# H R Khan: Silver linings in the Indian economy

Address by Shri H R Khan, Deputy Governor of the Reserve Bank of India, at the 5th Annual Banking Conference on "The silver lining of the Indian economy", organized by NMIMS School of Banking Management, Mumbai, 6 October 2012.

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Dr. Debashis Sanyal, Dean, Dr. Vrinda Kamat, Chairperson – MBA Banking, Faculty and students of the School of Business Management, NMIMS University, Shri. M G Sanghvi, Chairman & Managing Director, Syndicate Bank, Shri S K Jain, Executive Director, Bank of Baroda, distinguished invitees, ladies & gentlemen. It is a great pleasure to be amongst budding management professionals and corporate leaders of tomorrow. In the period of gloom and doom for the world in general and India in particular, it is important not to miss the bloom. I am therefore very happy to be invited to speak on silver linings in the Indian economy. In bad times the financial markets, the media, the investors and the consumers all get accustomed to focus on negative news and the positive news gets ignored. Similarly, in good times, markets and economic agents sometimes run ahead of the realities and completely discount the negative news and love to accept only the good news. In more uncertain times, as were recently, sentiments, beliefs and perceptions shift quite fast and do matter for eventual economic outcomes are characterized by multiple equilibria. These acquire the characteristics of self-fulfilling prophecy. Yet, in such a period, the economy stays in the saddle point if we ignore the bloom, simply because animal spirits are weak. So today, my objective would be to draw your attention to the silver linings that we can see for the Indian economy in the horizon. I would touch upon the positive streaks on the aspects of growth, inflation, fiscal and external sector at this juncture, and how these could become the turning point for the Indian economy provided we carry forward the momentum and convert intentions into actions.

### Recent policy actions start the course correction but momentum needs to be kept

Recent policy measures taken by the government are very significant. They have started the course correction from a point where the Indian growth story was close to getting seriously damaged. However, for these measures to succeed it is important to keep up the momentum. More steps and effective implementation over next 2–3 years are necessary to fully recoup the lost ground. The economy has been facing serious headwinds as growth had slowed down to 5.5 per cent or less for the last two quarters over and above the subdued growth rate of 6.5 per cent for 2011–12, a rate even lower than crisis period low point of 6.7 per cent growth in 2007–08. Our saving and investment rate had also slipped since 2008–09. Gross domestic saving rate averaged 32.7 per cent in three years 2010–11 against 35.0 per cent in the preceding three years due mainly to fall in public sector saving rate. Our gross domestic investment rate averaged 34.1 per cent against 34.9 per cent for the same periods as corporate investment rate fell sharply. Preliminary estimates suggest a further sharp drop in household financial savings in 2011–12 at less than 8.0 per cent of the GDP from more than 12 per cent two years back. Also, corporate investment is likely to have declined further. With falling saving and investment, rise in twin deficits and inflation, potential growth had also dropped by one percentage point or more in the post-global financial crisis period. As we know, potential growth indicates the rate of growth the economy can achieve consistent with stable macro-economic conditions. On the other hand, inflation rose sharply to above comfort levels since December 2009 and averaged 9.5 per cent for next 24-months before lowering to sub-eight per cent but still proving to be intransigent. It is staying sticky at over 7 per cent. Centre's fiscal deficit had slipped during 2011–12 to 5.8 per cent against the budgeted 4.6 per cent for the year and 4.9 per cent in 2010–11. With gross under-recoveries of oil marketing companies working out to over Rs1.8 trillion or

0.8 per cent of GDP due to unrevised prices of diesel, LPG and kerosene, there was little doubt the centre's GFD/GDP budgeted estimate would then have overshot by a wide margin. Even after the revision of diesel prices and capping of subsidised LPG cylinders, the budget imbalances are obvious, underscoring the importance of further fiscal measures to contain deficit this year.

