Duvvuri Subbarao: The global financial turmoil and challenges for the Indian economy

Speech by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the Bankers' Club, Kolkata, 10 December 2008.

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It is my pleasure to be here this evening and to be able to share my thoughts with an exclusive gathering of bankers. Since this is an in-house meeting and we are professional colleagues, I propose to be frank and forthright. I am glad to know that the Bankers' Club in Kolkata has been recently revived and is engaged in promoting professional interaction within the banking community.

The global financial crisis is now the staple of front page news. Banks around the world, including those in India, are in the forefront of managing the challenge of crisis resolution. Since it is so topical, I would like to take this opportunity to share my perspective on the current global turmoil, its impact on India, the outlook for the Indian economy and the challenges that lie ahead for the Indian banking system, in particular.

Global financial outlook

The global financial situation continues to be uncertain and unsettled. What started off as a sub-prime crisis in the US housing mortgage sector has turned successively into a global banking crisis, global financial crisis and now a global economic crisis. Text book economics often cites housing as a prime example of a non-tradable good. It is paradoxical that a quintessentially non-tradable good as housing has triggered a crisis of global dimensions. This crisis is also the first of a kind in the sense that it is the first financial crisis since the Great Depression that originated in the advanced economies and rapidly engulfed the whole world. Such is the depth and sweep of financial globalisation. By far, the most frequently asked question (FAQ) today is whether the worst – in terms of the financial sector meltdown, and in particular, failure of financial institutions – is behind us. No one is really willing to take a definitive call on this, which is a sign of the increasing number of unknown unknowns.

Even as recently as six months ago, there was a view that the fallout of the crisis will remain confined to the financial sector and that, at the most, there would only be a shallow recession in the advanced economies. These expectations, as it now turns out, have been belied. The contagion has traversed from the financial to the real sector; and it now looks like the recession will be deeper and the recovery longer than earlier anticipated.

Global economic outlook

Many economists are now predicting that this “Great Recession” of 2008/09 will be the worst global recession since the 1930s. The IMF made its customary forecast for global growth in the World Economic Outlook published in October 2008. By early November, the IMF had revised its forecast for global growth downwards – from 3.9 per cent to 3.7 per cent for 2008, and from 3.0 per cent to 2.2 per cent for 2009. There are two inferences that follow from this. First, that the global situation has deteriorated rapidly, in a space of less than two months. Second, that 2009 is going to be a more challenging year than 2008.

Emerging economies

Ironically, even as late as six months ago, it was intellectually fashionable to subscribe to the “decoupling theory” – that even if advanced countries went into a downturn, emerging economies will, at worst, be affected only marginally, and will largely steam ahead on their own. In a rapidly globalising world, the decoupling theory was never very persuasive; given the evidence of the last few months – capital flow reversals, sharp widening of spreads between sovereign and corporate debt, and abrupt currency depreciations – the decoupling theory has almost completely lost credibility. Growth prospects of emerging economies have most definitively been undermined by the ongoing crisis with, of course, considerable variations across countries.

Impact of the crisis on India

India too is having to weather the negative impact of the crisis. As the impact on India unfolds, there are two frequently asked questions: First, how is that India is affected when it came out of the Asian crisis relatively unscathed? Second, why is India affected even when its exports account for only 15 per cent of its GDP? The answer to both the questions lies in globalisation. We are certainly more integrated into the world economy today than ten years ago at the time of the Asian crisis. Integration into the world implies more than just exports. Going by the common measure of globalisation, India's two-way trade (merchandise exports plus imports), as a proportion of GDP, grew from 21.2 per cent in 1997-98, the year of the Asian crisis, to 34.7 per cent in 2007-08. If we take an expanded measure of globalisation, that is, the ratio of total external transactions (gross current account flows plus gross capital flows) to GDP, this ratio has increased from 46.8 per cent in 1997-98 to 117.4 per cent in 2007-08. These numbers are clear evidence of India's increasing integration into the world economy over the last 10 years.

We must also note another important difference between the crisis in the advanced countries and the developments in India. While in the advanced countries the contagion spread from the financial to the real sector, in India, the slowdown in the real sector is affecting the financial sector, which in turn, has a second-order impact on the real sector.

