Y V Reddy: Some comments on macro-stability in the Indian economy

Address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the release of the India Development Report 2008, by IGIDR, Hyderabad, 3 January 2008.

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Professor Nachane, Professor Radhakrishna, distinguished academics and friends,

I am thankful to Indira Gandhi Institute of Development Research (IGIDR) for granting me the honour of releasing the India Development Report 2008 (IDR 2008). This is the fifth in the series and I wish to place on record our deep appreciation of the contribution made by Professor Kirit Parikh for the initiative and for establishing a tradition of high quality.

I had the benefit of studying the IDR 2008 with great interest. It has the hallmark of scholarship and objectivity. It is deep in analysis and lucid in exposition. It is comprehensive in coverage and contemporary in focus. Above all, the most distinguishing characteristic of the report is its sensitivity to the issues that concern the millions of under-privileged, while not losing sight of debates centred around accelerating development. I compliment Professor Radhakrishna and his colleagues for an excellent empirical policy work. I commend the IDR 2008 to scholars and lay persons alike.

On this occasion, I will respond briefly to a very significant remark in the IDR 2008 in its section titled "Overview" since it relates to performance and prospects for the Indian economy. The remark reads as follows:

> *"The improvement in macroeconomic stability could be due to macroeconomic policies. While the prospects of achieving high growth are good, the prospect of maintaining macroeconomic stability must be rated low. The Indian economy is likely to be susceptible to periodic shocks originating from the global economy such as those related to global financial crises and volatility in crude oil prices."*

Of particular interest is the comment in the IDR 2008 on the prospects for maintaining stability, which have been rated low by the authors. I submit that this remark should be treated as an advice to the policy-makers to continue to accord a high priority to maintaining stability to be able to sustain the growth momentum in our country. I also agree with the comment that susceptibility arises essentially from global developments and hence I will treat this as another advice to us to be vigilant in managing the process of integration with the global economy.

The current turbulence in global financial markets appears to be particularly difficult to comprehend. The turbulence originated in advanced economies and among global financial centres, provoking coordinated actions by several leading central banks. Liquidity is being provided by leading central banks in ample measure, at relatively softer terms, for longer duration than ever before. Despite prevailing assessments regarding inflationary pressures, the concerned central banks are perhaps indicating softer interest-rate regimes thus inciting fears of stagflation. The globally highest-rated financial intermediaries, mainly banks, are releasing information on possible losses in installments giving rise to concerns of not merely liquidity. There is an ongoing process of repositioning of the world's leading reserve currency, which is naturally complex.

The unusual steps taken include, Government's assurance to all bank depositors in UK and arranged amalgamation of banks within what may be termed as public sector banks, in Germany. In USA, the proposal mooted for a Super Fund of $ 75 billion has not taken-off, while a proposal to freeze interest rates has not had desired impact on sentiment, so far. The scope for financial contagion to other economies cannot be ruled out and it is not clear how it will unfold in the year 2008. The impact on real economy, especially in terms of extent of decoupling of the world economy from the U.S. economy is still being explored. There is one certainty in these circumstances, and that is – extraordinarily uncertain times are ahead of us.

It is in this background that Reserve Bank had, in its Mid-Term Review, devoted considerable attention to the recent global developments, their possible impact on India and the need for enhanced vigilance.

The scholarly caution in the IDR 2008 in regard to the challenges of maintaining stability is arriving a few weeks after the U.K. based weekly *Economist* (dated November 17, 2007 – Pages 75-77) ranked India along with Turkey and Hungary as the riskiest economies among select leading emerging market economies. The article states, *inter-alia*, "Those with current-account deficits are vulnerable to a sudden outflow of capital if global investors become more risk averse. Economies where inflation and credit growth are already high and budget deficits large, such as India, have less room to ease monetary or fiscal policy if the economy weakens."

There is merit in clarifying in detail the perception of the Reserve Bank in regard to these related observations. At a general level, it is essential to recognise that the central banks concerned, being aware of the risks in respective jurisdictions, seek appropriate safeguards to ensure financial stability. India is no exception to this practice.

The *Economist* based its conclusion on the standard parameters such as current account, budget balance, inflation and increase in bank lending, for assessing the degree of risk and one cannot disagree with the relevance of these parameters in assessing risks. But, most of these risky elements have been a part of the functioning of the Indian economy for several years, almost all through the reform period, and yet the economy exhibited macro-stability and impressive growth even while withstanding some significant domestic and global shocks. In view of this evidence, we need to explore

a) the reasons for such risks not materialising in our economy so far; and

b) the measures needed, in future, for insulating the economy from such risks, to the extent feasible.

