Anand Sinha: Gauging the potential of emerging markets – can growth be achieved with durable financial stability

Opening remarks by Mr Anand Sinha, Deputy Governor of the Reserve Bank of India, at the 2nd FT-YES Bank International Banking Summit, Mumbai, 15 October 2012.

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1. Ms. Henny Sender, Chief Correspondent, International Finance, Financial Times and moderator for the panel discussion, my co-panelists, Mr. Bunt Ghosh, Head of Emerging Market Strategy for Asset Management, Credit Suisse; Mr. Sunil Godhwani, CMD, Religare Enterprises; Mr. Sizwe Nxasana, CEO, First Rand Group; Dr. Rana Kapoor, Founder, Managing Director and CEO, Yes Bank; other delegates and members of print and electronic media. A very good afternoon to you all.

2. While it is unequivocally agreed that financial stability is an objective that we must all pursue, especially in the light of the lessons learnt from the global financial crisis, the debate continues on how to balance growth and stability, given the fact that pursuit of financial stability may have costs in the nature of foregone growth. In the light of this heightened policy debate, the current panel discussion on "*Gauging the potential of emerging markets – Can growth be achieved with durable financial stability*" as part of the FT-Yes Banking Summit is very timely and apt.

3. Before the panel commences their discussions, let me briefly touch upon a few issues.

I. Growth vs stability – Is there a trade off?

4. The lessons of the global financial crisis have, very clearly, emphasised the significance of financial stability. If policies to ensure financial stability are not pursued, then the growth that comes with credit cycle in the upturn will be more than dissipated when the bust phase comes, with grave consequences for the financial system and macroeconomy in the form of large output losses, lack of growth, rising unemployment, impaired financial markets, weakened banks and financial system, impaired monetary policy transmission and a sense of pessimism. In such conditions, banks become extremely risk averse and do not have the required prudential strength to continue to lend. Moreover, with markets not having confidence in financial intermediaries, the funding costs become high. The result is deleveraging or a substantially reduced lending with higher lending rates. Thus, there is a significantly reduced credit supply while the economy desperately needs more credit. As noted by Governor, Dr. Subbarao[1], the damage financial instability can cause in poor and developing economies can be particularly severe. The striking fact about recessions with financial crises is that credit demand also gets substantially muted and growth takes much longer to pickup compared to other recessions, due to the overhang of debt and high leverage built up by households, corporates, banks and other entities in the financial system during the boom phase of the economy.

5. The pre-crisis period was marked by inadequate understanding of systemic risk and lack of framework to address it. It was also strongly believed that price stability achieved through inflation targeting would provide macroeconomic stability and was a necessary and sufficient condition for achieving financial stability. The regulators and supervisors had to ensure individually strong banks through microprudential regulation, and it was presumed

[1] "*Financial Stability: Issues and Challenges*", (Sep 2009) – speech by Dr. Duvvuri Subbarao.

that the highly sophisticated and efficient financial markets would distribute risks among economic agents who will have the wherewithal to handle risks. In alignment with the exclusive focus of monetary policy on price stability, the ruling doctrine (Greenspan put) was that, for a variety of reasons, monetary policy was not capable of, and did not have to, respond to asset bubbles. Instead, the debris from an asset bubble burst could be handled by aggressively easing monetary policy which would put the economy back on rails. The reason why this doctrine had survived till recently was because it had worked well in the previous episodes including the stock market crash of 1987 and the more recent dot com bubble. This doctrine now stands completely discredited in the light of the current crisis. The failure of the doctrine can possibly be explained by the much higher level of debt and leverage in the current crisis.

6. It is clear that there was inadequate understanding of systemic risks in the pre-crisis period and there was no framework to address them. In my view, the most notable and novel feature of Basel III framework is creating a framework for dealing with systemic risks and consequently with financial stability issues.

7. Let me now briefly discuss how the pursuit of financial stability i.e. dealing with systemic risks, necessarily has a cost in terms of growth. To deal with procyclicality issues (time dimension of systemic risk), capital and/or provisioning buffers are required to be built up during the upturn of the cycle for increasing the resilience of the banking system and leaning against the credit cycle with a view to moderating it.

8. To deal with the negative externalities arising out of the failure/impairment of highly interconnected banks (cross sectional dimension of systemic risk), i.e. systemically important banks (SIBs), measures are required to reduce their probability of failure and impact on the financial system if they failed. In other words, the measures for financial stability would aim at incentivising the SIBs to reduce their systemiticity. Here the trade off is with the advantages of the economies of scale and scope.

