

## Duvvuri Subbarao: India and the global financial crisis transcending from recovery to growth

Comments by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the Peterson Institute for International Economics, Washington DC, 26 April 2010.

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1. India clocked average growth of 9 per cent per annum in the five years to 2007/08. That growth momentum was interrupted by the financial crisis which impacted India too, more than we had originally thought but less than it did most other countries. Despite falling below 6 per cent for one quarter, the growth for the full year 2008/09 was a resilient 6.7 per cent. Current estimates are that the economy had grown between 7.2 and 7.5 per cent for the just ended fiscal year 2009/10 and that growth for 2010/11 will be 8+ per cent. The quick turn in sentiment following the uncertainty and anxiety of the crisis period has seen the return of the FAQ: When will India get on to double digit growth?

2. For policy makers, the FAQ translates to three nuanced questions:

- (i) In the short term, how do we restore the economy to its trend rate of growth while maintaining price stability?
- (ii) In the medium term, how do we raise the trend rate of growth itself without compromising financial stability?
- (iii) How do we ensure that growth is inclusive?

3. India is such an over analyzed country that it is difficult to be original. The answers to all the three questions above are all out there in the open, and they involve moving on with a host of structural and governance reforms. I want to use this platform provided by the Peterson Institute to comment on a few issues on the reform agenda that are relevant to the Reserve Bank of India.

### Capital flows

4. Volatile capital flows have been a central issue during the crisis, and continue to be so now as the crisis is ebbing. Emerging market economies (EMEs) saw a sudden stop and reversal of capital flows during the crisis as a consequence of global deleveraging. Now the trend has reversed once again, and many EMEs are seeing net inflows – a consequence of a global system awash with liquidity, the assurance of low interest rates in advanced economies over “an extended period” and the prospects of robust growth in EMEs. The familiar question of how EMEs can maximize the benefits and minimize the costs of volatile capital flows has returned to haunt the policy agenda.

5. One little known aspect of capital flows, what could perhaps be called the law of capital flows, is that they never come in at the precise time or in the exact quantity you want them. Managing these flows, especially if they are volatile, is going to test the effectiveness of central bank policies of semi-open EMEs. If central banks do not intervene in the foreign exchange market, they incur the cost of currency appreciation unrelated to fundamentals. If they intervene in the forex market to prevent appreciation, they will have additional systemic liquidity and potential inflationary pressures to contend with. If they sterilize the resultant liquidity, they will run the risk of pushing up interest rates which will hurt the growth prospects. Capital flows can also potentially impair financial stability. How EMEs manage the impossible trinity – the impossibility of having an open capital account, a fixed exchange rate and independent monetary policy – is going to have an impact on their prospects for growth, price stability and financial stability.

6. India has followed a consistent policy on capital account convertibility in general and on capital account management in particular. Our position is that capital account convertibility is not a standalone objective but a means for higher and stable growth. We believe our economy should traverse towards capital convertibility along a gradual path – the path itself being recalibrated on a dynamic basis in response to domestic and global developments. Post-crisis, that continues to be our policy. We will continue to move towards liberalizing our capital account, but we will revisit the road map to reflect the lessons of the crisis.

7. India's approach to managing capital flows too has been pragmatic, transparent and contestable. We prefer long term flows to short-term flows and non-debt flows to debt flows. The logic for that is self-evident. Our policy on equity flows has been quite liberal, and in sharp contrast to other EMEs which liberalized and then reversed the liberalization when flows became volatile, our policy has been quite stable. Historically, we have used policy levers on the debt side of the flows to manage volatility. This has been our anchor when we had to deal with flows largely in excess of the economy's absorption capacity in the years before the crisis. This has been our policy when we saw large outflows during the crisis. And I believe this will continue to be our policy on the way forward.

8. The surge in capital flows into some EMEs even as the crisis is not yet fully behind us has seen the return of the familiar question – the advisability of imposing a Tobin type tax on capital flows. Both before and after the crisis, there are examples of countries, notably Chile, Colombia, Brazil and Malaysia, which have experimented with a Tobin tax or its variant. Even as there are some lessons to be drawn from the country experience, on the aggregate, it does not constitute a sufficient body of knowledge for drawing definitive conclusions.

