and above all (v) challenges to financial supervisors in the emerging markets.

The challenges to emerging market banking supervisors have come to the fore of research agenda now. The policy concerns in the recent years, with increasingly large proportion of banking assets accounted for by foreign banks, are well documented in the Report of the BIS and the Working Paper referred to above. The issues relate to (a) licensing policy for foreign banks; (b) monitoring the local establishments of large international banks; (c) sheer variety and complexity of new financial products including derivatives; (d) familiarisation and understanding of when and to what extent the overseas parent banking organisations will support their cross-border operations in times of difficulties or crises; (e) managing systemic risks associated with cross-border banking; (f) the complications arising from the organisational positioning of the foreign banks that are not necessarily stand-alone institutions but are rather part of a holding company group, and the complexity of financial institutions active in a number of jurisdictions; and (g) possibility of increased operational risks due to integrated operations of consolidated financial institutions. While narrating the complexities, the IMF paper makes a reference to the broadening of supervisory concerns. "This is a particular concern in the cases where foreign commercial banks expand their operations rapidly in the area of non-bank financial services, such as insurance, portfolio management, and investment banking".(p.20). Hence, in the regulation and supervision of foreign banks, which have cross-border operations, the regulators will have to take into account all these fundamental realities.

On the basis of anecdotal evidence, and perceptions of supervisors in the emerging countries, some of the practical concerns need to be considered. First, there are occasions when the policy imperatives of the regulators and supervisors do not fully align with the strategic business goals of the banking

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[6] Committee on Global Financial System, 2004, 'Foreign Direct Investment in the Financial Sector of Emerging Market Economies', *Report of a Working Group established by the Committee on Global Financial System*, Bank for International Settlements, Basel.

[7] Song, Inwon, 2004, 'Foreign Bank Supervision and Challenges to Emerging Market Supervisors', *IMF Working Paper*, No.WP/04/82, Washington DC.

sector players. In such instances of conflict, it is likely that the interest of domestic banks would be more closely aligned with the policy objectives than the interest of the foreign banks. Second, there may be instances when the relationship between a supervisor and the supervised foreign bank become the subject matter of inter-governmental concerns which often puts emerging economies in a disadvantageous position. Third, the intimate knowledge that a national supervisor possesses in respect of domestic ownership of a domestic bank is normally not available in respect of all foreign investors in any bank - domestic bank or foreign bank with presence in the host country. Fourth, there are concerns about the affiliations between banks and commercial firms in terms of conflicts of interest and misallocation of credit. Similar concerns arise regarding affiliations between non-banking financial companies and banks as also between non financial companies and banks. (For example, see Terry J. Jorde "The future of banking - The Structure and Role of Commercial Affiliations" in the Symposium hosted by the Federal Deposit Insurance Corporation, U.S.A., July, 16, 2003). Fifth, there are several policy issues with regard to liquidity management that may arise in the course of wider foreign participation in the financial market in Asia, which have been well articulated by Eiji Hirano,[8] Assistant Governor of Bank of Japan. Two extracts from his Paper would be appropriate to the current context:

> "The question occurred to me as to whether or not there is an optimal way of accepting foreign participation which prevents adverse element of foreign participation. My tentative answer is probably not. Foreign participation inevitably has double-edged-sword nature, namely a source of stability as well as instability. If you expect greater benefits from foreign participation, you have to accept greater potential cost. That is probably the reality"………………. "The corollary of this proposition is that premature exposure of weak domestic banks to international competitors in domestic markets may run the risk of weakening overall systemic stability, which could have global implications".

There is a recent development which impacts the level playing field between foreign banks present in emerging market economies and the domestic banks. During the annual meetings of Bank for International Settlements on 26th June 2004, a formal announcement was made regarding the publication of the revised framework for capital adequacy, known as Basle II, as approved by Group of Ten (G-10) countries. The studies on quantitative impact of Basel II seem to indicate that the foreign banks operating in emerging economies would require less regulatory capital and by virtue of their lower capital servicing costs, could finely price their products and services to the detriment of domestic banks. However, it is too early to assess the advantage, if any.