The current account deficit (CAD) had risen to an all-time high of 4.2 per cent of GDP in 2011–12 and 4.5 per cent of GDP during Q4 of 2011–12. In other words, rising twin deficit, slowing growth and sticky inflation provided all the ingredients for a possible economic crisis. Noting this macro-economic deterioration, some international credit rating agencies had already put India's sovereign rating on a watch list for an impending downgrade that would have pushed India to a sub-investment grade.

## The slew of measures in a span of less than a month should count

Against this background, the policy actions that were announced in September 2012 should be seen as major initiatives to reverse the course of economic growth path in the country. In a slew of measures of economic reforms, the government raised diesel prices by ₹5 per litre and capped subsidised LPG cooking gas cylinders to six a year per household. It permitted foreign direct investment (FDI) in multi-brand retail up to 51 per cent, in aviation sector up to 49 per cent and in some broadcasting services up to 75 per cent. It also approved sale of its minority stakes in four public sector firms – Oil India (by 10 per cent), Hindustan Copper (9.59 per cent), MMTC (9.33 per cent) and Nalco (12.15 per cent) – to raise up to ₹150 billion – half its disinvestment receipts target for the year. These measures were followed up with an announcement that withholding tax liability will be reduced to 5 per cent from 20 per cent for the overseas borrowings /bond issuances for infrastructure sector by Indian firms during July 2012 and June 2015.

A debt relief package for the state power distribution companies (discoms) has now been approved. Once implemented efficiently, it can turnaround the investment scenario once again. This month, a package for the life insurance sector was also worked out. The package includes easing investment norms for insurers, faster clearance for new products, easing of procedures, allowing banks to sell products of more than one insurance company and possibly some tax concessions for the insurance sector. More sector-specific packages could follow allowing structural bottlenecks to be removed without sacrificing on regulatory discipline. The Cabinet has also cleared foreign equity cap in insurance sectors at 49 per cent through Insurance Laws (Amendment) Bill, 2008. It also approved certain amendments to the Pension Fund Regulatory and Development Authority (PFRDA) Bill, 2011 that included foreign investment ceiling in the pension sector at 26 per cent or such percentage as may be approved for the insurance sector, whichever is higher, may be incorporated in the present legislation. Besides, it approved several other plans that are important for the economy, such as the 12th Five Year Plan document for taking it to the National Development Council (NDC), amendments to the Companies Bill 2011, the Forward Contracts (Regulation) Amendment Bill, 2010 and the Competition Act, 2002. These moves show the intent and the policy direction though the ultimate impact would depend on the political process of law making that follows. There are several unknowns, such as, the timing of debates and votes, the floor management on the day of the vote and most importantly, the process by which political differences are narrowed enough to see the results. The foundation has been laid and one can be confident that the Indian democracy would once again stand the test of the time.

On our part, we certainly think that the slew of economic reforms measures undertaken by the government recently would impart a positive momentum to the economy. The Reserve Bank in its Mid-Quarter Review of Monetary Policy noted the likely positive impact of the changes in FDI policy on capital flows and over the long run on higher productivity, particularly in food supply chains. The Reserve Bank had been consistently arguing for need for supply-side responses to help contain inflation. Earlier in its Annual Report released in

August 2012, it had highlighted the urgent need to step up non-debt creating inflows, especially in the form of FDI in view of the wide current account deficit (CAD). It had argued for further improving the FDI inflows in sectors such as insurance, retail, aviation and urban infrastructure. It had noted that FDI in retail may be particularly helpful in improving supply chain management through greater investment in backend infrastructure, including cold storage for farm and poultry products.

Considering that these steps being undertaken paved the way for a more favourable growth-inflation dynamics, the Reserve Bank moved to address possible liquidity tightening ahead by a pre-emptive 25 basis point cut in its Cash Reserve Ratio (CRR) at its Mid-term policy announced on September 17, 2012. CRR is also a potent monetary policy tool and should help in lowering the cost of credit and augmenting its supply, thus improving credit flows. The CRR cut was in addition to a 50 basis point policy rate reduction that the Reserve Bank had effected in April 2012 in anticipation of action for fiscal consolidation and supply-side initiatives.

