Y V Reddy: Monetary and regulatory policies – how to get the balance with markets right

Remarks by Dr Y V Reddy, Governor of the Reserve Bank of India, as a panelist at the Annual General Meeting Panel of the Bank for International Settlements, Basel, 29 June 2008.

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Chairman Jean-Pierre Roth, Governor Meirelles, distinguished economist Bill White, fellow governors and friends.

It was a treat to listen to Edward Lord George's wonderful and erudite lecture on the "Approach to Macroeconomic Management – How it has evolved" and Sir Andrew Crockett's comments, as Chairman, on Lord George's Per Jacobsson Lecture and also on Lord George – "Steady Eddie" as he is warmly described. The Reserve Bank of India considers both of them as our special and lasting friends.

I am also thankful for the opportunity provided to me to share my thoughts on monetary and regulatory policies. At the outset I would like to underscore that the critical word in the title is "balance". So we have to recognize the links and interactions between the two, which may at times be reinforcing and at times be conflicting.

In this balance, "time-dimension" is important. We know whether the balance is right or wrong only ex-post. For example, when there is all round prosperity, everyone wants everything to be left to the markets; when things go wrong and there is pain, monetary and regulatory policies are invoked to save the situation. I will add that, in the balance to be maintained, public opinion is also important for the legitimacy and the effectiveness of monetary policy. Public opinion goes beyond financial markets and institutions, but it is useful to remember that it includes government and media also.

Country-context is important because institutional factors of governance, state of the market-development, and values are relevant in the context of "balance". Hence, we cannot be judgmental about "balance" across countries, but we should assess the balance only in a country-specific context.

I will present India's experience in recent years as to how we are viewing "balance", after recognizing all the above factors.

First, on monetary policies, we monitor the monetary and credit aggregates. We use both liquidity and interest rate instruments. A dynamic balance is evident from the spread between the repo and reverse repo rates, which is enlarged during times of uncertainties. It has moved from 150 basis points to 100 basis points when times were good and has now moved to 250 basis points, reflecting greater uncertainties. We believe that market participants should be willing to share some costs of uncertainties. Pre-emptive actions have been taken since 2004 to withdraw monetary accommodation, which were reinforced with measures aimed at moderating early signs of over-heating. Further, a differentiated approach between the permanent component and temporary component with regard to oil prices has been articulated in the policies. We did not treat oil prices entirely as a shock and focus on what is described as core inflation. While undertaking a nuanced approach to managing aggregate demand recognising the elements of shock and consequent impact on inflation expectations, the underlying demand conditions warranted several interest rate and liquidity measures in recent weeks.

Second, while monetary policy influences aggregates, reality in the financial sector is often dis-aggregated. So we have used regulatory policies to supplement the monetary measures. These relate mainly to risk weights, and provisioning requirements with regard to exposure to NBFCs, capital markets, real estate, consumer credit etc; sectoral caps; and more recently modulation of the exposure limits to oil companies.

Third, we do not take a view on asset prices, either in the real estate or the capital markets. Though we do not take a view, we wanted to protect the banking system form possible risks. In this regard, the nature of the markets is also important, for example, the housing markets in India are less than liquid. We also modified the overly conservative accounting norms that were earlier applicable to the Held to Maturity category, in India.

Fourth, A supervisory review process (SRP) was initiated with select banks having significant exposure to sensitive sectors, including reliance on call money market, in order to ensure that effective risk mitigants and sound internal control systems are in place. In the first round, a framework was developed for monitoring the systemically important individual banks. The second round of SRP was directed to analyse banks' exposure to sensitive sectors and identify outliers. Based on the analyses of these outlier banks, guidelines were issued to all banks indicating the need for better risk management systems in banks at operating levels.

In brief, in India the focus is on regulatory comfort rather than on regulatory compliance. In a choice between emphasis of regulations on saving capital and protecting depositors' interests or reinforcing financial system stability, the latter have always prevailed.

Fifth, we regularly interact with the industry associations namely the Indian Bankers' Association, the Foreign exchange Dealers Association of India, the Primary Dealers Association of India and the Fixed Income and Money Market Dealers Association of India. Incidentally, the last two were promoted by the Reserve Bank of India. We have three-stage participation in the process issue of important regulations. This normally involves preliminary discussions with the representative bodies and select market participants; preparation of a Technical Report by working groups that often include the regulators and the market participants and academia; and placing the Report in public domain for a feedback. On the basis of the Report and the initial feedback, draft guidelines are usually formulated and again placed in public domain for a feedback. These guidelines are finalized on the basis of the further feedback.

Sixth, our regulations and our policies are focused on the common person. This is, for example, reflected in our approach to transparency by the industry, the ombudsman mechanism, the setting up of a Banking Codes and Standards Board of India, guidelines on recovery agents etc. This focus on the common person enhances the legitimacy of the RBI in the public eye vis-à-vis market intermediaries. Though RBI issues micro regulations at times, this is necessary to strike a better balance between financial institutions and public interest at a micro level with reference to the common person.

Seventh, moral suasion and public articulation of concerns has helped in achieving a desired re-balancing of suspected excesses in risk-taking among banks. Some of the areas where moral suasion has been used are the need for banks to monitor unhedged foreign currency exposures of their corporate clients, adoption of appropriate incentive mechanisms by banks for encouraging disclosures of derivative exposures by their corporate clients, banks' reliance on non-deposit resources to finance assets, their excessive reliance on wholesale deposits and uncomfortable loan-to-value (LTV) ratios in respect of housing loans etc.

Eighth, the RBI has also focused on liquidity mechanisms and systems. Asset liability management is left to the banks, but regulatory limits on short term buckets are prescribed. Further, in order to reduce the extent of concentration of bank's liabilities the Reserve Bank had issued guidelines to banks in March 2007 placing prudential limits on the extent of their

Inter-Bank Liability (IBL) as a proportion of their networth (200%). Those banks which had a higher capital adequacy ratio of 125% of the regulatory minimum were allowed a higher limit of 300% of networth. In addition, prudential limits have also been placed on the extent to which banks may access the inter-bank call money market both as a lender and as a borrower.

Ninth, whenever out-of-the-ordinary situations arise, exceptional or flexible arrangements are needed. Timely flexibility, while reacting to the underlying balance is essential. This helps in avoiding more serious problems relating to the balance over the medium-to-longer term. For example, recently oil imports had to be financed through off-market processes. Delayed adjustments to such sudden and unexpected cross-border exogenous developments at such times may impose a stress on liquidity. Hence, addressing frictional issues of liquidity as distinct from underlying issues of levels of liquidity is required to look at the balance dynamics.

Thank you.