The policy-makers in emerging countries are fully aware of both the benefits and risks arising out of the presence of foreign banks and indeed foreign capital in banks, which leads them to impose a variety of forms of restrictions depending on the circumstances of each country. There are several ways in which restrictions are imposed on foreign ownership in the banking sector, whether through limiting the foreign investment in the domestic banks or the presence of foreign banks. Presence of a foreign bank is usually in one of the three recognized forms (viz., a branch, subsidiary or a wholly owned subsidiary) and only a particular form of organisation may be permitted usually with no choice to the foreign bank. There are some restraints on the type of business permitted to a foreign bank (such as being restricted to foreign currency operations or non-acceptance of retail deposits or other specified operations) as also stipulations in regard to the minimum capital requirement for a branch or a subsidiary of a foreign bank. There can also be practices amongst countries in regard to the aggregate foreign investment permitted in a local bank as also on the maximum holdings by an individual or a corporate entity or an entity controlled by foreign financial institutions in a local bank. Similarly, the regulations in some countries, consistent with the overall plan of financial integration, place an absolute limitation on the size of the total assets or capital of a foreign bank (which would indirectly restrict its total assets). It needs being borne in mind that certain policies in regard to the entry of foreign investors or a foreign bank in a country may be triggered due to extraordinary circumstances such as a financial crisis or as a part of a structured crisis management package. There are instances where as a part of response to banking crises, a higher level of initial foreign ownership have been permitted but with stipulations for dilution subsequently. Furthermore, certain countries which, *ab initio*, did not have any private sector banking might welcome the presence of foreign banks. Similarly, expectations of joining a regional bloc, say European Union, might result in welcoming of a larger presence of foreign banks.

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[8] Hirano Eiji, 2004, 'Policy issues concerning financial sector FDI in Asia: A global financial system perspective', CGFS Workshop, (mimeo), Seoul.

The extent of foreign investment, the nature of such investment, the appropriate form of presence and the profile of actual players in the banking sector are usually prescribed by the supervisors taking into account the multiple challenges faced in a given country context including the extent of financial integration sought to be achieved. In brief, each country picks up an appropriate package that is necessitated by the circumstances, which ensures the presence of foreign investors that fully satisfy the `*fit and proper*' criteria, and that the presence of foreign banks is in the best national interest. It is noteworthy that our policy in regard to foreign banks is a part of the planned strategy for rebalancing efficiency and stability in the financial system.

In this background, what should be the policy considerations governing the presence of foreign banks? First, the issue is not one of being for or against the foreign banks since financial integration necessitates their presence - be it in the industrialised or in the developing countries. There are, however, special problems in the case of emerging market economies which have not reached the "threshold" to be able to minimise the downside risks of the foreign banks' presence. These are key supervisory and regulatory issues which arise as a result of greater foreign participation in the domestic financial system. Hence, policy-makers, including the financial sector supervisors, have to carefully craft a road map to ultimately integrate the domestic financial sector globally while also moving towards the "threshold" based on perceptions of the international financial system and on domestic economic conditions. Second, quite often it is not a question of whether to have the presence of foreign banks, but, to what extent, under what conditions, over what time horizon and in what form - usually a particular form of presence being preferred. A more difficult question, especially in regard to foreign investors in local banks, is the identity and the nature of investors - recognising that an absolute majority of portfolio flows originate in tax havens. The problem is, however, less complex in regard to highly rated banks. Finally, there are pros and cons in any package of policy in regard to foreign banks. The weight to be attached to each of the pro and the con is country-specific, judgmental and evolving. Hence, a degree of transparency, a road map and considerable flexibility to the supervisors to exercise judgment on several aspects of entry and presence of foreign banks appear to be the desirable components of an appropriate policy framework in this regard.

