Y V Reddy: Implications of global financial imbalances for the emerging market economies

Remarks by Dr Y V Reddy, Governor of the Reserve Bank of India, at the round table discussion at the International Symposium organised by the Bank of France, Paris, 4 November 2005.

Please also refer to the website of the Reserve Bank of India for annex that accompanies this speech.

*   *   *

I am thankful to the Banque de France for inviting me to the international symposium on Productivity, Competitiveness and Globalisation to enable me to share my thoughts on financial stability. I intend speaking on the possible implications of global imbalances for the emerging market economies (EMEs) with special focus on India.

Although fast growing economies are generally grouped together as EMEs , some of their major macroeconomic indicators present a wide spectrum. While some of the EMEs are running large current account surpluses (such as China, the Russian Federation, South Korea, Venezuela, Malaysia, Taiwan and Brazil), some others are running current account deficits (such as Turkey, Hungary, South Africa, Mexico, India and the Czech Republic) and their current account balances range from a deficit of US$ 20 billion to a surplus of US $ 69 billion. While savings rates for select EMEs[1] range from nine per cent to 43 per cent of the GDP, in most of the EMEs the rates have increased and overtaken those of the industrial countries, with particularly high savings rates in China, Malaysia and Russia. Likewise, while some of the EMEs have fiscal surplus (Russia), several others have fiscal deficit (Turkey, India, the Philippines, Argentina and several other EMEs). Also, while some of the EMEs such as India are largely domestic-demand driven, some other EMEs, particularly in the East Asia (Malaysia and the Philippines) are largely dependent on exports to sustain their growth and their exports of goods and services range from 15 per cent to over 120 per cent of GDP. It is useful to note that while some of the EMEs are net oil exporters, some others are net oil importers.

Thus, given the diverse nature, macroeconomic conditions and policy regimes of the EMEs, it may be difficult to treat all of them as contributing to global financial imbalances, in the same manner, nor would all the EMEs be identically affected by the adjustment of global financial imbalances. It may, therefore, be somewhat difficult to speak about the implications of global financial imbalances for the EMEs as a group. I would, therefore, focus primarily on India, but the analytic framework could perhaps be of some help in appreciating the implications for different EMEs.

It is worthwhile to mention that there are some factors which could adversely impact the EMEs as a group, though with varying intensity. Global developments, particularly those in the world financial markets, have the most direct and serious impact on the financing conditions in the emerging markets. An abrupt and sharp adjustment of the currencies may potentially lead to a significant portfolio rebalancing by the foreign investors, which could cause sharp changes in the long-term yields. This, in turn, could result in volatility in the level and cost of capital flows with direct implications for the EMEs.

Volatility in financial markets could adversely affect the EMEs in many ways, and also in a complex and interrelated fashion. For convenience of analysis, the impact may be classified broadly into: (i) the impact on the financing conditions in which EMEs operate; (ii) impairment of the balance sheets of the banking sector, and (iii) hampering of the growth prospects in the real sector. Even within the same EMEs, the impact could vary across different entities such as the Government, the corporate sector, the households and the financial sector, depending upon the country-specific and institution-specific operating environment, the stage of development and the degree of integration with and exposure to the international financial markets. In view of the diversity of the EMEs and the complexity of impact of

---

[1] There is no single acceptable definition of EMEs, although they are commonly referred to as economies with high growth prospects. The IMF in its latest Global Financial Stability Report has categorised the following countries as EMEs: **Latin America** – Argentina, Brazil, Chile Colombia, Mexico, Peru, Venezuela; **Asia** – China, India, South Korea, Indonesia, Malaysia, Pakistan, the Philippines, Taiwan Province of China and Thailand; **Europe, Middle East and Africa** – Czech Republic, Egypt, Hungary, Israel, Jordon, Morocco, Poland, Russia, South Africa and Turkey. Select economic indicators of select EMEs are furnished in the Annex.

any unpredictable unwinding of global imbalances, it is proposed to analyse the possible implications, illustratively, with reference to India

