Y V Reddy: The growing influence of the emerging world

Speech by Dr Y V Reddy, Governor of the Reserve Bank of India, at the 2007 Money & Banking Conference "Monetary Policy Under Uncertainty", hosted by the Central Bank of Argentina, Buenos Aires, 4 June 2007.

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Mr. Chairman, Governor Redrado, Chairman Ignatiev and distinguished participants,

I am honoured by the kind invitation of Governor Redrado to visit Argentina and participate in the Annual Money and Banking Seminar at the Central Bank of Argentina with focus on “monetary policy under uncertainty”. I must compliment Governor Martin Redrado for assembling a galaxy of central bank Governors, leading market analysts and globally renowned academics. The assemblage is a tribute to the charm, popularity, knowledge and wisdom of Governor Redrado. I want to thank all the officials of the Central Bank of Argentina for the warm hospitality and excellent arrangements made.

My presentation is broadly in two parts. In the first part, I address certain general issues relating to the EMEs covering (i) the growing importance of the EMEs in the global context; (ii) distinguishing features of both convergence and divergence, in these economies; and (iii) some current concerns of the EMEs. I devote the second part to discuss India’s development and reform experience.

I. The growing importance of the Emerging Market Economies (EMEs)

A group of economies having some distinct market features was reportedly perceived and termed as “emerging markets” in 1981 by Antoine W. van Agtmael of the International Finance Corporation, the affiliate of the World Bank. Broadly, an EME is described as an economy with low-to-middle per capita income levels, characterised as transitional, *i.e*., in the process of moving from a closed to an open-market economy and embarking on an economic reform program that leads it to a stronger and more competitive economic performance, and simultaneously, to higher levels of transparency and efficiency in the functioning of the factor markets, including the financial markets. More generally, it can be held that what is and what is not an "emerging market" depends on the maturity of its institutions, that is, the rules of the economic market game – the law and the culture – and the institutions enforcing adherence to these rules (Kolodko, 2003). From an operational point of view, the EMEs may be considered to be the fast-growing economies, gradually transiting from the developing to the developed status. In the view of market-participants, the EMEs are the countries that are restructuring their economies towards greater market orientation and thus, offering a wealth of opportunities in trade, technology transfers and investment.

While the fast-growing economies are operationally grouped together as emerging market economies (EMEs), the group of countries constituting EMEs has not been clearly defined and hence, a discussion about the EMEs as a group, at times, becomes difficult. Nevertheless, the major countries amongst the EMEs are very well-recognised and an increased focus has been placed upon monitoring the performance and market conditions of the EMEs by the international financial institutions, leading economic intelligence agencies, credit rating agencies, leading multinational securities firms and financial journals. Academic and policy research on EMEs have also mushroomed, focusing particularly upon the monetary, financial and regulatory policies and the issues relating to trade, financial integration and liberalisation of capital accounts.

The EMEs represent the fast-growing group of countries and their share in world output is increasing. They are geographically spread across the world encompassing diverse cultures – Asia, Middle East, Europe, Africa and Latin America. On account of increasing trade flows, intra-EMEs as well as with the rest of the world, they play a critical role in determining the course of bilateral, regional and multilateral trade policies and developments. They have become the destinations for large movements of international private capital, attracted by high-return possibilities, dwarfing the official flows, including those from multilateral financial institutions.

Today, the EMEs as a group are reported to constitute about 80 per cent of the global population, representing about 20 per cent of the world's output. The share of the EMEs in the global GDP is increasing and is also a tribute to their sound macroeconomic policies, improving fiscal positions, stronger external sectors, increasing productivity, *etc.* According to some recent estimates, the EMEs will soon account for more than half of the world's PPP-based GDP.

The EMEs are also becoming crucial to the supply-demand dynamics of oil and food apart from services and manufacturing products, as also for improving environmental cooperation.

The rise of the EMEs, in general, has thus, made the globalisation a two-way process in which the emerging economies are changing from passive recipients to being part of active participants in global economy.

It is useful to recognise that some of the EMEs are becoming hubs of regional economic activity with sizeable populations, large resource bases, and huge markets. Their economic success is considered to have positive externalities for the neighboring countries and spurs their development process.