Several policy measures have been taken in less than a month. When these measures get implemented and feed through the system, they would contribute significantly to recovery of India's growth as well as growth potential. Capital flows have recovered and would go a long way in restoring confidence for business activity in the country. Growth would start improving as a result. Whether the recovery will be quick or slow-paced would depend on several factors, including global conditions, which at the moment are not very conducive in spite of some positive news on labour and housing markets in the US. What is important is that recent actions by the Government have reduced the macro-economic risks and structural impediments.

Part of our recent woes was self-inflicted as inadequate movement on policy and implementation fronts worsened investment climate that had already suffered due to global uncertainties and cyclical downturn in the Indian economy. This had added an element of structural retrogression in the Indian economy. The government has now shown its resolve to effectively redress this. If steps announced are well-implemented and if we stay on path of reforms, the economy would turnaround faster than what many expect. But several challenges remain and not only policy changes but effective implementation holds the key to success.

The most important challenge would be to further lower the twin deficits by staying on path of fiscal consolidation, keeping a tab on private consumption demand and using expenditure switching policies to lower CAD. Monetary policy would for some more time need to focus on inflation while using available space to support growth to the degree it can. Inflation, if left unattended to, can play the biggest spoil sport. The rupee has already appreciated 6.8 per cent against US dollar since the onset of this new wave of reforms on September 13, 2012. This may help lower inflation somewhat as exchange rate-pass-through takes place. However, it is important to understand that exchange rate is neither a first-best solution nor a sufficient tool for addressing the challenges of structural inflation that we face today. Ultimately, fiscal policy would need to work towards expediting supply-side responses and keeping private consumption demand in reasonable control. Monetary policy would need to be cautious in the interim.

### Downward cycle may be bottoming out

After a downturn, there are some signs of green shoots that if nursed with appropriate policies, including continuous economic reforms, with an eye on macro-financial stability, can pave the way of recovery for the Indian economy. Falling growth was somewhat arrested in Q1 of 2012–13. At 5.5 per cent, it was marginally better than in the 5.3 per cent in Q4 of 2011–12. While this is not a material improvement, when juxtaposed with the recent policy measures there is hope that growth would improve in coming quarters and more so next year. Rainfall has been deficient by 8 per cent from the long period average in 2012 monsoon season. The deficiency during June and July 2012 has adversely impacted the Kharif crop. However, good rainfall in August and September have improved the soil moisture content and reservoir levels and raised the prospects for a good Rabi crop. As we see subsequent rounds of crop estimates, the deficiency of about 10 per cent in case of food grains and oilseeds is likely to be reduced, thus providing a further silver lining.

India grew at a rapid pace with an average growth of 8.7 per cent during 2003–04 to 2007–08 essentially because investment boomed, especially in infrastructure such as power, roads and telecom. In the last three years of this period growth averaged 9.5 per cent before the Lehman crisis changed the world. India's potential growth was assessed at nearly 8.5 per cent during this period. India's growth dropped to 6.7 per cent during 2007–08 due mainly to spill over from global financial crisis. India, however, stood out as an island of calm that withstood global financial Tsunami. Its growth dropped less than its peers and it staged a V-shaped recovery clocking 8.4 per cent growth over next two years. However, the euro area crisis, the rising structural problems and high inflation combined to bring about a precipitous fall in India's growth. The growth dropped to 6.5 per cent in 2011–12 – lower than the crisis-affected growth of 6.7 per cent in 2007–08. More importantly, growth has averaged 5.4 per cent over last two quarters.

Is this the new normal? There are strong reasons to believe otherwise. While potential growth may have fallen, we are clearly running a negative output gap with realised growth below potential. With current momentum, we can also recoup our lost potential and after a few years start growing back at 8–8.5 per cent on a sustainable basis. What is important at this stage is to further improve macro-economic conditions by lowering twin deficits and to ensure that inflation stays below the threshold at which high growth cannot be sustained.