Recent macroeconomic developments in India

There are several noteworthy features of India's recent macroeconomic performance. First, the investment climate has improved and industrial and service sector activity has picked up. Second, buoyant exports have emerged as the driver of demand for a broad spectrum of industries. Third, there has been a modest attempt at and a commitment to achieve fiscal consolidation. Fourth, the trend inflation has declined over the years and inflation expectations stabilised. Fifth, India has been successful in managing liquidity against the backdrop of continuing capital flows. Sixth, India has emerged as a preferred destination for foreign investors and received about a quarter of the global portfolio flows to the EMEs in 2004. Seventh, India's foreign exchange reserves are in excess of the total outstanding external debt of the country. Eighth, the performance of the corporate sector has improved and some corporates are now listed on the international stock exchanges. Ninth, India's financial markets have deepened, widened and become vibrant over the years with a robust institutional framework and market infrastructure in place. Tenth, the profitability and soundness indicators of the banking sector have improved. Finally, India has been adopting international benchmarks for financial standards and best practices with suitable adaptations for Indian conditions.

The Indian economy today is characterised by an environment of confidence, positive business expectations, a renewal of rule-based fiscal consolidation, stable and orderly financial markets and institutions and progressive integration with the global economy. Real GDP growth for 2005-06 (April-March) has been conservatively projected at around 7.0 per cent, and more recently, revised upwards to a range of 7.0 to 7.5 per cent. Despite the sustained strength of export performance, the merchandise trade deficit is expected to be somewhat higher in 2005-06 than in the previous year, mainly on account of substantially higher oil prices and non-oil import demand for investment. For the year as a whole, while invisibles may finance a large part of the enlarged trade deficit, the current account deficit is expected to widen during 2005-06 but to remain within acceptable limits that can be financed by normal capital flows. The headline inflation is expected to lie in the range of 5.0-5.5 per cent. Consolidation of Central Government finances is the goal of fiscal policy at the Centre – the targets are: the gross fiscal deficit (GFD) of 3.0 per cent of GDP and the elimination of the revenue deficit by 2008-09. The fiscal position of State Governments also continues to undergo slight correction in terms of key deficit indicators.

Against this background, it may be useful to analyse the implications of global financial imbalances for India in terms of the likely impact on four separate balance sheets - of the government, of the Reserve Bank of India, of the corporate sector and of the banking sector.

Impact on the government

The Government of India does not raise resources from the international capital markets to finance the fiscal deficit, though the bilateral and multilateral sources do provide moderate amount of foreign currency funds. The Government could, therefore, be affected indirectly through the spill-over impact of external developments on domestic interest rates. What is of relevance, inter alia, is the nominal international interest rates and domestic interest rates, adjusted for inflation differential. To the extent there is a rise in domestic interest rates, there could be an increase in the cost of government borrowings of the Government. Since most of the outstanding debt is at fixed rates and not on floating rates, the rise in the borrowing cost will be incremental. This situation also provides greater headroom for a flexible monetary policy to adjust policy rates, as and when warranted, without any excessive impact on the fiscal deficit.

Impact on the Reserve Bank's balance sheet

The fiscal position of the Government could also be indirectly impacted through the nature of management of foreign exchange reserves held by the Reserve Bank. Volatility in the foreign exchange market exposes foreign exchange reserves to both operational and market risks. Depreciation in the value of any reserve currency vis-à-vis the domestic currency would result in an equivalent decline in the value of the reserves held, though the impact may be mitigated to some extent through appreciation of other currencies in which foreign exchange reserves are held. Also, increase in global interest rates would entail capital losses on the corresponding assets, including fixed income securities. Valuation and capital losses could impact the income of the Reserve Bank of India and thus, its surplus transferable to the Government which, in turn, would have fiscal implications. It is pertinent to mention that the Reserve Bank of India, as a matter of prudent practice, follows conservative accounting norms whereby the valuation gains/losses on foreign exchange reserves and gold are not taken to the profit and loss account, but instead, booked under a separate reserve head.

Impact on the Indian corporates

As a result of deterioration in global financial market conditions, spreads on corporate debt might widen suddenly due to shift in investor confidence in the global financial markets. Increase in the global interest rates may also have impact on other benchmarks such as LIBOR. A sharp rise in yields may entail an increase in cost of variable-rate debt contracted by the corporates. This, to some extent, could be offset if there is a depreciation of the relevant currency and consequent decline in the value of the existing debt contracted by corporates in that currency.

