Duvvuri Subbarao: Mitigating spillovers and contagion lessons from the global financial crisis

Speech by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the RBI-BIS Seminar on "Mitigating Spillovers and Contagion – Lessons from the Global Financial Crisis", Hyderabad, 4 December 2008.

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On behalf of the Reserve Bank of India, it is my pleasure and privilege to welcome all of you international delegates to India, to this wonderful city of Hyderabad, and to this RBI-BIS Seminar on "Mitigating Spillovers and Contagion – Lessons from the Global Financial Crisis".

Seminar context

This seminar is the second successive BIS seminar to be organised by the RBI, and marks an important milestone in the intellectual collaboration between the Bank for International Settlements (BIS) and the Reserve Bank of India (RBI). I want to thank the management of BIS for giving us the opportunity of hosting this seminar.

I understand the theme for this seminar, "Mitigating Spillovers and Contagion – Lessons from the Global Financial Crisis" was set several months ago. The global financial crisis has since become front page news. It is a tribute to the planners of this seminar, particularly Mr. Mar Gudmundsson of BIS and my predecessor as Governor of RBI, Dr. Y.V. Reddy, that in narrowing down to this topic they foresaw, ahead of many of us, the depth and sweep of the crisis.

Global financial and economic 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 cite housing as a prime example of a non-tradeable good. It is paradoxical that a quintessentially non-tradable good as housing has triggered a crisis of global dimensions. Such is the depth and sweep of financial globalisation. By far, the most dominant FAQ today is whether the worst in terms of the financial sector meltdown, 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.

The global economic outlook has deteriorated sharply over the last two months. Many economists are now predicting the worst global recession since the 1970s. In its World Economic Outlook, published in early October, the IMF forecast global growth of 3.9 per cent in 2008, and of 3.0 per cent in 2009. The IMF has since revised its forecast for global growth downwards to 3.7 per cent for 2008, and 2.2 per cent for 2009. Notably, advanced economies, as a group, are projected to contract by 0.3 per cent in 2009. If this gloomy outcome were indeed to come true, 2009 will mark the first year on record when emerging economies will account for more than 100 per cent of world growth.

Emerging economies

Emerging economies may be the sole contributors to global growth in 2009, but they too are hit hard by the crisis. 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 can largely steam ahead on their own. In a rapidly globalising world, the decoupling theory was never totally persuasive; given the evidence of the last few months – capital flow reversals, sharp widening of spreads on 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. The IMF revised its growth forecast for emerging economies for 2009 from its early October figure of 6.1 per cent to 5.1 per cent. Clearly emerging economies have a painful adjustment to make.

Impact of the crisis on India

India too is having to weather the negative impact of the crisis. Even as consumption and domestic investment continue to be the key drivers of our growth, India's integration into the world has been on the increase. 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 gross current account and gross capital flows to GDP, this ratio has increased from 46.8 per cent in 1997/98 to 117.0 per cent in 2007/08. These numbers are clear evidence of India's increasing integration into the world economy over the last 10 years.

No revolution in human history has been totally benign. So, it is the case with globalisation; globalisation comes with costs and benefits. Managing globalisation requires that we minimize the costs and maximize the benefits. India has undoubtedly benefited from integrating into the world. By corollary, we also need to manage the downside ramifications of integrating into the world, as indeed evidenced by the current context.

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. Even so, India is experiencing the knock-on effects of the global crisis, through the monetary, financial and real channels. Our financial markets – equity markets, money markets, forex markets and credit markets – have all come under pressure mainly because of what we have begun to call "the substitution effect". As credit lines and credit channels overseas went dry, some of the credit demand earlier met by overseas financing is shifting to the domestic credit sector, putting pressure on domestic resources. The reversal of capital flows taking place as part of the global de-leveraging process has put pressure on our forex markets. Together, the global credit crunch and de-leveraging were reflected at home in the sharp fluctuation in the overnight money market rates in October 2008 and the depreciation of the rupee.