From the perspective of public policy, managing the transition of the EMEs to the mature market economies is a challenging task. Compared to the transition-path traversed by the currently industrialised economies, the policy-makers in the EMEs face several pressures – in terms of compressed time frame for transition, technological compulsions towards more openness, the socio-political pressures, etc.

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 recognise 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. In fact, several unprecedented policy initiatives amongst many EMEs in the recent months in managing capital flows should be viewed in the context of the compulsions of dynamic trade-off between commitment and flexibility of policies in the external sector of the EMEs.

II. Some distinguishing features of the EMEs

The emerging markets and developing economies grew by 5.8 per cent during the past ten years as against 2.7 per cent growth in the advanced economies. This phenomenon is currently lending credence to the argument that growth in the emerging countries can perhaps help, to some extent, offset an economic slowdown in the US.

Second, in recent years, the inflation environment in the EMEs remained benign despite a significant rise in commodity prices. Average inflation in the EMEs has declined dramatically since the early 1990s, in many cases from double- and triple-digit levels, to about five per cent at present. This decline in inflation in the EMEs, now sustained for more than half a decade, is impressive.

Third, the EMEs have grown faster than the advanced economies in terms of volume of trade as well. Thus, the volume of exports from the emerging and developing economies had grown at an average rate of 8.9 per cent during 1998-2006 as against 5.5 per cent growth in the advanced economies.

Fourth, the EMEs attract significant capital flows. The net inflows of foreign private capital to the EMEs reached a level of US$ 256 billion in 2006. Foreign-investor demand for emerging market assets is reflected in a broad-based rise in inflows into dedicated bond and equity markets of the EMEs. Emerging-market corporate bond issuance in international bond markets rose to a record level of US$ 125 billion in 2006.

Fifth, as a result of persistently rising capital flows, foreign exchange reserves of the EMEs have increased significantly. Consequently, seven of the EMEs hold more than double the foreign exchange reserves of the G-7 group and account for 43.7 per cent of the global foreign exchange reserves, while the G-7 group of countries account for 21.1 per cent of the total. Similarly, while seven of the EMEs' foreign exchange reserves amount to about 38 per cent of their aggregate GDP, reserves held by the G-7 group are four per cent of their total GDP.

Sixth, along with the accretion of foreign exchange reserves from exports and capital account, most, though not all, of the EMEs also have high savings rates, which are further increasing steadily in many Asian and other emerging market economies. In these countries, savings are rising faster than investment.

Seventh, the considerable surge in market financing has been buttressed by substantial efforts to modernise the financial sector, enabling the EMEs to offer investors an increasingly wide and sophisticated range of financial instruments and, thus, to attract new types of investors. Overall, the EMEs are tending to put in place financial structures similar to those in the advanced countries.

Although the EMEs as a group have these common characteristics, they are also quite distinct from each other in certain respects. The overall improvement in the fundamentals of the EMEs masks a significant dispersion in most of the benchmark indicators, *viz.,* GDP growth, inflation, balance of payments, foreign currency reserves and public finances. Therefore, let me now enumerate some of the divergent features of the EMEs.

First, some of the countries are growing at a robust pace while growth in some others has been relatively slower in some of the recent years. Similarly, sources of growth are quite dissimilar across the EMEs.

Second, as reflected in the export-GDP ratio, external demand has been a more dominant driver of growth in recent years for some of the EMEs while some of the EMEs seem to be more domestic-demand-driven economies.

Third, there is a divergence in the external sector performance of the EMEs, as reflected in parameters like current account balances, level of external debt, *etc.* The EMEs including China, Indonesia, Malaysia and Russia have been maintaining current account surpluses since 1998 while some others have maintained current account deficits. External debt reductions have been particularly significant in Indonesia, Russia, Brazil, and also in Argentina following the 2005 debt exchange.

Fourth, the EMEs have a wide variety of exchange rate arrangements. Such diversity is only expected in view of the wide differences amongst these countries in economic and financial circumstances. However, as these countries have adapted to the expanding opportunities arising from deeper involvement in an increasingly integrated global economy and to the changes in their own economic environments, there has been a gradual movement towards greater flexibility in some of them.

Fifth, there are variations in terms of economic endowments such as rich natural resources and human capital.