Growth came down due to exceptional reasons. Firstly, inflation had stayed high for over two years and there is enough theoretical and empirical evidence to suggest that when inflation reaches that high and becomes persistent, the costs of deflation in terms of growth sacrifice turns out to be large. Part of the growth sacrifice occurs for reasons of monetary tightening that high inflation inevitably brings if complete macro-economic destabilization and possible hyper-inflation is to be averted. Hyperinflation risk is not something that can be dismissed lightly. Growth also comes down for reasons beyond monetary tightening. High inflation erodes consumers' real purchasing power and lowers aggregate demand. It acts as a regressive tax on poor and erodes their consumption base. Producers also postpone investment decisions in an era of heightened uncertainty. To contain the high level of inflation and manage inflationary expectations, monetary policy in India was tightened continuously since February 2010 and these risks were contained even though inflation still remains perceptibly higher than the Reserve Bank's comfort. Monetary policy needs to factor in the growth-inflation dynamics in a forward-looking manner but keep focussing on inflation for some more time so that inflation persistence is overcome. This would have a positive spin off for growth to recover. As we have stated in the Mid-Quarter Monetary Policy Review of September 17, 2012, when the policy initiatives being taken now by the Government materialize into concrete action, monetary policy will reinforce the positive impact of such actions while continuing to maintain its focus on inflation management.

Secondly, growth came down because of unfavourable global climate. The euro area crisis coming on the heels of Lehman crisis is playing on animal spirits. Global trade has decelerated sharply and is impacting investments. Indian industrial growth is found to be highly correlated with global industrial growth. As we integrate more and more with the rest of the world, we have to pay price of globalization even as we reap its benefits. As we have observed in this context, global developments affect our economy through commerce, capital flows, confidence, commodity price, contamination, currency rates and credit rating channels. Global business cycles are, therefore impacting both investment demand and with a lag impacting consumption demand as incomes fall and appetite for leverage reduces.

Thirdly, growth came down in India because investment climate was vitiated due to emergence of serious structural bottlenecks related to land, labour, regulatory framework, linkages or availability of funding, partly due to elevated concerns for asset quality. Part of the problem occurred in the mining sector, where judicial and executive efforts to improve governance have created a sort of a hiatus in activity. When a clearer operational regime comes into play businesses would adjust to more normal functioning based on fair returns. The other part of the problem was in the power sector where bulk of the 54 GW of new investments capacities created during the 11th Plan turned into potential bad investments as coal was in short supply. Mitigation of the problem is hopefully in the offing. If debt restructuring of discoms is well executed and coal supplies are quickly ensured, the power sector investments can revive in the 12th Plan. New capacity generation can easily match and possibly surpass that in the 11th Plan. Power sector can turn out to be a major driver of growth once again. As per the plans, the SEB losses are being cut by power tariff revisions.

## Investment revival is possible

Big steps for reforming power sector are now being taken and can pave the way for revival of investment. The debt restructuring of discoms is being done in an incentive-compatible manner and may not encourage moral hazard or regulatory forbearance. The scheme contains various measures required to be taken by state discoms and state governments for achieving the financial turnaround of the discoms. The restructuring / reschedulement of loan are to be accompanied by concrete and measurable action by the discoms / States to improve the operational performance of the distribution utilities. There may not be an immediate fiscal impact for the centre, given that its obligations under the scheme are medium-term in nature, the fiscal impact for the states in the near-term would be the interest outgo on 50 per cent of outstanding short-term loans which are to be taken over by them in a phased manner. While, a great deal of ground would still need to be covered for operational effectiveness of the scheme, it does have the capacity to reverse the falling fortunes of power sector investments. One hopes that the ticking clock of the potential time bomb of the power sector can now be defused. It is worth noting that the accumulated losses of the state power distribution companies (discoms) are estimated to be about ₹1.9 trillion as on 31st March, 2011.