9. Critics of Tobin tax contend that the tax is ineffective, is difficult to implement, easy to evade and that its costs far exceed the potential benefits, and all this because financial markets always outsmart policy makers. Supporters of the tax argue that if designed and implemented well, the tax can be effective in smoothing flows and that evading controls is not such a straight forward option as efforts to evade require incurring additional costs to move funds in and out of a country which is precisely what the tax aims to achieve.

10. In India, given the overall thrust of policy, we are quite agnostic on the choice of different instruments. The stereotype view is that we have an express preference for quantity based controls over price based controls. A critical examination of our policy will show that this view is mistaken. For example, on bonds we impose both a limit on the amount foreigners can invest as well as a withholding tax. Similarly, our policy on external commercial borrowing employs both price and quantity variables. We have not so far imposed a Tobin type tax nor are we contemplating one. However, it needs reiterating that no policy instrument is clearly off the table and our choice of instruments will be determined by the context.

11. The recent crisis has clearly been a turning point in the world view on capital controls. The Asian crisis of the mid-90s demonstrated the risk of instability inherent in a fully open capital account. Even so, the intellectual orthodoxy continued to denounce controls on capital flows as being inefficient and ineffective. The recent crisis saw, across emerging economies, a rough correlation between the extent of openness of the capital account and the extent of adverse impact of the crisis. Surely, this should not be read as a denouncement of open capital account, but a powerful demonstration of the tenet that premature opening hurts more than it helps.

12. Notably, the IMF published a policy note in February 2010<sup>1</sup> that reversed its long held orthodoxy. The note has referred to certain “*circumstances in which capital controls can be a legitimate component of the policy response to surges in capital flows*”. Now that there is agreement that controls can be “*desirable and effective*” in managing capital flows in select circumstances, the IMF and other international bodies must pursue research on studying what type of controls are appropriate and under what circumstances so that emerging economies have useful guidelines to inform policy formulation.

### Exchange rate management

13. Just as on capital flows, on exchange rate too, our policy has been consistent which is that we do not target a specific rate or level for the exchange rate. The Reserve Bank intervenes in the market only to smooth volatility which is harmful to trade and investment. The “volatility centric approach” to exchange rate also stems from the source of volatility which is capital flows. Despite not having a fully open capital account, we have experienced large volatility in capital flows as the following figures for the external sector for the four years to 2009-10 demonstrate.

<b>Trends in India’s External Sector</b>				
	2006/07	2007/08	2008/09	2009/10
CAD (% of GDP)	1.0	1.3	2.4	2.5
Net Capital flows (% of GDP)	4.8	8.7	0.6	3.8
Capital flows in excess of CAD (\$ billion)	36	92	(-) 20	14
Rupee appreciation (+) depreciation (-) vis-à-vis US\$ during the year	2.3	9.0	(-) 21.5	12.9

Note: Numbers for 2009/10 are rough estimates.

14. The above numbers show that capital flows were in excess of the current account deficit in the years before the crisis during India’s growth boom and that they had abruptly reversed in the crisis year 2008/09. The full balance of payments for the just completed fiscal year 2009/10 is not yet available but latest data show that the net accretion to reserves was modest.

<sup>1</sup> Ostry, Jonathan D. and Others (2010), “Capital Inflows: The Role of Controls”, IMF Staff Position Note, SPN/10/04, February 19, 2010.

15. The above numbers and trends are a demonstration of our policy stance. First, the two way movement shows that we have a flexible exchange rate, and also evidences the increasing flexibility of the rate over time in relation to the magnitude of flows.

16. Second, India does not have a deliberate strategy of building up reserves for “self-insurance”. The variations in our foreign exchange reserves are an offshoot of our exchange rate policy which is to intervene in the market only to smooth exchange rate volatility and prevent disruptions to macroeconomic stability. Third, even as our reserves got built up over the years owing to capital flows, the same reserves have been used to contain volatility in the event of capital reversals. Importantly, given our persistent trade and current account deficits, our foreign exchange reserves comprise borrowed funds which are qualitatively different from accumulation of reserves through trade and current account surpluses. Even so, it is clear that the reserves have helped us better cope with external sector vulnerabilities.