Sixth, institution building plays an important role in sustained development. Since the major EMEs have adopted the path of reforms at different points in time under different historical circumstances, their institutional strengths vary. For example, both China and Russia are transiting from a centrally-planned economy to a more open-market economy but their approach to reforms has been different and, thus, the level of institutional strength also differs. A contrasting level of institutional development is also evident from the fact that while some of the emerging markets witnessed financial crises in the 1990s, some others, like China and India, could avoid the contagion effect.

Seventh, another contrast within the group of the EMEs is that not all of them are equally exposed to similar shocks. For instance, if we look at oil trade of the EMEs, some of them are net exporters of oil and are benefiting from oil price spikes, while some others are net importers of oil. Hence, the EMEs, which are oil-importing consumers, face greater energy-security concerns in financing their long-term growth, while others are relatively better off to tackle the growing energy needs.

The EMEs exhibit very diverse characteristics to investors, whether in terms of country size, the size of financial markets, energy dependence, the level of forex reserves and, more generally, macroeconomic performance, Thus, not all the EMEs are equally impacted by the ongoing developments in the global economy and investors appear to differentiate between them. The advantage of such diversity is that the possibility of any synchronised behaviour or a potential for contagion amongst the EMEs is to some extent moderated. However, Governor Draghi of Bank of Italy explained in his address earlier today that there are new financial intermediaries, new financial instruments and new dispersed risks. Hence, the risk of contagion to the EMEs, through the financial markets, which appear to be even more integrated now, seems to have heightened, and the real sector in the EMEs might not remain immune to its consequences.

III. Current concerns of the EMEs

In the emerging market economies, growth has continued to be firm on account of adoption of sound macro policies and structural reforms. These were complemented by global factors such as strong commodity prices and abundant global liquidity. Concerns have, however, arisen regarding the sustainability of some of these factors. High investment growth, excessive lending, overhang of liquidity, strengthening retail demand and imbalances in trade and international payments are some of the factors causing concern in some of the EMEs.

In addition, there are a number of downside risks emanating from the behaviour of oil prices, adverse developments in the US housing market, persistence of global imbalances, large leveraged positions in financial markets and possible emergence of inflationary pressures. It is important to recognise the risk of an abrupt and disorderly adjustment of global payments imbalances. The exposure of emerging markets to risky financial assets of the mature markets has increased, and therefore, the overall global financial risks have increased. In the event of loss of or moderation in the risk appetite and the consequent unwinding of leveraged positions, there could be serious adverse impact on the emerging markets.

Global equity markets are also getting integrated irrespective of the stage of development of the markets. Volatility in international financial markets has increased in recent months with deterioration in the sub-prime segment of the US mortgage market in early 2007. Concerns over the systemic implications of hedge-fund failures and the wide diffusion of risks through derivative markets have also increased in recent years. Consequently, monitoring of risks has become much more complex than before. There are, therefore, serious concerns that financial markets/investors may be assigning insufficient weight to the downside risks.

The integration of the EMEs into the global markets has resulted in a wider diversity of financial institutions operating in the EMEs and a broader range of business strategies. With financial institutions in the advanced economies increasingly searching for profit opportunities at the customer and product level, foreign direct investment from the financial sector provides a route for accessing the EMEs, which offer attractive strategic business opportunities to expand. The growing involvement of foreign firms in the financial systems of the EMEs has given rise to certain concerns.

Finally, the recent rise in agriculture prices could potentially represent the beginning of a structural increase in prices. Impressive growth performance and consequent increase in food-demand of large populations, particularly in India and China, on an unprecedented scale in a short time span, generates huge demand pressures on food items, including edible oil. The growing demand for animal proteins could further accentuate the demand for agricultural products. The supply-side is also affected by diversion of corn and oil-seeds to produce bio-fuel as energy-substitute; mandated by law in some countries. The tendencies towards global-warming are adding to uncertainties on the supply side. The resultant mismatch between supply and demand could potentially have impact on prices of food articles. The consequent impact on inflation-perceptions and hence, on inflation expectations could be disproportionately large, perhaps even in the industrialised economies. At the same time, there are several challenges to public policy in managing the problem of food prices.