Indian corporates as also some of the public sector enterprises raise resources from the international capital markets. While a part of their external commercial borrowings is at variable interest rate, a part is at fixed interest rates. In order to avoid any serious impact of changes in the exchange rate on the balance sheet of the corporate sector, Reserve Bank has been advising banks to regularly monitor the unhedged position of the corporates and has also been exhorting corporates to hedge their foreign exchange exposures. Thus, India's corporates could be affected by the deterioration in the financing conditions only to the extent they are not hedged either by foreign-currency cash flows in the normal course of business or through recourse to appropriate hedging products. Corporates would, however, be affected to the extent interest rates firm up in the domestic market, depending on their exposure to debt relative to other liabilities.

Impact on the banking sector

Banks in India are dependent mainly on domestic deposits, predominantly at fixed rates, for their resource requirements. They would, therefore, be impacted significantly only if the adverse developments in the international capital markets are particularly severe. Banks, in general, also do not hold stock of securities in foreign currency. Banks in India have, thus, relatively small exposure to the foreign exchange market. Their foreign currency borrowings are subject to the prudential limit of 25 per cent of their Tier-I capital and they are also required to maintain capital against the net open position. Foreign currency borrowings by the banks are permitted beyond this ceiling, which is linked to the net worth, exclusively for the purpose of export finance.

Like many other emerging market economies, credit extended by banks in India has increased sharply in recent times. Credit growth, which was earlier seen largely in housing and retail loans, has now turned quite broad-based with agriculture and industry also joining to drive up the credit demand. The credit growth in some sectors, specially those related to assets which are experiencing price volatilities, is being monitored closely.

Banks are allowed to lend to resident exporters in foreign currency at internationally competitive rates of interest from their foreign currency lines of credit as well as out of funds available in exchange earners' foreign currency accounts, resident foreign currency accounts and foreign currency non-resident (banks) accounts. These loans are intended to finance domestic and imported inputs for export production. Foreign currency loans to exporters are generally hedged against credit risk since they are extended for bona fide underlying activity viz., export production. They are also usually covered for exchange risk since they are denominated in foreign currency. Banks are also allowed to extend loans in foreign currency to non-resident Indians against their FCNRB deposits. Funds in foreign currency deposits can also be utilized for lending to domestic corporates for working capital requirements in India, import financing, purchase of indigenous machinery, repayment of rupee term loans and external commercial borrowings.

Banks have also been extending credit for investment in the asset market. Like many other EMEs, asset prices in India have also risen sharply in the last couple of years. Should there be reversal of capital flows, asset prices may decline sharply exposing the banks' balance sheets to credit risk. There is a risk that rise in interest rates in general could impact housing prices and expose the balance sheet of the households to interest rate risk, leading to some loan losses for banks. The overall banking sector's exposure to housing loans is relatively small and may not have serious systemic implications. Likewise, the equity market has also seen a sustained uptrend. Reversal of capital flows could impact the equity market and some of the advances extended for investments in the equity market might turn non-performing. Again, Indian banks do not have large exposure in the asset market though, in the recent past, it has been increasing. Decline in asset prices could cause loan losses and capital losses, if the decline is significant, though the impact on banks' balance sheets might be muted, given their small exposure to the asset market.

The most significant impact on banks' balance sheet, however, could be felt through their investment portfolio. Banks in India hold substantial investments in Government and other fixed income securities. Such investments amounted to US $ 173 billion, constituting 35.1 per cent of their total assets as on September 16, 2005. To the extent a rise in international interest rates impacts the domestic interest rates, it would entail marked-to-market losses on the investment portfolios.