The Indian banking system

The Indian banking system is not directly exposed to the sub-prime mortgage assets. It has very limited indirect exposure to the US mortgage market, or to the failed institutions or stressed assets. Indian banks, both in the public sector and in the private sector, are financially sound, well capitalised and well regulated. The average capital to risk-weighted assets ratio (CRAR) for the Indian banking system, as at end-March 2008, was 12.6 per cent, as against the regulatory minimum of nine per cent and the Basel norm of eight per cent. Even so, India is experiencing the knock-on effects of the global crisis, through the monetary, financial and real channels – all of which are coming on top of the already expected cyclical moderation in growth. Our financial markets – equity market, money market, forex market and credit market – have all come under pressure mainly because of what we have begun to call “the substitution effect” of: (i) drying up of overseas financing for Indian banks and Indian corporates; (ii) constraints in raising funds in a bearish domestic capital market; and (iii) decline in the internal accruals of the corporates. All these factors added to the pressure on the domestic credit market.

Simultaneously, the reversal of capital flows, caused by the global de-leveraging process, has put pressure on our forex market. The sharp fluctuation in the overnight money market rates in October 2008 and the depreciation of the rupee reflected the combined impact of the global credit crunch and the de-leveraging process underway.

Outlook for India

The outlook for India, going forward, is mixed. There is evidence of a slow down in the economic activity. The real GDP growth has moderated in the first half of 2008-09. Industrial activity, particularly in the manufacturing and infrastructure sectors, is decelerating. The services sector too, which has been our prime growth engine for the last five years, is slowing, mainly in the construction, transport and communication, trade, hotels and restaurants sub-sectors. For the first time in seven years, exports have declined in absolute terms in October 2008. Recent data indicate that the demand for bank credit is slackening despite comfortable liquidity in the system. Higher input costs and dampened demand have dented corporate margins while the uncertainty surrounding the crisis has affected business confidence.

Inflation

On the positive side, headline inflation, as measured by the wholesale price index, has fallen sharply, and the decline has been sustained for the past four weeks, pointing to a faster-than-expected reduction in inflation. Largely, the falling commodity prices have been the key drivers behind the disinflation; however, some contribution has also come from slowing domestic demand. The reduction in prices of petrol and diesel announced last week, and a cut in the excise duties should further ease the inflationary pressures. To be sure, consumer price inflation for the months of September and October 2008 did increase. This is possibly owing to the firm trend in food-articles inflation and the higher weight of food articles in the measures of consumer price inflation. Historically, there has been a positive correlation between wholesale and consumer price inflation, and given this correlation, consumer price inflation too can be expected to soften in the months ahead.

RBI's policy stance

The Reserve Bank's monetary policy stance has consistently been to balance growth, inflation and financial stability concerns. When inflation surged earlier this year, the RBI had moved quickly to tighten policy. Then again, reflecting the unfolding global situation and expectation of decline in inflation, RBI has adjusted its monetary stance over the last couple of months. The endeavour of our monetary stance has been to manage liquidity – both domestic and forex liquidity – and to ensure that credit continues to flow for productive activities.

Measures taken so far

The RBI has taken several measures aimed at infusing rupee as well as foreign exchange liquidity and to maintain credit flow to productive sectors of the economy. Measures aimed at expanding the rupee liquidity included significant reduction in the cash reserve ratio (CRR), reduction of the statutory liquidity ratio (SLR), opening a special repo window under the liquidity adjustment facility (LAF) for banks for on-lending to the non-banking financial companies (NBFCs), housing finance companies (HFCs) and mutual funds (MFs), and extending a special refinance facility, which banks can access without any collateral. The Reserve Bank is also unwinding the Market Stabilisation Scheme (MSS) securities, roughly synchronised with the government borrowing programme, in order to manage liquidity.

Measures aimed at managing forex liquidity include upward adjustment of the interest rate ceilings on the foreign currency non-resident (banks) [FCNR(B)] and non-resident (external) rupee account [NR(E)RA] deposits, substantially relaxing the external commercial borrowings (ECB) regime, allowing the NBFCs and HFCs access to foreign borrowing and allowing corporates to buy back foreign currency convertible bonds (FCCBs) to take advantage of the discount in the prevailing depressed global markets. The Reserve Bank has also instituted a rupee-dollar swap facility for banks with overseas branches to give them comfort in managing their short-term funding requirements.

Measures to encourage flow of credit to sectors which are coming under pressure include extending the period of pre-shipment and post-shipment credit for exports, expanding the refinance facility for exports, counter-cyclical adjustment of provisioning norms for all types of standard assets (except in case of direct advances to agriculture and small and medium enterprises which continue to be at 0.25 per cent) and risk weights on banks' exposure to certain sectors which had been increased earlier counter-cyclically, and expanding the lendable resources available to the Small Industries Development Bank of India (SIDBI), the National Housing Bank (NHB) and the Export-Import Bank of India (EXIM Bank).