9. Thus, the pursuit of financial stability has cost in terms of growth. The other concern which is often voiced is that the capital buffers on the back of much higher level of equity required in the capital structure as per Basel III would leave banks with substantially lower Return on Equity (ROE) and it would become difficult to retain investor interest, rendering capital raising difficult. While these aspects understandably have caused concerns, these concerns have become particularly heightened due to the state of the global financial system and macroeconomy. The banking system particularly in the advanced economies has to build up its capital and liquidity levels and Basel III is to be implemented, even when the macroeconomy is in an uncertain and depressed state. Ideally, these measures could be implemented when the macroeconomy and financial system were in good shape. Therefore, many find giving up growth for pursuing financial stability in these circumstances not convincing. However, there is no option to recapitalising banks particularly in advanced economies because without this measure, the macroeconomy cannot recover. The alternative would be deleveraging on large scale to gain market's confidence and meet prudential standards, which will be highly detrimental to macroeconomy. Thus, there is a clear dilemma in the short term which will have to be addressed from a long term perspective. However, there is some comfort from the fact that studies show that Basel III implementation may not result in large cost for growth. The Basel Committee on Banking Supervision (BCBS) has carried out detailed impact studies which show that if the Basel III is fully phased in 35 quarters, the GDP growth will dip by 0.22 per cent from the trend path (i.e. 0.03 per cent p.a.) and converge to it after this period. For every percentage point increase in capital, the GDP growth will dip by 0.17 per cent during the transition phase. This is a very affordable cost for gaining from durable financial stability. That is why the Basel committee has kept the implementation period of 6 years to minimise the impact on growth and make it affordable. However, it should be noted that the actual impact on growth would obviously depend upon the capital levels at which banks would choose to operate. These levels are likely to be higher than the minimum prescribed by Basel III.

10. As regards the possible decline in investor interest due to lower ROE, it is argued that with lower leverage, banks would be much safer and hence investors would demand a lower return. Studies show that the average ROE in various segments (both financial and non-financial firms) over a longer period are not significantly different. Lower leverage would make the returns on banking stocks much less volatile which should suit the investors.

11. It is thus expected that the trade off from the pursuit of financial stability in the Basel framework would be a manageable cost in terms of growth and that investor interest in banking stocks would remain retained.

II. Gauging the potential of emerging markets

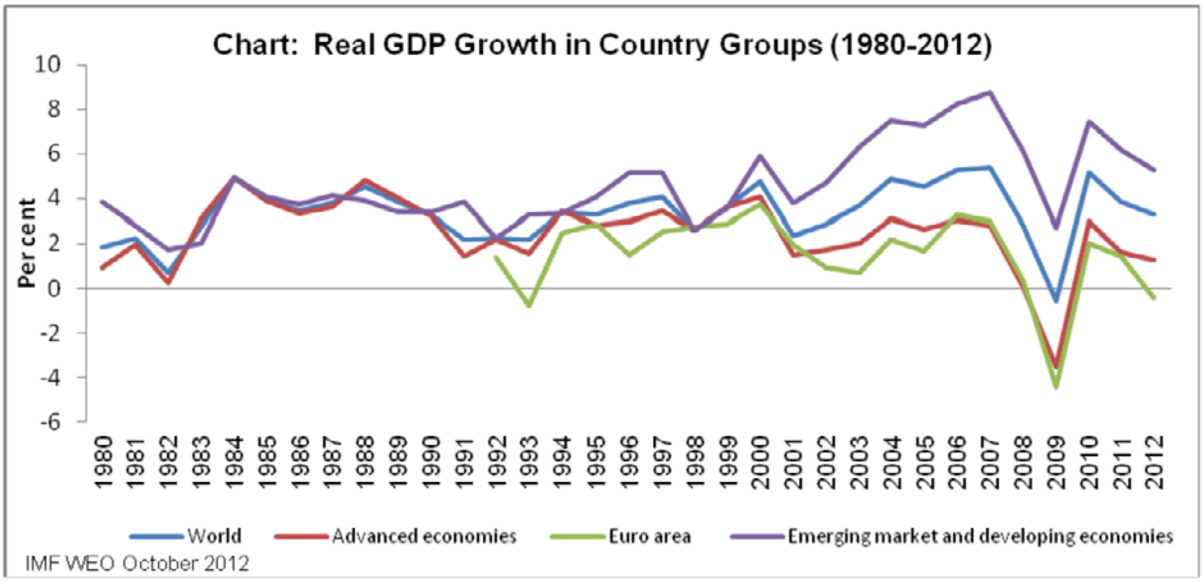
12. Now let me draw your attention to the other sub-topic of discussion "*Gauging the potential of emerging markets*". Many emerging market and developing economies (EDEs) have done well over the past decade and through the global financial crisis (Table). Growth in these economies accelerated during 2003–07, even as growth in advanced economies was considerably lower, triggering a vigorous debate on whether EDEs had decoupled from the advanced economies.