17. Our fairly flexible exchange rate policy has not been without costs. Importantly, because inflation in India has typically been higher than that in our trading partners in the recent period, the real effective exchange rate has appreciated significantly more than the nominal rate. This has implications for our external competitiveness, that too at a time when the world trade is recovering amid concerns relating to protectionism. Also if we have a flexible exchange rate, and if other countries which are our trading partners or those which compete for the same export markets have a fixed exchange rate, we get disadvantaged.

### **Inflation targeting**

18. The Reserve Bank is not a pure inflation targeter. Some people have suggested that the economy will be better served if the Reserve Bank becomes a pure inflation targeter. The argument is that inflation hurts much more in a country like India with hundreds of millions of poor people and that the Reserve Bank will be more effective at combating inflation if it is not burdened with other objectives. This argument is contestable.

19. Inflation targeting, characterized by a single target (price stability) and a single instrument (short term policy interest rate), has respectable academic credentials. An exclusive commitment to inflation enhances operational effectiveness and enforces accountability. The success of several developed economy central banks in maintaining price stability in the years before the crisis has also given it intellectual credibility. The unravelling of the “Great Moderation” during the crisis has however diluted, if not dissolved, the consensus around the minimalist formula of inflation targeting. The crisis has shown that price stability does not necessarily ensure financial stability. Indeed there is an even stronger assertion – that there is a trade-off between price stability and financial stability, and that the more successful a central bank is with price stability, the more likely it is to jeopardize financial stability.

20. Inflation targeting is neither desirable nor practical in India for a variety of reasons:

- First, it is inconceivable that in an emerging economy like India, the central bank can drive a single goal oblivious of the larger development context. The Reserve Bank must be guided simultaneously by the objectives of price stability, financial stability and growth.
- Second, food items which have a large weight (46–70 per cent) in the various consumer prices indices are subject to large supply shocks, especially because of the vagaries of the monsoon, and are therefore beyond the pale of monetary policy. An inflation targeting RBI cannot do much to tame a supply driven inflation except as a line of defence in an extreme situation.
- Third, which inflation index do we target? In India, we have one wholesale price index and four consumer price indices. There are ongoing efforts at a technical level

to reduce the number of consumer price indices, and I believe the technical issues are not insurmountable. But that still will not give us a single representative inflation rate for an emerging market economy with market imperfections, diverse geography and 1.2 billion people.

- Fourth, the monetary transmission mechanism in India is impeded because of a number of structural factors. Inflation targeting can be efficient and effective only after monetary transmission becomes streamlined.
- Finally, we need to manage the monetary fall-out of volatile capital flows that queer the pitch for a single focus monetary policy. A boom-bust pattern of capital flows can lead to large disorderly movements in exchange rates rendering both inflation targeting and financial stability vulnerable. Like other emerging economies, India too will have to navigate the impossible trinity as best as it can.

21. Post crisis, the “new environment hypothesis” which says that flexible inflation targeting, rather than pure inflation targeting, is more efficient is gaining ground. According to this hypothesis, if inflation is way off target, a central bank’s first call is to bring it within the acceptable range, and if inflation is within the range, the central bank can focus on other objectives.

22. The Reserve Bank’s “multiple indicator framework” adopted in 1998 and refined since then, in fact, subsumes a flexible inflation objective framework over the medium-term. Under this framework, while we strive for a balance among multiple objectives with the relative weights assigned to each objective varying as dictated by the prevailing macroeconomic context, we aim to achieve a medium-term inflation target. Our commitment in this regard is clearly defined in our own policy documents where we say our objective is to “contain perception of inflation in the range of 4.0 to 4.5 per cent in line with the medium-term objective of 3.0 per cent inflation consistent with India’s broader integration with the global economy”. Admittedly, our communication strategy is not yet best practice. We need to work, and indeed we are working, on improving dissemination, both at technical and non-technical levels. In the dissemination, we need to explain the inflation outlook, the priority assigned to different objectives, what impact our policy actions are intended to have and how they will take us towards the stated objectives.