To improve the flow of credit to productive sectors at viable costs so as to sustain the growth momentum, the Reserve Bank signalled a lowering of the interest rate structure by reducing its key policy rate viz., the repo rate by 250 basis points from 9.0 per cent as on October 19 to 6.5 per cent by December 8, 2008.

Although, we remain vulnerable to global financial and economic developments, the measures taken so far have eased the liquidity and credit flow situations considerably. I must also add that in managing the impact of the global crisis, we have been mindful that no policy initiative is totally costless. Managing this delicate balance between costs and benefits has been one of our challenges.

The measures taken by the RBI have been appreciated and criticised. I would like to assure you that we give as much importance to our critics as our admirers. While some of the criticism has been fair and value adding, some of it stems from an inadequate appreciation of the RBI perspective. I thought it may be useful to give our perspective so as to inform public debate on important monetary policy issues.

Everyone is now agreed that the way forward on this crisis at the present time is too uncertain. Even today, it is not possible to clearly see the path of the crisis and its resolution over the coming months. It is just not possible to have a precise road map all laid out to be unleashed in one go. This crisis does not allow us that luxury. And, mind you, India is not unique in this respect. Almost every country, whether or not directly affected, is having to manage under uncertainty. There are simply too many unknown unknowns.

In the circumstances, the stance of the RBI has been to respond to the evolving situation swiftly and effectively, and to the extent possible, in anticipation of immediate developments. We do have a road map that is comprehensive and practical. It would be our endeavour to adapt this road map to the evolving global developments and implement it flexibly and pragmatically. Our approach, as indeed of every prudent central banker around the world, has been to "cross the river by feeling the stones". The RBI will continue to be on vigil and do everything possible within its mandate to mitigate the impact of the crisis on the Indian economy.

The challenges ahead

Let me now turn to the major challenges facing the banking system in the country, particularly in the wake of the global financial crisis.

The first challenge: maintaining the credit flow

The outlook, both for the world and for India, continues to remain uncertain. The future trajectory of the global crisis is not yet clear. As I mentioned earlier, the year 2009-10 will be more challenging than the current one. There was a noticeable decline in the credit demand in the month of November 2008 but it is not yet clear if it was a one off episode or it reflects a trend. If it is indicative of slowing economic activity, it would be a major challenge for the banks to ensure healthy flow of credit to the productive sectors of the economy. As you know, economic growth, even in normal times, requires efficient financial intermediation. An economic downturn, therefore, requires even more efficient financial intermediation – and this is a major challenge that the banking community has to address. There is a need to ensure a steady credit flow to the real sector of the economy in order to sustain demand even while maintaining credit quality.

There are two aspects to lending viz., availability and cost of credit. While the availability of credit should not be an issue, the cost of credit seems to be an issue at the current juncture. There seem to be two reasons inhibiting the banks from extending credit: first, a high weighted-average cost of funds because of high interest rates on deposits; and second, concerns about credit quality, which makes the banks risk averse, particularly in lending to certain segments. During the last one month, there has been a sharp reversal in trend and, as noted earlier, credit demand seems to be slackening. The reduced funding demand on the banks should enable them to reduce the interest rates on deposit and thereby reduce the overall cost of funds. In addition, from a macro perspective the decelation of headline inflation noticed so far and the expectations of softening of inflation in the months ahead should enable a reduction in nominal interest rates. These developments in turn, would facilitate lending at lower interest rates, making fresh lending more viable and, at least partly obviating the risk aversion of the banks.

Let me assure you that the RBI, on its part, will continue to maintain adequate liquidity in the system to enable the flow of credit to the economy.

The second challenge: how do we reform financial sector regulation?

By far, the most contentious and most voluble debate triggered by the crisis has been about the flaws in the regulatory architecture of the financial sector. Several issues have come to the fore. I will mention just a few. How can complex derivative products, which transmitted risks across the system, be made more transparent? What are the financial stability implications of structured products like credit derivatives? Are exchange traded derivatives better than over-the-counter (OTC) derivatives? How do we eliminate the drawbacks of the "originate-to-distribute" model? Is universal banking, the model that the United States has now turned to, appropriate? Can we apply the same regulatory regime for both wholesale and retail banks?

The burden of all the above questions is to identify the drawbacks in the present regulatory regimes and indicate possible solutions. There is no doubt that we must pursue all these questions. In doing so, I would urge that we remember two things. The first thing to remember is that no one size fits all. For example, universal banking may be good in some of the countries and in some of the situations, and not so in others. The second thing to remember is that some regulations, arguably, have been behind the curve. There is no denying that regulations have to keep pace with innovations in the financial markets but in doing so, we must be mindful of the risks of over-tightening the regulations lest they stifle innovation.