The reform process in India, lays emphasis on appropriate sequencing of reforms. Firstly, the Reserve Bank, in particular, has been treating reforms in financial and external sectors as means to broader objectives of accelerated growth with stability rather than as ends in themselves. Secondly, reform in external sector makes a clear distinction between the costs and the benefits of trade liberalisation, and between the risks and rewards of capital account liberalisation. Thirdly, a hierarchy in capital flows is recognised and management of capital account is advocated on that basis. Fourthly, the pace and content of reform in financial and external sectors are calibrated after taking into account reforms in real, fiscal and public sector as a whole.

These approaches to reform have had a salutary impact on the preparedness of financial institutions, financial markets, public policy and above all, public opinion to participate gainfully in the reform process.

Way forward, there is considerable merit in persisting with these approaches that have ensured macro-stability, while fine tuning them to the changing times and global challenges. Reserve Bank will, in regard to both growth and stability, continue to pursue its policy of being enlightened by theory, educated by global experiences, and conditioned by domestic realities without being bound by any particular ideology.

A major area of vulnerability for us is the high consolidated public-debt to GDP ratio of over seventy percent and persisting, though moderating, consolidated fiscal deficit. The policies and practices in management of public-debt in India are acutely conscious of these and hence policies to mitigate risks on this account are carefully crafted by taking recourse to all the instruments at the command of the Reserve Bank in a coordinated manner. At the same time, reforms in government securities markets have been undertaken in a systematic and well-sequenced manner by a judicious combination of regulation and development of markets. Further, sovereign debt is wholly denominated in domestic currency, except a specified small component open to Foreign Institutional Investors and multilateral/bilateral aid.

Way forward, with a view to mitigate the potential risks, there is clearly a case for continuing with such a well nuanced and coordinated policy of management of public debt, as long as fiscal vulnerability persists, while at the same time, responding to changing circumstances.

Similarly, reform of the financial sector commenced early in the reform cycle and the gradual, well-calibrated, consultative and cautious approach has paid rich dividends. For most part, the framework for reform in these sectors has been designed by those who have distinguished themselves in the practice of central banking but possessing knowledge of theory and having international experience. No doubt, a critical component of reform, in public-sector banking, is underway, warranting careful attention to this aspect in deciding on the pace and content of further reforms in this area. The Reserve Bank has taken timely steps to moderate recently observed high growth in bank credit and has also imposed enhanced provisioning and risk-weights for select sensitive sector exposures to assure desired quality in bank-lending.

Way forward, it is recognised by us that extreme sensitivity to risks in financial institutions and financial markets is desirable, both on account of domestic factors and global uncertainties.

The external sector has, by and large, exhibited significant strength and resilience. These positive features could be attributed to the framework for reform provided by Governor, Dr. Rangarajan, and the strategies to meet contingencies as also forex management provided by Governor, Dr. Bimal Jalan. In the recent years, we have been building on these strengths while carefully monitoring the movements in the current account to ensure that the current account deficits are within sustainable levels. No doubt, the prevailing increases in capital-flows and global uncertainties are posing severe challenges to the public policy. Reserve Bank has been alive to the potential problems in this regard and I have had occasion to refer to these while releasing the India Development Report in January 2005. The need for active management of Capital account and issues relating to such management are well recognised now, but the complexity of relevant issues in the implementation of such management has increased. These matters merit a separate and detailed treatment which is a subject matter of my inaugural address at the Annual Conference of Indian Economic Society today.

Let me conclude by appreciating the IDR 2008's emphasis on macro-stability. While there is no visible immediate threat to financial stability in our country, at this juncture, we recognise the need for continued but heightened vigilance. We believe in taking timely, prompt and appropriate measures to mitigate the risks, to the extent possible, being conscious of difficult dilemmas. Let me also reiterate the continued commitment of the Reserve Bank to lay stress on macro-economic stability in a way that it enhances the prospects, not merely for accelerated growth but for a genuinely more inclusive growth. The need for such a continued commitment of public policy is, I believe, the main message from the India Development Report 2008.

It is my honour and privilege to release the India Development Report, 2008.

Thank you.