Duvvuri Subbarao: Risk management in the midst of the global financial crisis

Speech by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the Financial Management Summit 2009 organized by the Economic Times, Mumbai, 22 May 2009.

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Thank you for inviting me to be the keynote speaker at this Financial Management Summit. The global economy is passing through its deepest financial and economic crisis of our time. Protecting the Indian economy from the worst impact of the crisis has been a big challenge for the government and the Reserve Bank. Equally, I am conscious of the fact that industry, business and investors gathered here today have had to make very challenging adjustments in these difficult times.

The Chinese have a saying, “may you live in interesting times.” I can hardly complain. These have been very interesting times for me, perhaps a bit too interesting. I came into the Reserve Bank when runaway inflation around the world, and here in India, was the overriding concern. Less than a month later, this turned into the biggest global recession of our times with severe financial dislocation and concerns about deflation becoming the global chorus.

Crisis management around the world

During this period, macroeconomic management, needless to say, has been challenging. The financial crisis called into question several fundamental assumptions and beliefs about economic resilience and financial stability. With all the advanced economies in a synchronised recession, global GDP is projected to contract for the first time since the Second World War. We were lulled into believing that the rewards of the Great Moderation were with us for ever to enjoy until the Great Unravelling hit us and forced us into this Great Recession.

Governments and central banks around the world have responded to the crisis in an unprecedented show of policy force. The shock and awe of fiscal stimulus and monetary easing is still with us. Importantly, given the nature of the crisis, purely national responses have been supplemented by global efforts. The G-20 group of nations met twice in the last six months. At their April 2009 meeting, the G-20 leaders collectively committed to take decisive, coordinated and comprehensive actions to revive growth, restore stability of the financial system, restart the impaired credit markets and rebuild confidence in financial markets and institutions.

The crisis has forced macroeconomic policy around the world into clearly uncharted territory. Governments and central banks took largely unprecedented fiscal and monetary policy measures to prevent the global recession from turning into a protracted depression.

Some analysts said this was an over reaction. Others criticized the tyranny of the short term compromising medium term sustainability. But received wisdom and mainstream view have been that it was clearly safer to err on doing too much rather than doing too little. Thus the policy response should be seen as an insurance against this risk. But there is no real way of judging whether we are overinsuring or underinsuring. If indeed the world has overinsured, then there is a risk that all this liquidity has the potential to trigger a bout of undesirable inflation. Conversely, if we have underinsured, then this recession could turn deeper, nastier, and longer. And as we know from experience, there is no way to measure *apriori* whether we have insured right. So policymakers all over the world are perhaps erring on the side of overinsuring – keeping financial markets flush with liquidity, providing substantial fiscal support, using the breathing space provided by the policy support to restructure the financial system, and hoping that they can withdraw the liquidity and stimulus as the recovery firms up and before inflationary threats take root.

Notwithstanding the relative calm in recent weeks, the global financial outlook continues to be uncertain. It is not clear that we have seen the end of the emergence of tainted assets, and doubts persist on whether the initiatives underway are sufficient to restore the stability of the financial system. There is continued debate on the adequacy of the fiscal stimulus packages across countries, and their effectiveness in arresting the downturn, reversing job losses and reviving consumer confidence. Many major central banks have nearly or totally exhausted their conventional weaponry of calibrating policy interest rates and are now resorting to unconventional measures such as quantitative and credit easing. Given the erosion of the monetary policy transmission mechanism, there are concerns about when and to what extent monetary response, admittedly aggressive, will begin to have an impact on reviving credit flows and spurring aggregate demand.

India – crisis response and challenge

At home, the impact of the crisis has been deeper than anticipated earlier although less severe than in other emerging market economies. The extent of impact has caused dismay, mainly on two grounds: first, because our financial sector remains healthy, has had no direct exposure to tainted assets and its off-balance sheet activities have been limited; and second, because India's merchandise exports, at less than 15 per cent of GDP, are relatively modest. Despite these mitigating factors, the crisis hit India underscoring the rising two-way trade in goods and services and financial integration with the rest of the world.

There have been several comforting factors going into the slowdown. First, our financial markets, particularly our banks, have continued to function normally. Second, India's comfortable foreign exchange reserves provide confidence in our ability to manage our balance of payments notwithstanding lower export demand and dampened capital flows. Third, headline inflation, as measured by the wholesale price index (WPI), has declined sharply. Consumer price inflation too has begun to moderate. Fourth, because of mandated agricultural lending and social safety-net programmes, rural demand continues to be robust.

Both the Government and the Reserve Bank responded to the challenge strongly, and in close coordination and consultation. The Reserve Bank shifted its policy stance from monetary tightening in response to the elevated inflationary pressures in the first half of 2008-09 to monetary easing in response to easing inflationary pressures and moderation of growth engendered by the crisis. The Reserve Bank's policy response was aimed at containing the contagion from the global financial crisis while maintaining comfortable domestic and foreign exchange liquidity. Taking a cue from the Reserve Bank's monetary easing, most banks have reduced their deposit and lending rates.

