Urjit R Patel: Financial system and the macroeconomy

Opening remarks by Dr Urjit R Patel, Governor of the Reserve Bank of India, at the Centre for Advanced Financial Research and Learning (CAFRAL) Conference on "Financial System and the Macroeconomy", Mumbai, 7 December 2017.

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1. It gives me great pleasure to be here this morning to share some observations and thoughts. The theme of this international conference: “Financial System and the Macroeconomy”, and the papers that are slated for presentation touch upon a number of issues that the Reserve Bank has been grappling with. (Needless to say, some of the conference participants who follow the Indian economy closely would already be aware of what I am about to briefly enunciate, but others may not, and these remarks would, I hope, be helpful to them.)

2. For us in India, an eventful 2017 is drawing to a close with important transformations in place, viz., a new monetary policy framework with decision making by a Monetary Policy Committee (MPC); demonetisation of high value currency notes; introduction of a goods and services tax (GST) regime; the Insolvency and Bankruptcy Code (IBC); promulgation of the Banking Regulation (Amendment) Act and a recapitalisation plan for government-owned banks. As these key changes mould India’s financial sector landscape, let me take this opportunity to briefly explain how they will shape the outlook.

3. **Entrenching macroeconomic stability:** Two significant developments have taken place in the recent period. First, the primary objective of monetary policy in India has been defined explicitly “to maintain price stability while keeping in mind the objective of growth". Second, an MPC has been constituted with the task of setting the benchmark policy rate in pursuit of this goal defined in the amended RBI Act (2016). The new monetary policy framework has been playing an important role in shaping inflation expectations and outcomes. With some disinflation underway, inflation expectations are, perhaps, getting re-anchored, indicative, in part, of the credibility earned by the new framework; but these are early days, and hence considerable caution and vigilance is warranted on the inflation front. Recent success in containing inflationary pressures needs to be viewed in the broader context of entrenching macroeconomic stability in which the Government has played a crucial part.[1]

4. Alongside, the current account deficit remains within sustainable levels, other indicators of external viability such as the ratios of indebtedness to GDP and/or reserves are also reflecting a healthy improvement. The Government has pursued the path of fiscal consolidation and the ratio of public debt to GDP is gradually declining. International investors have warmed to where the Indian economy is currently positioned and this is reflected in sizeable foreign investment inflows. Meanwhile, domestic financial markets have shown resilience and stability in spite of escalation of global geo-political uncertainty and heightened volatility in financial markets. These developments have enabled the build-up of “buffers” against unforeseen shocks.

5. **Taming the non-performing assets problem:** A landmark development relating to resolution of stressed assets is the Insolvency and Bankruptcy Code (IBC) 2016. From the Reserve Bank’s point of view, a great enabler in this context has been the Banking Regulation (Amendment) Ordinance promulgated in May and subsequently enacted in August this year. By the authority it conferred on the Reserve Bank to issue directions to banks to initiate resolution processes, it scales up the ability of the Reserve Bank to deal decisively with stress in banks’ balance sheets and unclog the flow of credit to grease the wheels of growth. In the year ahead, we must seize this opportunity to overcome the debilitating problem of corporate loan delinquency and get our banks back into the mainstream of financial intermediation. The recently chalked out recapitalisation plan of the Government for public sector banks will ensure that flows to productive sectors (and credit-worthy borrowers) are not impeded and growth impulses are

nurtured. The Government has also proposed to take steps to improve the corporate governance of PSBs by strengthening boards, bringing objectivity into management appointments, and decentralising decisions to the professional board.

6. The risk-based supervisory process of the Reserve Bank keeps flagging the risks in the balance sheet of banks which are taken up with the institutions concerned for remedy. Previously, effective enforcement action on the specific violations/breaches has been a gap in implementation. The new **Enforcement Department** was established in April this year for this function; viz., concentrate on its mandate to develop a rule based, consistent framework to deal with breaches of law, rules and directions. Effective deterrence enforced through such actions is expected to contribute to strengthening the credit culture overall.

7. The Indian economy is at an important juncture. Our recent growth numbers may have disappointed some in the first quarter of this fiscal year, but the second quarter has recorded an uptick and the slowdown may well be bottoming out. If one sees far, structural changes that come with temporary disruptions can be growth and efficiency-augmenting in the medium to long term. This is what has happened, for instance, with the introduction of the GST. It should yield gains that will mean better tax compliance and a more efficient tax system that in turn will impart a permanent upward push to our growth. To add one more important reform to the list, there has been substantial liberalisation of Foreign Direct Investment (FDI) policy, embraced by FDI investors with record inflows to India.