### **Harmonizing monetary and fiscal policies**

23. One of the mega trends in macroeconomic management world over in the last few decades has been the gradual abatement of the fiscal dominance of monetary policy. This has been the trend in India too. The ebbing away of fiscal dominance has been a continuous process but two discrete events marked significant milestones. The first was the agreement between the Reserve Bank and the Government to completely phase out ad-hoc treasury bills from April 1997, a move that saw the termination of the egregious practice of automatic monetization by the central bank of the government’s fiscal deficit. The second was the enactment of the Fiscal Responsibility and Budget Management (FRBM) Act which, among other things, prohibited the Reserve Bank from financing government debt in the primary market with effect from April 2006. These trends got a further boost as a result of the fiscal consolidation during 2004-08 which yielded space for monetary policy. The healthy transition of monetary policy from fiscal dominance to functional autonomy was halted, if not reversed, by the response to the crisis, which necessitated fiscal expansion and monetary accommodation of that higher fiscal deficit.

24. In India, both the Government and the Reserve Bank have begun the process of exit from the expansionary stances of the crisis period. The Government has programmed a reduction in the gross fiscal deficit from 6.8 per cent of GDP in fiscal year 2009/10 to 5.5 per cent of GDP in 2010/11. The Reserve Bank began the reversal of its crisis response accommodative stance by terminating sector-specific liquidity facilities, incrementally raising

the cash and liquidity reserve ratios and the policy interest rates. Going forward, the challenge for India, as it indeed is for every country, is to unwind the expansionary policies harmoniously since inconsistencies between fiscal and monetary policies can be costly in economic terms.

25. As indicated earlier, the two crisis years – 2008/09 and 2009/10 – saw government borrowing rising sharply and abruptly. Even so, the Reserve Bank, as the Government's debt manager, could manage the borrowing programme by maintaining easy liquidity conditions. Surely, yields on government securities had firmed up, but only modestly. Even as fiscal deficit this year (2010/11), as a percentage of GDP, is lower, the absolute amount of government borrowing in gross terms is roughly of the same order as in last year. Indeed, measured by the metric of fresh supply of government paper, the borrowing this year will be higher than in last year, and this perhaps will be a more influential determinant of the yield trajectory. Meanwhile, the economic conditions have changed since last year in important ways. First, inflationary pressures are stronger, thereby restraining the flexibility for infusing liquidity through open market operations (OMO). Second, last year banks held significant quantities of Market Stabilization Scheme (MSS) bonds issued earlier for sterilizing the liquidity arising from capital flows. The Reserve Bank bought back those bonds to infuse systemic liquidity. That option is not available this year as the quantum of MSS bonds remaining is very marginal. Finally and importantly, as recovery is taking hold, private credit demand is reviving. But the upward pressure on yields on government securities and the consequent pressure on interest rates makes "crowding out" a potential possibility.

26. Even setting aside crisis related developments, "fiscal dominance" of monetary policy continues to be a concern. The long term interest rates are influenced significantly by the yields on government securities and hence on the size of the government borrowing programme, thereby eroding to some extent the efficacy of monetary transmission. The credibility of the Reserve Bank's inflation management, therefore, is critically dependent on the credibility of Government's fiscal consolidation.

27. Fiscal consolidation is important for a number of other weighty reasons apart from the inflation dimension. The Government has initiated action on the recommendations of the Thirteenth Finance Commission (TFC) on the revised road map for fiscal responsibility. In drilling down the road map, the Government should also keep in view two relevant objectives. First, fiscal consolidation should shift from exclusive reliance on increasing revenues to focus on restructuring expenditures. The consolidation effort should target slashing recurring expenditures rather than one-off items. Second, it is important, even as targeting quantitative indicators, to pay equal attention to the quality of fiscal adjustment.

### **Improving monetary policy transmission**

28. The standard tool of central banks is the short term interest rate which they use to influence interest rates across financial markets, and thereby steer the financial conditions in the economy. During the crisis, central banks around the world reduced policy rates ferociously, and in many advanced economies the rates are at or near zero. However, financial markets refused to respond and remained in seizure reflecting the near total collapse of monetary transmission.

29. The effectiveness of monetary transmission, the process by which the central bank's policy signals influence the financial markets, is a function of both tangible and intangible factors. It depends on the depth and efficiency of the financial markets. It also depends on the overall confidence and sentiment in the financial system. Typically, monetary transmission in emerging economies tends to be slower, reflecting shallow financial markets and inefficient information systems.