First, there are invariably strong domestic political-economy considerations in managing food-production and ensuring food security.

Second, the increasing global financialisation of commodities evident now could help, but it could also potentially add to volatility – since in recent years, there has been a growing presence of financial investors in the markets for commodities-based financial instruments.

Third, the weight of food items in price indices is large in many EMEs and hence, it would pose dilemmas for monetary management.

Fourth, in such a situation, in any comparison of inflation between the EMEs and the industrialised economies, some of the EMEs might emerge worse off, owing to higher weight for food items in their price indices.

Finally, those EMEs, which are coping with second order effects of recent oil-price increases, may find any possible shock on food prices, somewhat burdensome. In case, adverse developments on this account occur and happen at a time when global liquidity is withdrawn or risk-premia increase sharply, there could be policy dilemmas for the EMEs, even after accounting for upside risks, both in terms of efficiency and resilience.

It is, however, gratifying to note that in India, the government has taken measures for immediate supply-side management of food items, which should mitigate, to an extent, the concerns in this regard. The National Development Council, the highest policy-making body in India, met last week and finalised a vigourous programme for enhancing production and productivity in Agriculture.

IV. India: development and reform experience

India is the second most populous country, but is amongst those which have the youngest demographic profile in the world. The "demographic dividend" is expected to extend over the next few decades of this millennium. India is unique in pluralism in terms of languages, religions, ideologies and traditions spread over twenty-eight provinces and seven federally governed union territories, each with its distinct identity and socio-cultural ethos. The Constitution of India recognises 22 languages as the official languages. India is well endowed with natural resources, human resources and varied climatic regions. The institutional architecture is unique with flexible federalism, democracy with universal adult suffrage, and coexistence of public and private sector.

Growth

The average growth rate of the Indian economy over a period of 25 years since 1980-81 has been about 6.0 per cent – a significant improvement over the annual growth rate of 3.5 per cent over the previous three decades from 1950-51 to 1979-80. In the more recent period, the Indian economy has entered a high-growth phase with the growth rate averaging 8.6 per cent in the last four years and over nine per cent per annum during the last two years. The growth rate is expected to be about 8.5 per cent for 2007-08.

Over the years, while the GDP growth has accelerated, the population growth rate has moderated, giving a sharp impetus to the growth in per capita income. Since the 1990s, per capita income has been growing at an average rate of around 4.0 per cent, implying that a person's income will double in nearly 18 years. A person with a life expectancy of, say, 72 years could thus see his income doubling at least three times in his adult life. If the current GDP growth rate of around 9 per cent is maintained, a person can hope to see the standard of living multiplying by almost five times in his lifetime.

The industrial sector constituted 19.6 per cent of GDP in 2006-07. Indian industry has emerged from a period of restructuring and organisational change during 1996-2003. In the subsequent years, there is a growing realisation of productivity and efficiency gains and is increasingly becoming internationally competitive.

The main driver of the Indian economy currently is the services sector, which constitutes 61.9 per cent of GDP in 2006-07 and contributed two-thirds of average real GDP growth for the period 2002-07.

The strengthening of economic activity has been supported by persistent increase in domestic investment rate from 22.9 per cent of GDP in 2001-02 to 33.8 per cent 2005-06 coupled with an efficient use of capital. It must also be noted that over 95 per cent of investment during this period was financed by the domestic savings only. Domestic saving rate has also improved from 23.5 per cent to 32.4 per cent over the same period. The contribution to improvement in savings has come both from private corporate sector and public sector.

Inflation

While growth has picked up, over the years, inflation rate has been moderated to lower levels ensuring price stability. Initially, the inflation rate accelerated steadily from an annual average of 1.7 per cent during the 1950s to 6.4 per cent during the 1960s and further to 9.0 per cent in the 1970s before easing marginally to 8.0 per cent in the 1980s. The inflation rate declined from an average of 11.0 cent during 1990-95 to 5.3 per cent during the second half of the 1990s.

In the recent years, inflation rate has averaged around 5 per cent. In recognition of India's evolving integration with the global economy and societal preferences, the resolve, going forward, is to condition policy and expectations in the range of 4.0-4.5 per cent in the medium term. It may be of interest to note that, since independence, the Wholesale Price Inflation on average basis was above 15 per cent in only five out of fifty years. In thirty six out of fifty years, inflation was in single digit and on most occasions high inflation was due to shocks – food or oil.