The outlook for India, going forward, is mixed. There is evidence of economic activity slowing down. At the same time, headline inflation, as measured by the wholesale price index, has fallen sharply, and the decline has been sustained for the past three weeks, pointing to a faster than expected reduction in inflation. Clearly, falling commodity prices have been the key drivers behind the disinflation; however, some contribution has also come from slowing domestic demand. To be sure, consumer price inflation for the months of September and October did increase. This is possibly owing to the firm trend in food articles inflation and the higher weight of food articles in measures of consumer price inflation. Historically there has been a correlation between wholesale and consumer price inflation, and given this correlation, consumer price inflation too can be expected to soften in the months ahead.

The Reserve Bank's monetary policy stance has always 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.

I do not intend to go into a detailed cataloguing of all the measures we have taken, but I do want to mention that we have instituted both aggregate measures as well as sector specific measures. 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.

Going forward, developments in the real economy, financial markets and global commodity prices point to a period of moderation in growth with declining inflation. 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.

The Reserve Bank's policy endeavour will be to ensure an orderly adjustment, and to minimise the pain of its impact. In particular, we will try to maintain a comfortable liquidity position, see that the weighted average overnight money market rate is maintained within the repo-reverse repo corridor and ensure conditions conducive for flow of credit to productive sectors, particularly the stressed export and small and medium industry sectors. We hope that all economic agents will plan their business activities on the basis of this assurance.

Lessons from the crisis

The crisis is by no means over. Drawing lessons may therefore appear a bit premature. There may yet be surprises. Even so, it will be instructive to put our minds together to understand how we got here and how we may avoid the mistakes and excesses in the future. It will be presumptuous on my part to anticipate the whole gamut of issues that you will bring to the discussion. Given your collective experience and expertise, that will indeed be a rich contribution. But I want to take this opportunity to raise some of the more important debates thrown up by this crisis. I will refer to five debates.

1st debate: How do we manage global imbalances?

In popular perception, the collapse of Lehman Brothers on 15 September 2008 will remain as the trigger for the global crisis. At one level, that many well be true. Indeed, for several years ahead, I can see ourselves furiously debating the famous counterfactual, "If Lehman had not been allowed to fail, …..".

However, if only we look a little deeper, we will trace the origins of the crisis to the build up of global imbalances during the 90s and this first decade of this century. There is of course a separate debate on what caused the build up of imbalances? Is it excess consumption of the US, or is it the savings glut in emerging Asia with the US helping out as the “consumer of the last resort”?

Be that as it may, there is little disagreement over the mega trends that lead to the imbalances. First, there was the globalisation of labour. Emerging Asia added nearly three billion to the world pool of labour as it integrated into the world through the 90s. What this did was to reduce production costs at the aggregate level and increase Asia's comparative advantage. In a manner of speaking, Asia produced and America consumed. Asian economies ran up huge surpluses on their trade accounts which were mirrored by current account deficits in the US. This geographical savings – consumption imbalance was inherently fragile, but we refused to acknowledge it. Instead, we lulled ourselves into believing that we have entered, what Mervyn King of Bank of England famously called NICE era – “non-inflationary consistently expansionary” era. It is these imbalances that generated easy liquidity and low interest rates which in turn encouraged under-pricing of risk and deterioration in credit quality.

So, the debating issue is, can we prevent global imbalances from building up in the future? There is an argument that global imbalances are inevitable given the demographic profile of the world. Emerging economies typically have younger populations with a higher marginal propensity to save. Conversely, advanced countries with ageing populations have a higher marginal propensity to consume. If the demand for, and supply of, savings at the global level is structurally so well matched, how do we prevent a recurrence of global imbalances?

2nd debate: Is self-insurance a viable option for emerging economies?

Writing in the Business Standard last week, Arvind Subramanian of the Peterson Institute for International Economics had raised the issue of self insurance – accumulation of foreign reserves – as a buffer against financial crises. Following the Asian crisis, East Asian countries built up huge reserves as a deliberate policy of self insurance. China and India too built up reserves, with an important difference though. China's reserves derive from current account surpluses and are therefore an unencumbered asset, whereas India's reserves have been built up from capital flows, and are therefore encumbered by liabilities. It is this war chest of reserves that has given the muscle to the emerging economies to withstand the worst impact of the ongoing crisis.