8. Let us now turn outward and situate the Indian economy in an international backdrop. Today we are living in a world of ever increasing financial globalisation. The absolute size of capital flows today is large and, worryingly for policymakers, also volatile. Globalisation has brought about a rapid integration of markets across boundaries with swift and massive movements of capital in search of returns (so called “alphas” and “betas” depending on the current fad!). In its train have accrued tremendous gains in terms of global growth, trade and welfare, but it has also amplified risks, and in particular, the vulnerability to financial crises of overwhelming magnitude and speed. This begs the question: are we in an environment of excessive financialisation? Let us reflect on a few numbers. Total global external liabilities have grown from 30 per cent to 190 per cent of global GDP between 1980 and 2015, far outpacing the growth in global trade (from 19 per cent to 28 per cent of GDP over the same period). The main vehicle of this new globalisation has been cross-border banking flows, which constituted a third of global capital flows in the decade prior to the financial crisis. In parallel, the global trade network has become increasingly interconnected through supply chains that transcend national borders, and by the advent of new players, especially from the developing world. Emerging market and developing countries taken together contribute 37 per cent of global trade (up by about 15 percentage points since 2000). India’s cross border gross financial flows (both inflows and outflows) have also increased: to 47 per cent of GDP by 2016–17 from 12 per cent of GDP in 1990–91. Along with stable form of capital flows such as FDI that come with relatively long-lasting interest in domestic entities, foreign portfolio (both equity and debt) capital flows have also increased making the economy (***like that of other open emerging markets***) susceptible to enhanced volatility and sudden stop or reversal risks.

9. Therefore, as India – like other emerging markets – has undoubtedly benefited from globalisation, we are also more exposed than before to vulnerabilities that come in its wake. Our increasing dependence on the external world is reflected in outstanding external liabilities (both debt and non-debt), which increased from about 30 per cent of GDP in March 2005 to 41 per cent of GDP in March 2017. India’s net international investment position (i.e., outstanding assets minus liabilities) has moved over the period from about –7 per cent of GDP to –17 per cent of GDP. This is consistent with a prolonged phase of running current account deficits which have been financed by increasing net liabilities to the rest of the world. With easing of limits over the years, there has been a rise in foreign portfolio capital flows. (Of course, this has to be appreciated in the context of the obvious economic benefits from international financial flows into

capital scarce countries).

10. Movement of capital in and out of the country is often linked to policy cycles in other countries which throw up the challenges of international policy spillovers. With every new tail event, the churn becomes larger, the volatility ever higher, threatening to overwhelm the modest defences that emerging markets are able to muster. How does one protect policy independence in such a world? Do we need meaningful and deeper international policy coordination? Or, ***universal financial safety nets rather than the asymmetric ones*** available at present only to a small number of countries, which is more ***reminiscent of apartheid rather than universality***. Meanwhile, emerging markets that are at the receiving end of global financial turbulence, are systematically denied access to such risk sharing. The time has come to end this sectarian approach and to make the access to swap lines equally available rather than only for the privileged.[2] While emerging markets have shown a degree of resilience to the turmoil of recent years, they remain vulnerable to liquidity and bridge financing gaps that are debilitating even if transitory.[3] Against this background, building up adequate buffers in the form of foreign exchange reserves is a natural ***self-insurance*** to manage these risks better and thereby prevent the risks from assuming systemic proportions, threatening financial stability. In the absence of a broader swap network, the macroeconomic environment of each country will inform the choice of policy instruments. In such a milieu, international financial stability is endangered when the inadequacy of buffers precipitates a crisis in one country and assumes global proportions. Likewise, there cannot be any common code or uniform approach to capital account liberalisation. Nimble capital flows management needs to be intellectually mainstreamed (as also in practice) as a ***conventional*** matter-of-fact component of the macro-prudential toolkit. Indeed, any attempts to discourage the use of foreign exchange reserves as a macro-prudential tool would necessitate that capital flows have to be managed more actively. Conference deliberations today and tomorrow could, perhaps, help shape the dialogue in this regard.[4]

11. The conference may explore: How effective are such policies? Should we think of them as short-term interventions or long-term policies?

12. Financial stability is also endangered by asset bubbles. Yield chasing investors – both domestic and foreign – can catalyse (contribute to) frothiness in asset markets. How much attention should central bankers be paying to such froth in asset markets in deciding monetary policy?

13. The link between asset markets and the real economy is another area of continuing interest for central banks. While the issue probably came to the fore during the global financial crisis, the mechanisms and channels which link them qualitatively and quantitatively are of fundamental importance for monetary policy.

14. A related source of concern for policymakers is about managing inflation. There is growing global uncertainty regarding the determining factors of inflation, especially in advanced economies. Do we need to rethink the monetary transmission mechanism itself or is the recent weakening of the traditional link between policy and inflation just a temporary phenomenon?

15. A number of the papers in this conference will address some of these subjects. I look forward to fruitful discussions which will not just push the debate forward on these issues but, hopefully, also provide some enlightening policy insights.

16. Thank you.

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[1] The Government has been, inter alia, active in managing price pressures in some of the key food items.

[2] One aspect in this context which hasn't received the requisite attention is that those economies/central banks which are privileged members of this network are (implicitly and inadvertently) incentivised to be reckless or

follow policy that is sub-optimal from a global welfare perspective; in other words, is moral hazard perhaps exacerbated?

[3] Real economy implications on account of Hysteresis can be deep and durable.

[4] There needs to be considerable rethinking around the practice of “naming and shaming” countries with terms such as “currency manipulator”, especially since the economic logic behind this is doubtful.