The Government launched three fiscal stimulus packages between December 2008 and February 2009. These stimulus packages came on top of an already announced expanded safety-net programme for the rural poor, the farm loan waiver package and payout following the Sixth Pay Commission report, all of which too added to stimulating demand.

As the monetary and fiscal stimuli work their way through, and if calm and confidence are restored in the global markets, we can see economic turn around later this year. After averaging nine per cent growth over the last four years, economic activity in India has slowed since the last quarter of 2008. The outcomes in recent months have been mixed. While overall industrial production fell again in March, cement and steel production have shown some preliminary signs of upturn. Segments in the automobile sector, particularly two and three wheelers and passenger cars, are showing modest revival of demand. The industrial and business outlook is improving. These signs are not unambiguous — there is as yet no clear sign of export decline reversing the trend, and credit growth continues to be subdued.

Taking the evolving global situation and the domestic conditions into account, in our Annual Policy Statement last month, we projected real GDP growth of 6.0 per cent for 2009/10. The balance of our assessment continues to support this growth projection.

While the risks from the uncertainties in the global financial markets continue to persist, there are risks on the domestic front too. The challenge is how we manage the recovery. The fiscal and monetary response now on will have to weigh in the state of the economy going forward 6-9 months. If the global recovery takes root and private investment demand revives faster, there could be less of a case for further stimulus. On the other hand, if global financial markets do not stabilize and global recovery does not take hold by the last quarter of 2009, we would realize with the benefit of hindsight, that the domestic policy response should have been stronger.

So, where and how does the economic dilemma fit into the topic of risk management, which is the subject of this summit? It fits in because the context throws up questions about risk management in the macroeconomy. How does one hedge against the uncertainty of outcomes of toady's fiscal and monetary policy actions? How does one insure against such risks? Clearly there are no easy ways; if indeed there were, we would not be having this seminar. I will focus on three aspects: monetary policy, fiscal policy, and financial stability to define the contours of uncertainty.

Looking ahead – monetary policy

On the monetary policy front, managing the risk calls for maintaining ample liquidity in the system. The RBI has done so the past six months through a variety of instruments and facilities. And in the April 2009 policy review, we extended the tenure many of these facilities. Some will argue, and rightly so, that this might be sowing the seeds of the next inflationary cycle. And this is exactly the kind of risk one has to grapple with. So while the Reserve Bank will continue to support liquidity in the economy, it will have to ensure that as economic growth gathers momentum, the excess liquidity is rolled back in an orderly manner. It is important to note though that even as the monetary easing has increased liquidity considerably, at the aggregate level this has not been out of line with our monetary aggregates unlike in many advanced countries. As such, the challenge of unwinding will be less daunting for India than for other countries.

The rise in macroeconomic uncertainty and the financial dislocation of last year have raised a related problem. The adjustment in market interest rates in response to changes in policy rates gets reflected with some lag. In India monetary transmission has had a differential impact across different segments of the financial market. While the transmission has been faster in the money and bond markets, it has been relatively muted in the credit market on account of several structural rigidities. However, the earlier acceleration in inflation coupled with high credit demand appears to have added to these rigidities by prompting banks to raise deposits at higher rates to ensure longer term access to liquidity. High deposit rates in turn have not allowed banks to cut lending rates at a faster pace consistent with the growth and inflation outlook. Although deposit rates are declining and effective lending rates are falling, there is clearly more space to cut rates given declining inflation. Making liquidity available in sufficient quantity, as RBI has done, should also help by giving confidence to banks of the availability of funds.

Looking ahead – fiscal policy

The challenge for fiscal policy is to balance immediate support for the economy with the need to get back on track on the medium-term fiscal consolidation process. The fiscal stimulus packages and other measures have led to sharp increase in the revenue and fiscal deficits which, in the face of slowing private investment, have cushioned the pace of economic activity.

The first order of economic business for the new government will be the full budget. Given the still soft economy, the pressure to provide more stimulus will persist. While this may help in the very near term, the sustainability of the recovery requires returning to responsible fiscal consolidation. The borrowing programme of the government has already expanded rapidly. The Reserve Bank has been able to manage the large borrowing programme in an orderly manner. Large borrowings by the government run against the low interest rate environment that the Reserve Bank is trying to maintain to spur investment demand in keeping with the stance of monetary policy.

The Reserve Bank will continue to use a combination of monetary and debt management tools to manage the government borrowing programme to ensure its successful completion in a smooth manner. During the first half of 2009-10, planned Open Market Operations (OMO) purchases and Market Stabilisation Scheme (MSS) unwinding will add primary liquidity which will be equivalent, in terms of monetary impact, to reduction of CRR by three percentage points. This should leave adequate resources with banks to expand credit. However, with every percentage point increase in the fiscal deficit, maintaining adequate liquidity in the system becomes that much more difficult. Managing this trade off between our short term compulsions and longer term sustainability will be one of the big challenges going forward.