Stability

An important characteristic of the growth phase of over a quarter of century is the country's resilience to shocks and during this period, we have witnessed only one serious balance of payments crisis triggered largely by the Gulf war in the early 1990s. The Indian economy in later years, could successfully avoid any adverse contagion impact of shocks from the East Asian crisis, the Russian crisis during 1997-98, sanction like situation in post-Pokhran scenario, and border conflict during May-June 1999. Seen in this context, this robust macroeconomic performance, in the face of recent oil as well as food shocks, demonstrates the vibrancy and resilience of the Indian economy.

External sector

The Indian economy has evolved from a virtually closed economy until early 1980s to one that is opening up and rapidly integrating into the global economy since the commencement of major reforms in early 1990s. In terms of a traditional measure of openness, the ratio of exports and imports (both goods and invisibles) to GDP has risen steadily from 21.1 per cent in 1991-92 to over 50 per cent in 2005-06 and is expected to have gone up further in 2006-07. Both exports and imports have been rising above long-term trend in recent years. The merchandise trade deficit is currently close to 7 per cent of GDP; however, the current account deficit is under 1.5 per cent of GDP, mainly due to the knowledge and competitive advantage we have in services and the steady support from remittances from Indians working abroad.

The liberalisation of the current account took place in the early part of the reforms and we attained current account convertibility in August 1994. In India, capital account liberalisation is sequenced in response to domestic developments, especially in real and fiscal sectors, and the evolving international financial architecture.

Fiscal federalism

Under India's federal system of government, the Constitution allocates the revenue powers and expenditure functions between the Central and State Governments. The borrowing by the sub-national governments is in effect subordinated to prior approval by the national government. Furthermore, State Governments are not permitted to directly borrow externally.

The fiscal management in the country has significantly improved, specially, after the adoption of the Fiscal Responsibility and Budget Management Act, 2003 by the Central Government. The State Governments are also adopting similar Acts and have made consistent efforts to improve fiscal management. The fiscal consolidation, in terms of reduction in fiscal deficit, is taking place in the finances of both the Central and State Governments.

The fiscal-management of Central Government is broadly in the direction of achieving the targeted ratio of gross fiscal deficit (GFD) to gross domestic product (GDP) to three per cent and eliminate revenue deficit (RD) by 2008-09. It may be noted that the GFD / GDP and RD / GDP ratios are already budgeted to reduce to 3.3 per cent and 1.5 per cent in 2007-08. In the recent years, there has been a significant improvement in State level finances also. The GFD of all States declined from 4.7 per cent of GDP in 1999-2000 to 2.7 per cent of GDP in 2006-07, while the RD came down from 2.8 per cent of GDP to 0.1 per cent of GDP. Most States have also enacted fiscal responsibility legislations. As a result, the combined fiscal deficit of the Central and State governments has declined to around 6.6 per cent of GDP in 2006-07 from around 10 per cent in the early 2000s.

The Reserve Bank plays two crucial roles in relation to the Indian fiscal system, namely as banker to and debt manager of both the Central and State Governments. While undertaking the role of banker for, both the Central and State Governments, the RBI also provides temporary support to tide over mismatches in their receipts and payments in the form of short-term advances.

The Reserve Bank plays a significant role as Advisor to Central and State governments on federal fiscal relations. The Reserve Bank sensitizes the State Government on important fiscal issues. Since 1997, the Reserve Bank has been organizing a biannual Conference of Finance Secretaries of State Governments. This Conference, right from its inception, has provided a very useful forum for interaction among all the stakeholders (State Governments, Central Government and the Reserve Bank) on matters related to State finances and arriving at consensual solutions of issues of policy and operational significance.

Public debt

The Reserve Bank manages the market loans, which constitute around 50 per cent of public debt of the Centre and States. In the pre-reforms period, i.e., before 1991, the primary objective of the debt management was to minimize costs of borrowing. This, however, resulted in repression of the financial sector on account of statutory provisions requiring banks and financial institutions to invest in government securities at pre-determined rates. Recognising the criticality of the impact of such a system on financial sector development, the Reserve Bank has undertaken a series of measures since the early 1990s to move to a market determined interest rate from the administered interest rate regime. The automatic monetisation of budget deficits of Central Government by the Reserve Bank was discontinued since 1997-98, and currently, the Reserve bank does not participate in the primary issuance of the government paper.