Table: Cross-Country Growth Rates of Real GDP (at market prices)*

Country / Country Group	2007	2008	2009	2010	2011	2012 P
1	2	3	4	5	6	7
World	**5.4**	**2.8**	**-0.6**	**5.1**	**3.8**	**3.3**
Advanced Economies	**2.8**	**0.1**	**-3.5**	**3.0**	**1.6**	**1.3**
Germany	3.4	0.8	-5.1	4.0	3.1	0.9
Japan	2.2	-1.0	-5.5	4.5	-0.8	2.2
Singapore	8.9	1.7	-1.0	14.8	4.9	2.1
United Kingdom	3.6	-1.0	-4.0	1.8	0.8	-0.4
United States	1.9	-0.3	-3.1	2.4	1.8	2.2
Euro Area	**3.0**	**0.4**	**-4.4**	**2.0**	**1.4**	**-0.4**
Emerging and Developing Economies	**8.7**	**6.1**	**2.7**	**7.4**	**6.2**	**5.3**
Brazil	6.1	5.2	-0.3	7.5	2.7	1.5
China	14.2	9.6	9.2	10.4	9.2	7.8
India	**10.0**	**6.9**	**5.9**	**10.1**	**6.8**	**4.9**
Indonesia	6.3	6.0	4.6	6.2	6.5	6.0
Russia	8.5	5.2	-7.8	4.3	4.3	3.7

*: Calendar Year P: Projected

Source: International Monetary Fund, World Economic Outlook (WEO), October, 2012



13. EDEs proved more resilient against the Great Recession than advanced economies. Successful reforms from the 1990s have made the EDEs more responsive to market forces. The latest World Economic Outlook (IMF – Oct 2012) has indicated that the marked improvement in the resilience of EDEs – measured by their ability to sustain economic expansions and recover quickly form downturns – is attributed to better policy making (countercyclical policy, inflation targeting, and flexible exchange rate regimes) and improved policy space (characterized by low inflation and favorable fiscal and external positions) coupled with reduced incidence of shocks, more specifically the homegrown shocks. The EDEs are spending more time in expansions and are having smaller downturns than advanced economies. Consequent to the increased resilience, the EDEs have virtually led the post crisis recovery and account for almost all global growth.

14. While the share of EDEs in global output is still small at about 30%, the contribution of EDEs to global growth has been increasing at about 70%. One remarkable development over the last decade has been the narrowing, and now almost total elimination, of the "investment gap" between advanced economies and EDEs. Investment in advanced economies has decelerated and even declined, reflecting their lower growth rate, aging populations and much higher capital base. In absolute terms, not too long ago (2005), investment in EDEs was a quarter of that in advanced economies. Today, EDEs invest about the same as advanced economies in US$ terms – around US$ 5.5 trillion.

15. The recent growth in some emerging market and developing economies has been supported by capital inflows, strong credit growth, and for those that export commodities, by the continued strength of commodity prices, which are prone to reversals given the increasing financial interconnectedness, through trade, finance and confidence channels. This suggests that these economies' prospects might not be that robust (Frankel, 2012)[2]. Though the EDEs displayed relative resilience to external shocks and put up a stronger economic growth performance during the crisis period, the notion of a complete decoupling of developing and developed countries appears impossibility. While the Global Financial Crisis dented the decoupling hypothesis to a large extent, the Eurozone crisis which has escalated since May 2012 through fiscal slippages, banking downgrades and political uncertainty, seems to have completely demolished it. Moreover, some of the policy space the EDEs built over the past decade was used up during the global crisis and has not yet been

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[2] Frankel, Jeffrey, 2012, "Will Emerging Markets Fall in 2012?" *Business & Management Journal*, Vol. 2, No. 2, pp. 119–20.

fully rebuilt, increasing the vulnerability of these economies to shocks, both external as well as internal.