Self-insurance, of course, is not costless, as Subramanian himself argues. Reserves should ideally be built through current account surpluses. This implies greater reliance on the external sector, particularly exports. But such reliance on exports can become a liability if export demand shrinks which can happen for reasons exogenous to the emerging economy. There is obviously a trade off here. Self-insurance, as defined by reserve build up through aggressive exports, offers protection against financial contagion, but it also makes the economy vulnerable to trade contagion. How do we balance this trade off between vulnerability to financial contagion and vulnerability to trade contagion?

Another relevant issue is that self-insurance may not be necessary, indeed may be redundant, if international collective arrangements – regional or multilateral – can provide easy, quick and unconditional liquidity during a crisis. For example, the motivation for self-insurance will be less compelling if the recently instituted IMF's Short-term Liquidity Facility for Market Access Countries or the swap facility offered to select countries by the US Federal Reserve become more common and can be accessed with relatively low transaction costs.

So, the second debating issue I want to raise is the following: "Is self-insurance a viable policy option for emerging economies?"

3rd debate: 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. 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 countries and in some 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. But in doing so, we must be mindful of the risks of over tightening regulations so much that they stifle innovation.

While on the subject of reforming regulation, there is also the larger question of risk modelling. True, the probability of risk follows a normal distribution – popularly called the bell curve. But our regulatory regimes have been tailored to respond to the central, higher probability portion of the bell curve. Typically, we ignored the black swan lying in the long tail of the curve. We now know from the benefit of hindsight that this was a fatal flaw. The black swan represents the low probability, high risk events that pose systemic risk. While our regulatory regimes were tailored to address institutional failures, they were not equipped to address systemic failures.

So, the issues for debate are the following. What are the flaws of the current regulatory regimes? How do we fix them? In what ways can international cooperation be fostered in this regard? How do we address the black swan systemic risk events?

4th debate: How do we address regulatory arbitrage?

Around the world, regulations governing the banking system have typically been quite stringent on the premise that the interests of the depositors need to be protected. But under the very nose of the regulators grew a very extensive and complex network of a "shadow banking system", comprising hedge funds, broker-dealers, private equity funds, structured investment vehicles and conduits and money market funds. This shadow banking system was typically highly leveraged, and had an extensive nexus with the banking system. However, the shadow banking system suffered much lighter regulation. This "regulatory arbitrage" encouraged loose practices, hunt for quick yields and non-transparent and risky financial products. When the systems began to unravel, it was realised that many of these institutions in the shadow banking system pose as much of a systemic risk as banks. The moral of the story is that if an institution is "too big to be allowed to fail", it is also too big to be let off with loose regulations.

So, the question for debate is, how do we address the problem of regulatory arbitrage?

5th debate: How do we keep the financial sector in line with the real sector?

Last, and perhaps most important, let me turn to the debate surrounding the efficiency gains of financial engineering. We got ourselves into believing that significant value could be created by slicing and dicing securities. Illustratively, we believed that financial alchemy could turn the "lead" of sub-prime mortgages into gold and platinum of "AAA" securities. In many ways, the malady was worse. We failed to learn from earlier crises. We should have learnt that the modern financial system with its deregulated markets, highly leveraged players and large capital flows was dangerously fragile. We should have seen the crisis incubating behind the dazzle of financial alchemy. We should have noticed the regulatory systems getting lax and behind the curve. Instead what happened was just the opposite. The complexity, sophistication and finesse associated with it gave the financial sector a larger than life profile. Lulled by the seemingly benign economic environment, we deluded ourselves into believing that for every real life problem, no matter how complex, there is a financial sector solution.

Forgotten in the euphoria of financial alchemy is the basic tenet that the financial sector has no standing of its own; it derives its strength and resilience from the real economy. It is the real sector that should drive the financial sector, not the other way round.

So, the issue for debate is, how do we keep the financial sector in line with the real sector?

Summary and conclusion

That brings me to the close of the five debates relating to the lessons from the global financial crises. To summarize, the five debates I have raised are the following:

i) How do we manage global imbalances?

ii) Is self-insurance a viable option for emerging economies?

iii) How do we reform financial sector regulation?

iv) How do we address regulatory arbitrage?

v) How do we keep the financial sector in line with the real sector?

I am aware that there are several other important issues beyond what I have raised. I hope and trust that we will have an opportunity to discuss all these issues. I wish you all a rewarding learning experience over the next two days.