It is true that the aggregate stock of public debt of the Centre and States as a percentage of GDP is high, currently at around seventy five per cent. It is also useful to note that there are several unique features of management of public debt in India, which imparts overall stability to macro-economy. First, States have no direct exposure to external debt. Second, almost the whole of public debt is local currency denominated and held almost wholly by residents. Third, public debt, of both Centre and States is actively and prudently managed by the Reserve Bank of India ensuring comfort to financial markets without any undue volatility. Fourth, the government securities market has developed significantly in recent years in terms of turnover, depth and participants, and significant further improvements are underway. Fifth, most debt carry fixed coupons and not indexed to inflation. Sixth, the Government has not ventured into sovereign marketable debt issues in foreign currency. Seventh, contractual savings supplement marketable debt in financing the deficits. Finally, direct monetary financing of primary issues of debt has been discontinued since April 2006. Hence, the high stock of public debt relative to GDP as also the relatively higher fiscal deficits in the past have not been a matter of concern as far as stability is concerned. However, it is recognised that the long-term sustainability as well as further liberalisation of the external and financial sectors, to foster growth momentum, would call for further reduction of both debt and deficits to prudent levels.

Financial sector reforms

The Indian financial system of the pre-reform period, before 1991, essentially catered to the needs of planned development in a mixed-economy framework, where the Government sector had a predominant role in economic activity. Interest rates on Government securities were artificially pegged at low levels, which were unrelated to the market conditions. The system of administered interest rates was characterised by detailed prescriptions on the lending and the deposit side, leading to multiplicity and complexity of interest rates. As would be expected, the environment in the financial sector in those years was characterised by segmented and underdeveloped financial markets coupled with paucity of financial instruments. Consequently, by the end of the eighties, directed and concessional availability of bank credit to certain sectors adversely affected the viability and profitability of banks. Thus, the transactions between the *de facto* joint balance sheet of the Government, the Reserve Bank and the commercial banks were governed by fiscal priorities rather than sound principles of financial management and commercial viability. It was then recognised that this approach, which, conceptually, sought to enhance efficiency through a co-ordinated approach, actually led to loss of transparency, accountability and incentive to seek efficiency.

Banking

The banking system in India has undergone significant changes during last 16 years. There have been new banks, new instruments, new windows, new opportunities and, along with all this, new challenges. While deregulation has opened up new vistas for banks to augment incomes, it has also entailed greater competition and consequently greater risks. India adopted prudential measures aimed at imparting strength to the banking system and ensuring its safety and soundness, through greater transparency, accountability and public credibility. The capital adequacy ratio has increased to 12.4 per cent for scheduled commercial banks as at end March 2006, which is much above the international norm. Commercial banks' net profits remained at 0.9 per cent of total assets during 2004-05 and 2005-06, up from 0.16 per cent in 1995-96. The ratio of NPLs to total loans of scheduled commercial banks, which was as high as 15.7 per cent at end-March 1997, declined steadily to 3.3 per cent by end-March 2006. The net non-performing assets declined to 1.2 per cent of net advances during 2005-06 from 2.0 per cent in 2004-05. According to the preliminary financial results available for most of the banks for the year 2006-07, the financial soundness has improved further.

Our banking sector reform has been unique in the world in that it combines a comprehensive reorientation of competition, regulation and ownership in a non-disruptive and cost-effective manner. Indeed our banking reform is a good illustration of the dynamism of the public sector in managing the overhang problems and the pragmatism of public policy in enabling the domestic and foreign private sectors to compete and expand. There has been no banking crisis in India.

The Government took steps to reduce its ownership in nationalised banks and inducted private ownership but without altering their public sector character. The underlying rationale of this approach is to assure that the salutary features of public sector banking were not lost in the transformation process. On account of healthy market value of the banks' shares, the capital infusion into the banks by the Government has turned out to be profitable for the Government.