16. It is not unexpected therefore, that lately, the EDEs' growth has been slowing down. Apart from the negative spillovers from the macroeconomic conditions in advanced economies, deleveraging and financial uncertainties have led to volatile capital flows. Additionally, diverse factors specific to the domestic economies of the EMEs have also been responsible for their slowdown. Chinese economy slowed sharply, owing to a tightening in credit conditions (in response to threats of a real estate bubble), a return to a more sustainable pace of public investment, and weaker external demand in advanced economies due to their slowdown. China's surplus, for instance, fell to 2.8% of GDP in 2011 from more than 5% in 2010. China's growth in Q2 of 2012 fell to a three-year low of 7.6 per cent, down from 8.1 per cent in Q1. China's economy continues to weaken, with the industrial sector growing by just over 9 per cent in July, the lowest in three years. India's activity suffered from waning business confidence amid slow approvals for new projects and sluggish structural reforms and policy environment designed to rein in inflation. Brazil's economy, in the first quarter of 2012, grew at its slowest pace (at 0.2 per cent q-o-q) in more than two years. Brazil has been hit by falling commodity prices and capital outflows, and central and Eastern Europe, by weak demand in the EU and retrenchment by euro area banks.

17. Many of the larger and faster growing EDEs are close to, or above, potential, which suggests that they will not be able to drive global growth as before. A perceptible shift in the growth strategy of some EDEs in favour of increase in domestic consumption and demand, entailed significant rise in wage levels which is adding to inflationary tendencies. The scope for policy maneuverability in the EDEs at present seems to be limited as compared to 2008–09. While during the time of Global Financial Crisis, the domestic factors in EDEs were supportive which encouraged them to put in place monetary and fiscal stimulus measures, the domestic environment in most of the EDEs during the Eurozone crisis is not conducive either because of rising inflation or fiscal tightness or widening current account deficits or combination of all, broadly reflecting the legacy of Global Financial Crisis. Coming to the specifics, the EDEs' capacity to provide monetary stimulus is constrained by rising inflationary expectations, and their ability to announce any aggressive fiscal stimulus is limited by the mounting gross public debt.For example, in the depths of the 2008 credit crunch, China made 4 trillion Yuan (US$ 586 billion) fiscal injection over two years; and surge in bank credit by 17.6 trillion Yuan helped prop up the global economy. China would now find it difficult to set in motion a big fiscal stimulus as its official government debt, though only 27 per cent of GDP, crosses 60 per cent if bank lending to local governments are included. In the circumstances, it is perhaps appropriate to focus on group of countries where there is some elbowroom for stimulus measures. While China, Indonesia and Russia have relatively higher capacity to use monetary and fiscal policies to support growth, Egypt, India, Brazil and Poland have the less room for a stimulus[3].

18. There is another line of thinking which suggests that in the event of weak consumption and investment demand, EDEs would need to discover innovative ways of boosting aggregate demand in a non-inflationary manner. In a few EDEs with poor infrastructure facilities, scaling up infrastructure investment provides one such avenue, just as reconstruction in Japan and Thailand is expected to ignite reacceleration of output.

19. Questions, nevertheless, remain about how smooth and durable the transition from export-oriented growth to domestic demand will be, especially in economies where household debt is relatively high. It is also not clear what the shift in the composition of

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3 *The Economist* ranking of 27 emerging economies according to their monetary and fiscal wiggle-room, January 26, 2012.

growth would mean for policies, in particular, if economies in the region were to intervene less in the foreign exchange markets.

20. To conclude, EDEs have certain positives on their side in the longer term perspective. Late demographic transition suggests that these countries would continue to enjoy the bonus of productive workforce in the coming years, and the life cycle hypothesis suggests that EDEs may account for a significant portion of global savings. With these advantages on their side, stronger autonomous growth by EDEs, driven by domestic demand, combined with structural reforms in both advanced economies and EDEs, would clearly help maximize positive feedbacks that benefit all. However, despite some decoupling, EDE growth remains bound to recovery in advanced economies. Rebalancing growth towards domestic consumption in EDEs is under way, but it will be many years before they can become self-propelling engines of growth. In the given scenario to expect that the EDEs, by themselves, will be able to lift global growth to the pre-crisis levels appears to be unrealistic.

III. Indian growth and outlook

India's growth performance

21. After a sharp recovery from the global financial crisis and two successive years of robust growth of 8.4 per cent, GDP growth decelerated sharply to a nine-year low of 6.5 per cent during 2011–12. There has been a decline in the average savings rate from 35.0 per cent during 2005–08 to 32.7 per cent during 2008–11, led by a sharp decline in public sector saving rate that has not been offset by private savings. The reduction in the average public sector savings rate in the post-global crisis period largely reflects the impact of fiscal stimulus measures as well as the decline in the contribution of non-departmental enterprises. Average investment rate has also declined in the post-crisis period.