## Financial sector can remain robust with efforts to contain newer fragilities

India has stood out amongst its peers with an enviable record on financial stability. India's gross non-performing assets (NPAs) of scheduled commercial banks as a percentage of gross advances had declined from 12.7 per cent in 1990-91 to 2.4 per cent in 2010–11. In case of public sector banks, this ration had dropped from 14.0 to 2.3 per cent over the same period. However, during the recent economic downturn, there has been a sharp deterioration in asset quality of the public sector banks (PSBs), as the ratio reversed to 3.2 per cent in 2011–12. While the NPA levels are still low by historical trends or cross-country comparison, newer fragilities were obvious by the high slippage ratio and a spurt in restructuring loans. The slippage ratio of the PSBs increased to 5.7 per cent of gross advances by at the end of 2011–12 from 4.2 per cent a year ago. The recovery also slowed down, especially in the stressed sectors. While some of these changes reflect the NPA cycle that generally tracks economic cycle, the sectoral bottlenecks also had a role to play in such deterioration.

There has been movement towards resolving the sector-specific issues, especially in power and aviation. With gradual improvement in economic activity, the stress may be further reduced across all sectors. This will bring back some of the strength of the bank balance sheets that had got eroded in recent years. Unlike many other countries, India is a bank-dominated financial system. Though the role of the financial markets has increased over the year, the financing pattern of the corporates suggests that banks account for over a fourth of total sources of funds for the corporates. As such, maintaining health of the banks is important so that they can nurse recovery by credit expansion with the silver linings already on the horizon. The ratio of bank credit to GDP in India is around 55 per cent, which is much below what is prevalent in many advanced economies. Therefore, the challenge for Indian banks is to facilitate the growth of the real sector through financial products and innovations subject to adequate safeguards and adoption of sound risk management policies. In the Indian context, foreign banks can potentially play a significant supplementing role of resource mobilization to fund higher growth, apart from augmenting competition and efficiency among the banks. For example, foreign banks still have a lot of leeway available for funding infrastructure projects vis-à-vis the prescribed exposure limits. Further, given the higher requirements of lending to the priority sectors under the revised policy framework, foreign banks can bring in a lot of innovations and better practices and processes to lend to the critical sectors of the economy like the SMEs and agriculture.

The Reserve Bank has been a conservative central bank that accords very high priority to financial stability. It is for this reason that the Reserve Bank is focussed on the implementation of the Basel III norms. It is also training its eyes on curbing increasing slippage and withdrawing regulatory forbearance that supports it in a phased manner. Some transitory sops to infrastructure loans in case genuine delays in commencement of commercial operations are possible but these should be the exceptions rather than the norm. Maintaining financial discipline is of paramount importance and this would certainly demand higher accountability and sacrifice by the promoters. On Basel III, the Reserve Bank has unveiled the broad course that the banks need to follow. With gradual improvements in market conditions, capital raising options for the banks would steadily improve. It should be possible for public sector banks (PSBs) to raise about ₹1.5 trillion of equity over the period of a little over 5-years till the end of 2017–18. The shareholders' value locked in the PSBs need to be tapped by innovative means. Stronger banks are in fact needed to support credit flows for higher growth in the Indian economy.