The third challenge: regulatory forbearance and relaxing regulatory norms

There has been a sustained demand from various quarters for exercising regulatory forbearance in regard to extant prudential regulations applicable to the banking sector. As a part of counter-cyclical package, we have already made several changes to the current prudential norms. These include: (a) reduction in the risk weights for claims on unrated corporates and commercial real estate to 100 per cent; (b) reduction in the provisioning requirement for all standard assets to 0.40 per cent; (c) permitting housing loans to be restructured even if the revised payment period exceeds ten years; (d) making the restructured commercial real estate exposures eligible for special treatment if restructured before June 30, 2009.

There are demands for further regulatory forbearance. For example, there has been a demand to relax the asset classification norms by increasing the period of delinquency beyond the current norm of 90 days after which the loan asset is required to be classified as non-performing. The objective underlying the demand is to permit the banks to avoid recognising non-performing loans (NPLs) for a longer period. Is it desirable to change the NPL norm by relaxing the 90 day rule? The demand is presumably premised on the argument that the relaxation in the norm will make the banks' financials look better, allow them to reserve less, conserve capital, and may even allow them to offer more credit (or at least not cut back on credit). However, there are several forceful arguments against the relaxation sought. Let me mention a few.

(i) Delay in recognition of NPL removes pressure on the banks to deal promptly with the problem. History suggests that delayed recognition of impairment in the value of the assets makes the problems only worse. The sooner banks restructure the loan (through, say, CDR mechanism) or, where appropriate, send the loan for collection, the better.

(ii) This global downturn is likely to be a prolonged one. If banks do not recognise their problem loans here and now, and deal with them expeditiously, the problem will only get compounded with the passage of time and will keep haunting them in future.

(iii) The prudential regulatory norms ought not to be changed lightly, especially when markets are on edge. If the impression gains ground that the modified norms under-state the extent of impairment and over-state the asset quality in the banking sector, the markets could suspect the worst and needlessly penalise the banks through market discipline.

These are the issues we need to reflect on in moving towards further regulatory forbearance.

The fourth challenge: effective implementation of Basel II framework

As you are aware, a part of the Indian banking system has already migrated to the Basel II Framework effective March 31, 2008 and the remaining commercial banks are slated to do so by March 31, 2009. However, having regard to the state of preparedness of the system, we have, for the present, adopted only the simpler approaches available under the Framework. The RBI is yet to announced the timeframe for adoption of the Advanced Approaches in the Indian banking system but the migration to these Approaches is the eventual goal – for which the banking system will need to start its preparations in all earnestness.

The migration to the Advanced Approaches poses several significant challenges to the bankers and, as the banking regulator and supervisor, also to the RBI. The first challenge is the availability of long time-series data for computing the risk parameters required under the Advanced Approaches. Good-quality, consistent and reliable data and information relating to the loan portfolios of the banks as also sophisticated IT resources are critical to the proper risk assessment under the Basel II framework. Data limitation is a key impediment to the design and implementation of credit risk models. This may prove to be a major challenge for us in India, given the wide-spread branch network – though the increasing computerisation in the banking industry should prove to be of great help.

The second challenge is that the Advanced Approaches for credit risk and operational risk envisaged under the Basel II Framework also require use of risk models by the banks. This, in turn, requires internal validation of these models by the banks themselves as also by the supervisors before the models can be permitted to be used for regulatory capital purposes. Such a validation process demands expert skills which need to be developed and nurtured.

Third, since Basel II Framework is primarily about ensuring robust risk management in the banks, its effective implementation, particularly the Advanced Approaches, will demand rapid and significant upgradation of skills – both at the level of the banking system as also within the RBI. In this context, the challenge that banks are likely to face will be multi-faceted, viz., assessing skill requirements, identifying and bridging the gaps, identifying talents, putting the available talents to optimum use, attracting fresh talents, retention of talents, and change management. Banks would, therefore, need to pay special attention to strengthening their risk management infrastructure, in all its dimensions, including the human resources. We, in the RBI, are mindful of our part of the challenges in this regard and are taking necessary measures.

The implementation of Basel II requires closer cooperation, information sharing and co-ordination of policies among sectoral supervisors, specially in the context of financial conglomerates. The existence of separate supervisory authorities to regulate different segments of the markets within a jurisdiction may create challenges in implementation of Basel II not only within a jurisdiction but also across jurisdictions – which would require effective cross-border supervisory cooperation and co-ordination.

The fifth challenge: the challenge of banking development and financial inclusion in Eastern India

Banking development in the eastern region of the country, as measured by several parameters, is lagging behind the national average. Let me give some evidence to illustrate this.