22. Notwithstanding the slowdown in recent years, India's real GDP growth rate has remained among the highest in the world. As observed by the Prime Minister in his intervention at the meeting of the full Planning Commission on September 15, 2012, "*Indian economy ended the Eleventh Plan with some notable achievements. The economy grew at an average annual rate of 7.9 per cent. This is commendable for a period which saw two global crises – one in 2008 and another in 2011.*"

Growth outlook

23. In the "First Quarter Review of Monetary Policy Statement for 2012–13" (FQR) issued by the Reserve Bank of India on July 31, 2012, the Reserve Bank had revised downwards the projected GDP growth from 7.3 per cent to 6.5 per cent for 2012–13 in the backdrop of deficient monsoon and weak industrial activity. The mid-quarter review (MQR) of monetary policy issued on September 17, 2012 stated, *"Economic activity picked up modestly in Q1 of 2012–13 in relation to the preceding quarter; but the sluggish momentum of value added in Q1 was evident across all sectors of the economy, and particularly in industry. Lead indicators point to slack activity in Q2 as well. …".* Furthermore, the MQR stated that *"….Domestically, growth continues to be weak amidst a negative investment climate; however, the recent reform measures undertaken by the Government have started to reverse sentiments. The Government undertook long anticipated measures towards fiscal consolidation by reducing fuel subsidies and selling stakes in public enterprises. Further, steps taken to increase foreign direct investment (FDI) should contribute to both greater capital inflows and, over the long run, higher productivity, particularly in the food supply chain."*

IV. Stimulating growth – The way forward

24. It would be important to recreate the favourable macroeconomic environment in India that prevailed prior to the global crisis which ensured a growth rate of over 9 per cent

for 3 consecutive years (2005–06 to 2007–08) – namely moderate inflation, fiscal consolidation and a low order of current account deficit. This may not be entirely feasible in the short-term, the external environment being what it is and given its interlinkages with the domestic economy. However, it is imperative that a concerted policy effort is adopted to bring back the economy on rails.

25. Measures are also needed to improve the flow of resources to infrastructure sector on a commercial basis. While this has several dimensions, the setting up of Infrastructure debt funds is a positive move in this direction. Some of other issues include rationalization of stamp duties across states and re-look at tax treatment of Pass-Through-Certificates (PTC). Alternative means of risk mitigation through CDS or bond insurance are being explored. More players are also needed to help corporate bond market acquire depth and vibrancy.

26. The envisaged resumption of the fiscal consolidation process in the Union Budget 2012–13 and the recent hike in the prices of retail prices of petroleum products (towards capping of budgetary subsidies) are also important steps in this regard. While increase in the retail prices of petroleum products could lead to short-term price pressures, these are likely to have a long-term beneficial impact on the macroeconomic environment. Sustained fiscal consolidation would also help to turnaround public sector savings which along with private sector savings would be important for financing investment requirements. In this context, the need to reverse the migration of household savings from financial assets into gold, would also be important. This would also help to mitigate the pressure on the balance of payments, to some extent. Ensuring adequate supply side response will be vital.

27. As stated in the Mid-Quarter Review, monetary policy also has an important role in supporting the growth revival. *".. several challenges remain, one of which is persistent inflation. But, as policy actions to stimulate growth materialize, monetary policy will reinforce the positive impact of these actions while maintaining its focus on inflation management. Only this will ensure that the economy derives the maximum benefit from the recent, and anticipated, fiscal and supply-side policy measures*."

28. I would conclude by drawing on one of the most important lessons of the crisis that there is a need to deal with the procyclicality by building up the resilience of the banking system and moderating the credit cycle in the upturn phase of the economy to prevent large financial imbalances building up in the economy which could prove to be disastrous when the economy enters the downturn phase. There would, thus, certainly be a tradeoff between growth and stability in the short term. In the long term, growth and stability are not mutually exclusive but are interdependent with one feeding on the other. *Stability without growth is regressive and growth without stability is disastrous.* The policies that are being put in place to build resilience and stability into the system, while they may appear impacting the growth in the short term, are certainly going to have a positive effect on the growth prospects in the medium to long term. As regards the emerging market growth story, while these economies have, with adequate policy space created out of better policy making, supported the global growth so far, it would be too much to expect them to continue to shoulder the burden on a long term basis. These economies are already feeling the brunt of global slowdown, uncertainty in financial markets and very accommodative monetary conditions in the advanced economies. At the same time, they do not have adequate monetary or fiscal space due to legacy of crisis. Finally, coming to Indian scenario, there is a slowdown in Indian growth story. We need to reflect on the shortcomings in the system, make amends and get our act together to spur growth. Bringing the fiscal and current account deficits under control and addressing the supply side issues would be the key. However until the global conditions improve it would be difficult to achieve the pre-crisis growth rates. Conferences of this kind contribute significantly in pursuit of optimal solutions to challenges we face today.

Now, let me join the panel in discussing these issues further.....