### Containment of twin deficits remains a challenge but within our realm

The impact of the recent governmental measures in reducing the fiscal deficit is not likely to be very large. In effect the reduction in diesel and LPG subsidies would amount to marginal fiscal correction in the current fiscal year. This underscores the importance of taking both short term measures for moving closer to the budget targets as well as long term steps to structurally correct the deficit, thus eventually lowering the fiscal dominance of monetary policy. Recently, the Kelkar Committee has estimated that GFD/GDP ratio for 2012–13 could slip by 1 percentage point to 6.1 per cent from the budgeted 5.1 per centif corrective measures are not taken. It has also made several recommendations on fiscal consolidation laying down a path to narrow it down to 5.2 per cent in 2012–13, 4.6 per cent in 2013–14 and 3.9 per cent in 2014–15, when the effective revenue deficit can be brought to zero. Improved tax collection, asset sales, pruning of subsidies and rationalization of planned spending holds the key to this path. Disinvestments, minority stake sales, higher PSU dividends, hiking urea prices and widening services tax net are part of the recommended strategy. The bottom line is that a workable path to fiscal consolidation is available – be it through the Kelkar Committee or through the rolling targets set following the 13th Finance Commission. What is important is to get there or at least very close to there through sustained efforts and not become lax in face of political or electoral cycles. It is expected that the government would take further aggressive steps to prevent fiscal slippage this year and complete its borrowing programme broadly in line with what was envisaged and without any undue pressures in the financial markets. This can make substantial contribution to keeping interest rates low and reviving the economy. In fact, the recent announcement of the Central Government's borrowing calendar for the second half of 2012–13, which sticks to the budgeted borrowing figures reflect Government's resolve for containing the Gross Fiscal Deficit (GFD). It is, however, imperative that further strong measures forfiscal corrections are implemented in the rest of the year broadly in line with the Kelkar Committee recommendations. Recent appreciation of the Rupee has, besides mitigating the risk of imported inflation, would also greatly aid in containment of GFD by way of reduction in subsidy burden of the Government arising out of high Rupee cost of imported oil.

The trends in the external sector are also showing signs of some improvement after considerable stress witnessed last year. The CAD/GDP ratio declined to 3.9 per cent in Q1 of 2012–13 from 4.5 per cent in Q4 of 2011–12. While this is a positive development, it has come about as imports contracted in face of growth slowdown and some benefits accrued from exchange rate pass-through from rupee depreciation in 2011–12 and in the first quarter this year. Macroeconomic and external sector policies would need to still factor in external sector risks in the coming period, especially as event risks emanating from global developments remain significant. Therefore, further efforts would be necessary to contain CAD and bring it in line with its sustainable level of around 2.5 per cent of GDP. The recent reform measures have brought about major change in global investor perception. These investors are now willing to continue investing in India's long-term growth story. Another silver lining is that India's net international investment position (NIIP) that reflects the net claims of non-residents on India has improved with the decrease in these claims by US$23.9 billion over the previous quarter to US$220.3 billion as at end-June. While this largely reflects the valuation changes, augmentation of non-debt creating flows in the new phase of economic reforms would certainly lower external financing risks, thus providing a much needed cushion against our external sector pressures.

**We need to convert the silver linings to our advantages**

I would like to conclude by saying that India in the second half of 2012–13 is shaping as very different from India in the first half. There are positives emerging across the horizon. This is reflected in our currency movement that will bring further positive spin offs by lowering inflation, fiscal deficit and reducing corporate stress. Growth could start improving into the next year. Battle against inflation is, however, far from over and we need careful calibration of monetary and non-monetary responses to tame it. Late revival of monsoon and steps taken/being planned to improve the supply responses should moderate the inflationary pressure overtime. Stronger fiscal measures on the path envisioned would pave the way for sustained recovery. We have seen marginal improvement in CAD. This should not, however, lull us into any complacency as the path to its sustainability requires several adjustments. It is equally important that correctives now being put in place do not attenuate regulatory prudence or deflect the focus away from long term sustainability of the external sector by taking a short term view of the proposed solutions for improving capital flows.

The slew of measures in a short span need to be turned into a habit of well-paced action, improved execution and governance and credible commitment without backtracking or reversals. A more gradual-paced reforms earlier enabled us to achieve high growth path. In the context of steps taken/planned for our reforms, one area where we need to focus seriously is on communication, both internal and external. This should encompass convincing our domestic constituency about the experience and benefits of reforms which have to be carried forward for achieving the goals of inclusive growth by having a strong and resilient macro-economy. It would also imply meaningful engagement with the international rating agencies and investor class. There is no reason to believe that these would not work though there are still many a bridge to cross to translate the intentions to deliverables on the ground. The silver linings are now visible on the horizon. We need to build upon them and implement our plans in the right earnest. The door of opportunity is again knocking at us. These silver linings lifting the dark clouds are, however, not something as part of our destiny but they are within our reach, if we work hard on them with all sincerity to convert them to our long term advantages

Thank you all for giving me this opportunity to share some of my thoughts with you.