An independent Banking Codes and Standards Board of India was set up on the model of the UK in order to ensure that comprehensive code of conduct for fair treatment of customers is evolved and adhered to. With a view to achieving greater financial inclusion, since November 2005, all banks need to make available a basic banking "no frills" account either with "nil" or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. Banks were urged to review their existing practices to align them with the objective of "financial inclusion".

There is a scheme of Ombudsman, located in fifteen cities to provide redressal to grievances of the bank customers. Customer-service is accorded high priority in the supervisory evaluation and according regulatory comfort to the Reserve Bank.

With a view to strengthening the supervisory framework within the RBI, a Board for Financial Supervision (BFS) was constituted in 1994, comprising select members of the Reserve Bank's Central Board with a variety of professional expertise to exercise "undivided attention to supervision" and ensure an integrated approach to supervision of commercial banks and financial institutions. The Reserve Bank has also instituted Off-site Monitoring and Surveillance system for banks in 1995, which provides for Early Warning System as also a trigger for on-site inspections of vulnerable institutions.

Development of financial markets

Financial markets in India in the period before the early 1990s were marked by administered interest rates, quantitative ceilings, statutory pre-emotions, captive market for government securities, excessive reliance on central bank financing, pegged exchange rate, and current and capital account restrictions. As a result of various reforms, the financial markets have now transited to a regime characterised by market-determined interest and exchange rates, price-based instruments of monetary policy, current account convertibility, phased capital account liberalisation and auction-based system in the government securities market. A noteworthy feature is that the government securities and corporate debt market are essentially domestically driven since FII and non-resident participation in these markets are limited and subjected to prudential ceilings.

The Reserve Bank has taken a proactive role in the development of financial markets. Development of these markets has been done in a calibrated, sequenced and careful manner such that these developments are in step with those in other markets in the real sector. The sequencing has also been informed by the need to develop market infrastructure, technology and capabilities of market participants and financial institutions in a consistent manner.

The Reserve Bank has accorded priority to the development of the money market as it is the key link in the transmission mechanism of monetary policy to financial markets and finally, to the real economy. The Reserve Bank has special interest in the development of government securities market as it also plays a key role in the effective transmission of monetary policy impulses in a deregulated environment.

A qualitative change was brought about in the legal framework by the enactment of the Foreign Exchange Management Act (FEMA) in June 2000 by which the objectives of regulation have been redefined as facilitating trade and payments as well as orderly development and functioning of foreign exchange market in India. The legal framework envisages both the developmental dimension and orderliness or stability. The legislation provides power to the government to re-impose controls if public interest warrants it. The RBI has undertaken various measures towards development of spot as well as forward segments of foreign exchange market. Market participants have also been provided with greater flexibility to undertake foreign exchange operations and manage their risks.

Linkage between the money, government securities and forex markets has been established and is growing. The price discovery in the primary market is more credible than before and secondary markets have acquired greater depth and liquidity. The number of instruments and participants has increased in all the markets, the most impressive being the government securities market. The institutional and technological infrastructure has been created by the Reserve Bank to enable transparency in operations and to provide secured payment and settlement systems.

Monetary policy

The preamble to the Reserve Bank of India Act, 1934 sets out in a way broadly the tone of Reserve Bank's monetary policy objectives: "*to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage".* Thus, unlike the current trend in many advanced and emerging countries, there is no explicit mandate for price stability or formal inflation targeting in India.

The broad objectives of monetary policy in India have been to maintain a reasonable degree of price stability and ensuring adequate flow of credit to help accelerate the rate of economic growth. The relative emphasis placed on price stability and economic growth is modulated according to the prevalent circumstances in the economy. Of late, considerations of macroeconomic and financial stability have assumed an added importance in view of the increasing openness of the Indian economy.

The recognition of change in the financial market dynamics in the wake of financial market reforms also prompted a change in the operating procedures of the monetary policy. The framework of monetary policy has been accorded greater flexibility with the adoption of the multiple indicator approach since 1998-99 moving away from a monetary targeting framework.