30. The monetary transmission mechanism in India has been improving but is yet to fully mature. There are several factors inhibiting the transmission process. First, India has a

government sponsored small savings programme characterized by administered interest rates and tax concessions. Operating through a huge network of post offices and field agents, the small savings scheme has an enormous and impressive reach deep into the hinterland. Banks are typically circumspect about reducing deposit rates in response to the central bank's policy rate signals for fear of losing their deposit base to small savings. The government too has not adjusted the rates on small savings on a regular basis to offset their competitive edge.

31. Second, depositors enjoy an asymmetric contractual relationship with banks. When interest rates are rising, depositors have the option of withdrawing their deposits prematurely and redepositing at the going higher rate. On the contrary, when deposit rates are falling, banks do not have the option of repricing deposits at the lower rate because of the asymmetry of the contract. This structural rigidity clogs monetary transmission. Banks are typically unable to adjust their lending rates swiftly in response to policy signals until they are able to adjust on the cost side by repricing the deposits in the next cycle. Third, and importantly, monetary transmission is also impeded because of large government borrowings and illiquid bond markets.

32. There is a stereotype view that monetary transmission broke down during the crisis in India too like in advanced economies. This is incorrect. Monetary policy signals transmitted to the money and bond markets reasonably efficiently. Monetary transmission in the credit market was admittedly slower but this had more to do with the structural rigidities explained above rather than any crisis related impediments in the financial markets.

33. In evaluating monetary transmission during the crisis, it should be remembered that the contagion of the crisis transmitted to India though largely the confidence channel; the financial markets were affected more by a perception of scarcity than actual scarcity. As such, market conditions improved markedly in fairly quick order since the Reserve Bank's assurance that it will maintain "abundant" liquidity inspired widespread confidence in the markets. It is important to recognize that in India, the crisis transmitted from the real to the financial sector unlike in the advanced economies where the transmission was from the financial sector to the real sector. The implication of this is that the decline in credit flow, as banks have asserted, was due more to a decline in credit demand from the private sector rather than any increased risk aversion on the part of the banks.

34. It should be recognised that the clogs in monetary transmission in India are possibly exaggerated because of the current system of loan pricing. Banks are required to declare a benchmark prime lending rate (BPLR) but they enjoy the freedom to lend at rates below their BPLR. Over time, sub-BPLR lending has become a rule rather than an exception. Currently about two thirds of bank lending takes place at rates below the BPLR. As many interest rates are indexed to the BPLR, banks have been reluctant to adjust their BPLRs in response to policy rate changes as changes erode their discretionary flexibility in pricing loans. The BPLR system has therefore become an inadequate tool to evaluate monetary transmission.

35. Improving monetary transmission is important if the Reserve Bank's efforts at promoting growth with price stability are to be effective. The problems indicated above suggest obvious solutions. An important reform initiative post crisis has been the replacement of the BPLR system by a new base rate [BR] system which will come into effect on July 1, 2010. Each bank will determine its own BR reflecting all those cost elements which are common across borrowers. A bank will then charge its borrowers the base rate plus a premium on top of that reflecting customer specific risk. The BR will thereby set the floor for all lending rates. Concurrently, the ceiling interest rate on export credit and small loans up to Rs. 200,000 has been withdrawn making deregulation of lending rates complete. The new system is expected to be transparent, fair and contestable and will help in improving monetary transmission to credit markets.

## **Conclusion**

36. In the course of my comments, I have spoken about five specific issues:

- (i) Capital flows
- (ii) Exchange rate management
- (iii) Inflation targeting
- (iv) Harmonizing monetary and fiscal policies
- (v) Improving monetary policy transmission

37. My effort has been to indicate our priorities and clarify our policy stance on some issues thrown up by the crisis. This is by no means an exhaustive list of our challenges or tasks. That I am sure will be a much longer listing.

38. The final thought that I want to leave with you as I finish is that the growth drivers that powered India's high growth in the years before the crisis are all intact. The challenge for the Government and the Reserve Bank is to move on with reforms to steer the economy to a higher growth path that is sustainable and equitable.