The banking sector, however, has acquired some added strength to absorb such probable shocks, largely aided by regulatory actions. Apart from having built up a significant capital base reflected in the capital to risk-weighted assets ratio (CRAR) for the sector of 12%, specific steps have been taken to meet the interest rate risk. First, separate provision for capital against market risk has been introduced. Second, a gradual building up of Investment Fluctuation Reserve up to 5% of the marked-to-market portfolio (out of tax-free profits) by March 2006 has been mandated, and several banks have already achieved the target. Third, an enabling risk management environment has been provided to banks to hedge their risks through vanilla derivative instruments. Fourth, Conservative accounting norms followed did not allow banks to book unrealized gains. Fifth, as a one time measure, banks were allowed to transfer securities to HTM, after booking the MTM losses against these. Thus, banks in India, in general, have the resilience to withstand some rise in interest rates.

Impact on the real sector

Readjustment of the currencies would also have implications for the real sector. Significant readjustment of the currencies and rise in interest rates could slow down the global growth. This would entail a reduction in export opportunities and reduction in investment demand for EMEs, in general, many of which depend on export demand to sustain their growth. Rise in interest rates, by slowing down spending, may have a negative impact on the global economic growth. Thus, readjustment of the currencies may affect several EMEs in a significant way.

The impact of any slowdown on India may be assessed with reference to two factors. First, India's economy is largely domestic-demand driven. While India's exports constituted 11.5 per cent of GDP, its share in the world trade is only 0.8 per cent. Second, India's exports basket is fairly diversified.

Some concerns arise with regard to the implications for employment in case of a slowdown in the exports sector, especially with regard to the significant specialisation in BPO/IT Enable Services. Rapid job growth that absorbs the huge supply of agricultural labour into its industrial work force is necessary for socio-economic stability in India. Any negative impact on employment resulting in substantial decrease of real earnings and widening income inequality is likely to reduce overall welfare and increase the cost of structural adjustments required, especially in the absence of meaningful social safety nets.

Monetary and prudential measures as responses

The outlook for output growth in India has improved in the recent months, particularly with the momentum gained in manufacturing sector. However, persistence of global imbalances and high oil prices with a significant permanent component do pose some risks. Furthermore, the credit growth has recently been extremely strong possibly impacting credit quality, while money-supply is over-shooting the anticipated trajectory and strong investment demand coupled with high oil-prices is turning the current account surplus into a deficit, though modest and manageable through normal capital flows. These developments pose new challenges to maintaining price and financial stability while ensuring momentum in growth. Consequently, in the Mid-Term Review of Annual Policy Statement for the year 2005-06, released on October 25, 2005, several measures have been announced to contain and manage the downside risks.

First, the reverse-repo rate (overnight liquidity absorption by Reserve Bank) has been increased by 25 basis points to 5.25 per cent, keeping the spread between reverse repo and repo at 100 basis points. The Bank Rate, being the signalling rate for medium term, is retained at 6.00 per cent.

Second, rationalization of limits on banks' exposure to capital market has been announced, restricting it to 40 per cent of a bank's net worth while simplifying the exemptions and coverage.

Third, the general provisioning requirement for standard advances has been enhanced from the present level of 0.25 per cent to 0.40 per cent except in regard to Banks' exposures to laggards in credit-growth, namely, Agriculture and Small and Medium Industries.

Fourth, a decision had been taken to treat the entire balance under Investment Fluctuation Reserve as Tier I capital, thus providing some head-room to banks to raise Tier II capital in future.

Fifth, revised guidelines are being issued on corporate restructuring mechanisms to be followed by banks in the light of experience gained.

Sixth, having regard to the recent trends in the credit markets, RBI is initiating a supervisory review process with select banks having significant exposure to some sectors, namely, real estate, highly leveraged non-banking financial companies, venture capital funds and capital markets. The purpose of such a review is to ensure that effective risk mitigants and sound internal controls are in place for managing such exposures.

Some reflections

From the above discussion, it is clear that the Impact on India would depend on the pace and extent of currency and current account readjustments, and changes in global interest rates. While India by itself hardly contributes to global financial imbalances, any large and rapid adjustments in major currencies and related interest rates or current accounts of trading partners could indirectly impact the Indian economy.