In the new operating environment, the Reserve Bank has been increasingly relying on a mix of market-based instruments and changes in reserve requirements, when necessary, for the conduct of monetary policy. Reliance on direct instruments has generally been reduced and a policy preference for indirect instruments has become the cornerstone of current monetary policy operations. However, there is no hesitation in using direct instruments whenever appropriate. The Reserve Bank currently uses multiple instruments to ensure that appropriate liquidity is maintained in the system, consistent with the objective of price stability, so that all legitimate requirements of credit are met. Towards this end, the Reserve Bank pursues, *inter alia,* a policy of active management of liquidity through open market operations including liquidity adjustment facility (LAF), market stabilisation scheme and cash reserve ratio, and deploys the policy instruments at its disposal, flexibly, as warranted by the situation. Changes in fixed reverse repo/repo rates set by the Reserve Bank from time to time for the conduct of its LAF, under which the central bank conducts daily auctions for the banks, have emerged as the main instruments for interest rate signaling in the Indian economy. Institutional mechanisms have been evolved in parallel to improve transparency and communication of monetary policy. Governor Redrado, who spoke earlier, referred to several issues including difficulties in transmission channel in the EMEs, and I agree with him.

Traditionally, four key channels of monetary policy transmission are identified, viz., interest rate, credit aggregates, asset prices and exchange rate channels. The interest rate channel emerges as the dominant transmission mechanism of monetary policy. Nevertheless, it is fair to regard the credit channel as running alongside the interest rate channel to produce monetary effects on real activity. Changes in interest rates by the monetary authorities also induce movements in asset prices to generate wealth effects in terms of market valuations of financial assets and liabilities. The exchange rate channel is relatively less important in the Indian context, though its relevance is gradually increasing. In the recent period, a fifth channel – expectations – has assumed prominence in the conduct of forward-looking monetary policy in view of its influence on the traditional four channels.

Current challenges

Before concluding, I would like to share with you some of the challenges for the medium term.

First, the most complex and challenging issue relates to development of agriculture. While over 60 per cent of the workforce is dependent on agriculture, the sector accounts for barely 20 per cent of the GDP. Further, the GDP growth generated from agriculture is only marginally above the rate of growth of the population, which is not adequate to ensure rapid poverty reduction. On May 29, 2007, our Honourable Prime Minister announced a major scheme to double the growth rate of agriculture to 4.0 per cent over the 11th Plan period. The Government would provide Rs. 250 billion for new farm initiatives launched by States. A time-bound Food Security Mission was also announced to counter rising prices of food products and to ensure visible changes in their availability over three years.

Second, the growth story in any developing country can not be complete without assessing its impact on the poverty and employment situation. The Planning Commission has stressed that India should strive for “more inclusive growth”. The number of people living below the poverty line has decreased from 36 per cent in 1993-94 to 22.0 per cent in 2004-05. Again, the issue is to bring more and more people out of poverty by providing them the productive employment opportunities. The Approach Paper to 11th Five Year Plan suggests that doubling the growth of agricultural GDP to 4 per cent per annum will improve rural employment conditions, by raising real wages and reducing underemployment. However, even if this is attained, an overall growth of 9 per cent will further increase income disparity between agricultural and non-agricultural households, unless around 10 million workers currently in agriculture find remunerative non-agricultural employment. This poses a major challenge not only in terms of generating non-agricultural employment but also in matching its required location and type.

Third, delivery of essential public services such as education and health to large parts of our population is a major institutional challenge. It is strongly felt that education will empower the poor to participate in the growth process and the large gaps in availability of health care, in terms of minimum access to the poor, need to be filled.

Fourth, a critical constraint to economic growth in India in recent years has been the infrastructure deficit. The Approach Paper to the 11th Five Year Plan has estimated that for accelerating the GDP growth from 7 to 9 per cent, there is a need for accelerating the current level of investment in infrastructure from 4.6 per cent of GDP to 8 per cent during the Plan period. The issue of providing adequate and quality infrastructure has already attracted attention of policy makers at all levels. The most important issues here are regulatory framework and overall investment climate, which are being addressed by the Government. Apart from higher levels of investment, issues of governance and management including policies relating to appropriate pricing and user charges are being addressed to achieve satisfactory results.

V. Summing up

Let me conclude by expressing my deep appreciation and thanks for the courtesies extended by the Central Bank of Argentina and personally by Governor Redrado.