**Our approach**

India's approach to financial sector reforms, in general, and to the management of the external sector, in particular, has served the country well, in terms of aiding growth, avoiding crises, enhancing efficiency and imparting resilience to the system. The development of financial markets has been, by and large, healthy. The basic features of the Indian approach are gradualism; co-ordination with other economic policies; pragmatism rather than ideology; relevance to the context; consultative processes; dynamism and good sequencing so as to be able to meet the emerging domestic and international trends. In order to facilitate an understanding of the approach, a few illustrations would be in order. Convertibility on current account was announced in 1994 by the Government and the exchange control restrictions were removed over a period of time, emphasising the need for underlying real transactions and reasonableness of amounts. However, the repatriation and surrender requirements still dominate the system, though some people aver that it is inconsistent with the concept of current account convertibility. The intention to move over to capital account convertibility was announced in 1997 and its achievement is still an ongoing process - which differentiates the roles of individuals, corporates and financial intermediaries. Likewise, in regard to Primary Dealers (PDs), initially in 1996 only the PDs promoted by local banks or financial institutions were licensed. Foreign bank-sponsored PDs were licensed after about three years. In the banking system, diversified ownership of public sector banks has been promoted over the years and the performance of their listed stocks in the face of intense competition indicates improvements in the system. They do co-exist with several old and new private sector banks, and some of the new private sector banks have proved to be of global standards. Recently, some of private sector banks promoted by domestic financial institutions have been permitted to conduct Central and State Government business supplementing the public sector banks. In February 2004, transparent guidelines were issued by RBI in regard to the prior acknowledgement from RBI for any acquisition / transfer of shares of a private sector bank which would take the aggregate shareholding of an individual or a group to equivalent of five percent or more of the paid up capital of the bank. While this requirement already existed, transparency was imparted by the guidelines. On July 2, 2004, a comprehensive policy framework for ownership and governance in private sector banks has been placed in the public domain, by the RBI in the form draft guidelines, for wider public debate. Based on the feedback received, a second draft of the guidelines would be prepared and put in public domain for further discussions.

Foreign banks have been operating in India for decades with a few of them having operations in India for over a century. Quite a few foreign banks from diverse countries set up operations in India during the mid-1990s following the liberalisation of the Indian economy. The number of foreign bank branches in India has increased significantly in recent years since a number of licences were issued by RBI - well beyond the commitments made to the World Trade Organisation. Although foreign banks can operate in India only by way of branch presence, some of the foreign banks have established several subsidiaries in the form of either Non Banking Finance Companies or limited companies in the non financial sector in India that undertake diverse businesses such as dealing in securities, leasing and finance, information technology, etc.

The presence of foreign banks in India has benefited the financial system by enhancing competition, resulting in higher efficiency. There has also been transfer of technology and specialised skills which has had some "demonstration effect" as Indian banks too have upgraded their skills, improved their scale of operations and diversified into other activities. At a time when access to foreign currency funds was a constraint for the Indian companies, the presence of foreign banks in India enabled large Indian companies to access foreign currency resources from the overseas branches of these banks. Creating inter-bank markets in money and foreign exchange is a challenge in several developing countries. In India, however, the presence of foreign banks, as borrowers in the money market and their operations in the foreign exchange market, resulted in the creation and deepening, in terms of both volumes and products, of the inter-bank money market and forex market though by virtue of their skills and resources, the foreign banks tend to dominate in some financial markets. In the days ahead, the challenge for the supervisors would be to maximise the advantages and minimise the disadvantages of the foreign banks' local presence by synchronising the emerging dominance of their local operations with the progress in the domestic financial markets as well as in liberalisation of capital account.

In terms of the Press Note No.2 (2004 Series) issued by the Ministry of Commerce and Industry on March 5, 2004, the FDI limit in private sector banks was raised to 74% under the automatic route, including the investment made by FIIs. Foreign banks, according to the Press Note, will be permitted to have either branches or subsidiaries, not both. They may operate in India through only one of the three channels viz., (i) branch/es; (ii) a wholly owned subsidiary; or (iii) a subsidiary; with aggregate foreign investment up to a maximum of 74% in a private bank. The Press Note mentioned that the guidelines in this regard will be issued by the Reserve Bank of India. Reserve Bank is currently examining various options for strengthening the financial sector, in general, and the banking sector, in particular, concurrent with the well-calibrated de-regulation process already set in motion. The liberalisation measures would need to take into account several imperatives, such as, consolidation of domestic banking sector; restructuring of Development Finance Institutions; and appropriate timing for the significant entry of foreign banks so as to be co-terminus with the transition to greater capital account convertibility while being consistent with our continuing obligation under the WTO commitments. It is also necessary to examine several issues relating to implementation of the Press Note No.2 not in isolation but as part of overall reform paradigm of the banking sector. In respect of foreign banks, issues include: choice of the mode of presence, acceptable transition path, according national treatment, addressing supervisory concerns, linkages between foreign banks and their presence in other (non-banking) financial services and the timing of various measures as per a road map to be drawn up. Reserve Bank intends to formulate the guidelines, through an ongoing process of consultation, as in the past. The proposed guidelines in this regard are expected to carry forward the process of financial integration of India in a carefully calibrated and transparent manner.

Thank you, ladies and gentlemen. Let me wish you all the best in your careers; and, that would ensure that my grand children will also be the beneficiaries of a happier India.