From the case of India, it is also clear that readjustment of the currencies and rise in interest rates would impact different EMEs differently. Despite rise in short-term interest rates, long-term interest rates, instead of rising, have moderated, leading to a further flattening of the global yield curve and narrowing down of credit spreads. EMEs have taken advantage of favourable financial conditions. During the first half of 2005, EMEs focused on operations aimed at meeting domestic and external obligations and lengthening maturities. However, higher global interest rates could contribute to widening of emerging market bond spreads, particularly those with high debt to GDP ratio. In view of expected deceleration in financial conditions, some emerging markets have cushioned by advancing their external financing, taking advantage of current benign financial market conditions. Emerging market economies have, however, continued to improve their debt structures in an effort towards reducing their vulnerability to external shocks. EMEs have carried out active liability management operations aimed at meeting their financial requirements while minimising the cost of debt and its risks. Some countries have taken steps to develop their local markets and have reduced the amount of foreign currency-linked domestic debt, while gradually improving the maturity profile. Some of the EMEs have also reduced the share of domestic debt indexed to the exchange rate.

Compared to the past crises, the EMEs, in general, are now resilient and in a better position to absorb a financial shock. They have developed resilience to shocks by improving their macroeconomic conditions and regulatory frameworks. EMEs have been achieving a healthy growth with more or less stable inflation and have reduced their dependence on external demand. There has also been an improvement in fiscal positions, supported by the development of domestic securities markets. The external debt burden has declined and the composition of financial flows has changed with lower reliance on borrowings from international banks. Several EMEs have addressed the weaknesses that led to the earlier crisis by strengthening prudential regulation and supervision more in line with international best practices. Banks' balance sheets have improved and capital ratios have risen. Corporate governance practices have also improved. To the extent EMEs have introduced flexibility in their exchange rates, their vulnerability to external shocks has declined. All these factors have reduced the vulnerability of EMEs. Large reserves held by EMEs should also enable them to cope with the volatility arising out of a sudden shift in market sentiment.

While macroeconomic fundamentals of several EMEs are strong, placing them in a relatively better position to withstand deterioration in international financing conditions, economic performance of some EMEs has been found to be less robust. The conditions in these economies may get accentuated by adjustment of global financial imbalances and high and volatile oil prices. A possible volatility in the global financial markets emanating from a rise in interest rates could magnify and propagate the problems associated with less than satisfactory performance in some of the EMEs, making them vulnerable to sudden reassessment of country risk. Such threats are real as the default rates of sub-investment grade borrowers could increase. Credit derivatives, which have proliferated in recent years and whose pricing has depended on relatively untested models and default correlation assumptions, may in particular be vulnerable to corrections.

The main challenge for EMEs is to continue to take advantage of the current favourable external financing conditions and at the same time pursue domestic macroeconomic and structural reforms necessary for long-term stability. In fact, some EMEs have well-advanced external financing, in some cases even including prefinancing for 2006 . EMEs have made significant gains in terms of healthy growth, stable inflation, large trade surplus, greater exchange rate flexibility and lower debt burden. While EMEs are preparing themselves to face sudden shocks, efforts need to be made by all concerned for an orderly adjustment of global financial imbalances. While co-ordinated policy action would minimise the cost of rebalancing, perhaps, a stress testing by all the concerned regulators in the EMEs to assess the extent of the resilience could be helpful.

The EMEs, despite their diversity, seem to generate expectations of high growth and are generally characterized by less-than-fully developed markets, specially financial markets. Consequently, there are significant cross-border capital flows, with market perception of high risk and high reward in EMEs. It is useful to note that implicit in the word “emerging” in the very title given to the EMEs as a group, is the notion that they are undergoing a rapid change or transition. We must recognize that the transition embraces demographics, political institutions, social dimensions and related attitudes. These all-encompassing changes have an in-built potential for uncertainties, possibly some volatility, but it gets exacerbated by the international capital flows, particularly when the changes in such flows happen to be unrelated to domestic fundamentals. In such a situation, managing the transition turns out to be a critical challenge for policy making, and the management requires a more difficult and dynamic trade off between commitment and flexibility in policy.

Overall, while added risks – both upside and downside – are inevitable with increasing global financial and economic integration, the EMEs may consider strengthening their resilience through not only sound macroeconomic management but also by adopting appropriate prudential measures. Over a period, co-ordinated efforts, both at regional as well as global levels, could also help EMEs to cushion themselves better against the risks of financial globalisation.

Thank you.