- In March 2008, the all-India per branch population coverage was 15,400. For the eastern region, the figure varied from 25,000 in Bihar to 9,600 in Sikkim..
- In March 2007, at the all-India level, the per capita deposit was Rs. 28,600. The corresponding figure for the eastern region was Rs. 14,400. Similarly, as against the per capita credit of Rs 28,600 at the all-India level, the corresponding figure for the eastern region is only Rs. 7,200.
- In March 2007, at the all-India level, the population of people having bank accounts was 41 per cent. The corresponding population for the eastern region was only 30.7 per cent, ranging from 21.1 per cent for Bihar to 39.6 per cent for West Bengal.
- In March 2007, at the all-India level, the credit-deposit ratio was 74.5 per cent. For the eastern region, the ratio was just 50 per cent.

In terms of infrastructure coverage and other development indicators, the eastern region is not as developed as other regions of the country. Admittedly, this affects the credit absorption capacity and may also explain some of the lagging parameters mentioned above. However, this can not be an excuse for inaction. It should be impetus for vigorous action.

Finance can lead development just as much as it can be led by it. This is specially true for the poor. Nearly a third of the people of Bihar and West Bengal are below the poverty line. Through greater financial inclusion it should be possible to provide savings, loan and insurance products at affordable prices and this can generate income and employment in a very significant measure.

We must recognise that the opportunity cost of formal finance for the borrower is so high that mere financial inclusion can unlock value that today is accruing to rentiers and informal finance providers. This apart, transaction costs can be reduced through the kind of scale of operations that only banks are capable of achieving and this itself become a source of value creation.

Financial inclusion can not be reduced to a mere number game. The actual impact of financial inclusion and expanded banking coverage must be felt at the grass-root level. I find that a number of measures have been initiated to deepen the banking penetration in the region. For example, in West Bengal, a Task Force for extending banking facilities in unbanked Gram Panchayats (GP) was constituted by the State Level Bankers' Committee in December 2007. The task force has identified 511 GPs at which bank branches will be opened in next three years and at 427 GP-centres in the following three years. I understand that the State Government has agreed to provide premises adjacent to the GP offices and extend other facilities like road connection and power at such centres.

Where a full fledged branch can not be opened immediately, banks could look at covering the unbanked areas through satellite offices, weekly branches, or use the business correspondent model for ensuring greater coverage within a shorter period. Information Technology (IT) solutions should also be explored for providing a back bone of credit information, customer information apart from facilitating more efficient credit delivery and reducing cost of payments and remittances.

I understand there has been an interesting and innovative experiment undertaken in West Bengal for promoting financial inclusion. A Financial Inclusion/Literacy Campaign was launched in an urban slum area viz., the Basanti Colony, Ultadanga, Kolkata in mid-October 2008 in association with six commercial banks. These banks are the State Bank of India, United Bank of India, UCO Bank, Allahabad Bank, Bank of India and Bank of Baroda – which had branches in the vicinity of the slum area. All six banks were allotted separate counters for opening of accounts as well as to campaign for their bank-specific products. Free photo facility for account holders was provided and the cost was shared by all the participating banks. The initiatives such as this should be pursued and the full range of financial services provided to these areas. I understand that the Local Council extended support for obtaining identity documents required for opening of bank accounts. This experiment demonstrates what banks can do if only they are responsive, sensitive, proactive and result oriented.

Coming to sectoral flow of credit, while the share of agriculture in the State's SDP is higher than at the all-India level, the share of agricultural credit in total credit is roughly the same for the State. This points to the need to look at bankable schemes in the agriculture sector. Also, NABARD has a very significant role to play in this region. As the micro and small enterprises account for 7.2 per cent of total credit in the region, SIDBI too, as a development finance institution, has to play a prominent role in accelerating and catalysing the flow of bank credit to the MSE sector in the region.

Although not often acknowledged, effective financial intermediation has been one of the important factors behind India's recent growth episode. Efficient financial intermediation is a formidable challenge where poverty and disadvantage are high. You, as senior bank managers in the eastern region of the country, have a bigger challenge and greater opportunity. A bigger challenge because you have to be even more efficient than elsewhere, and a greater opportunity because by being responsive and sensitive, you can make "a bigger difference".

Conclusion

Going forward, developments in the real economy, financial markets and global commodity prices point to a period of moderation in growth with declining inflation. What is heartening though is that the fundamentals of our economy continue to be strong. Once calm and confidence are restored in the global markets, economic activity in India will recover sharply. But a period of painful adjustment is inevitable. It is our collective challenge – for you, the bankers, and for us at the RBI – to respond to this extraordinary situation effectively and return India to its path of growth and poverty reduction.

Thank you.