Looking ahead – financial stability

Beyond monetary and fiscal policies, preserving financial stability is key to navigating these uncertain times. A sound and resilient banking sector, well-functioning financial markets, robust liquidity management and payment and settlement infrastructure are the pre-requisites for financial stability. The banking sector in India is sound, adequately capitalized and well-regulated. By all counts, Indian financial markets are capable of withstanding the global shock, perhaps somewhat bruised but definitely not battered.

But how sure can we be? Here we have some encouraging news. Amidst the din of the financial turmoil and the all-consuming fixation on rate cuts over the last six months, a seminal report on the health of the Indian financial system has received less notice than it deserved.

Committee on Financial Sector Assessment (CFSA)

In March this year, the Government and RBI jointly released the report of the Committee on Financial Sector Assessment (CFSA) that was co-chaired by Deputy Governor Rakesh Mohan and Finance Secretary Ashok Chawla. The report is the culmination of work started in September 2006 to undertake a comprehensive self-assessment of India's financial sector, particularly focusing on stability assessment and stress testing and compliance with all financial standards and codes.

The CFSA owes its origins to the Financial Sector Assessment Program, FSAP for short, that was initiated in 1999 and carried out jointly by the IMF and the World Bank after the Asian crisis. Several countries, including India, participated in this long drawn and resource intensive exercise. This program so far has been conducted by the IMF and the World Bank using experts from around the world to carry out the assessment with participation from the host country.

While India had earlier participated in the FSAP conducted by the IMF and World Bank, to the best of my knowledge, we are first country to make a self assessment of its financial sector in line with the FSAP. This is a remarkable achievement especially as the assessment conformed to the structure and procedure laid down by the IMF, the World Bank and several standard-setting bodies like the BIS, IOSCO and IAIS. As the previous Finance Secretary, I had watched the process first hand. By all accounts, this was a large and complex exercise.

But the Government and the RBI remained committed to a rigorous, transparent and unbiased process.

The CFSA followed a forward-looking and holistic approach to self-assessment, based on three mutually reinforcing pillars: financial stability assessment and stress testing; legal, infrastructural and market development issues; and an assessment of the status of implementation of international financial standards and codes. The first pillar is essentially concerned with stability assessment. Taking into account the legal, regulatory and supervisory architecture in India, the CFSA felt the need for involving, and associating closely, all the major regulatory institutions in the financial sector – the RBI, SEBI and IRDA, besides the relevant government departments. Direct official involvement at different levels brought about enormous responsibility, ownership, and commitment to the process, ensuring constructive pragmatism when faced with contentious issues.

Since the assessment required comprehensive domain knowledge in the various technical areas examined, the CFSA initially constituted Technical Groups comprising officials with first-hand experience in handling the respective areas from the regulatory agencies concerned as well as the government to undertake the preliminary assessment and to prepare technical notes and background material in the concerned areas. This ensured that officials who are well-conversant with their own systems and are aware of the existing strengths and weaknesses could identify the best alternative solutions.

To ensure an impartial assessment, the CFSA constituted four external independent Advisory Panels, comprising non-official experts drawn from within the country. These Panels made their assessments after thorough debate and rigorous scrutiny of inputs provided by the Technical Groups. To further strengthen the credibility of this assessment, the Advisory Panels' assessments were peer reviewed by eminent international experts.

The CFSA then drew up its own overview report at the final stage, drawing upon the assessments, findings and recommendations of the Advisory Panels and the comments of the peer reviewers. The assessments and recommendations comprise six volumes. All the six volumes are freely available on RBI's website and I would strongly recommend that you read them. If six volumes are daunting, then read at least the first two volumes, viz., the Executive Summary and the Overview Report.

Overall, the CFSA found that our financial system is essentially sound and resilient, and that systemic stability is by and large robust. India is broadly compliant with most of the standards and codes though gaps were noted in the timely implementation of bankruptcy proceedings.

Of immediate interest, and related closely to the current macroeconomic conditions, the CFSA also carried out single-factor stress-tests for credit and market risks and liquidity ratio and scenario analyses. These tests show that there are no significant vulnerabilities in the banking system. This does not mean that NPAs will not rise in this economic slowdown. NPAs may indeed rise, as the Reserve Bank has pointed out. But given the strength of the banks' balance sheets, that rise is not likely to pose any systemic risks, as it might in many advanced countries.

Risk assessment, however, is a continuous process and the stress tests need to be conducted taking into account the macroeconomic linkages as also the second round and contagion risks. The Reserve Bank intends to formalize this process by setting up an inter-disciplinary Financial Stability Unit to monitor and address systemic vulnerabilities.

India outlook

Le me now conclude. We are, as I said at the beginning, in uncharted policy territory. The crisis is forcing countries around the world to test the limits of their fiscal and monetary tools. This is true for macroeconomic policy, and I believe it is also true for business policy, which you will be discussing today. Our economy remains fundamentally strong despite the adverse impact of the global financial crisis. With the right mix of macroeconomic policy and corporate strategy, my sense is that, as an economy, we will emerge from this global recession stronger than before.

Once again thank you for this opportunity to share my views. I wish your deliberations all success.