Shaktikanta Das: Reflections on current policy issues facing the Indian economy

Speech by Mr Shaktikanta Das, Governor of the Reserve Bank of India, at the Investors' Roundtable, 9th Vibrant Gujarat Global Summit 2019, Gandhinagar, 18 January 2019.

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I am very happy to participate in the 9th edition of Vibrant Gujarat Global Summit. It is indeed a pleasure to be here and share my thoughts on various contours of the Indian economy. I thank the organisers of this event, namely the Government of Gujarat, National Investment and Infrastructure Fund and the Department of Economic Affairs, Ministry of Finance, Government of India for inviting me to this Roundtable.

2. As this august audience would know, India in recent years has emerged as one of the most vibrant economies in the world. Not only has India survived many global shocks successfully in recent years, it also tops the list of fastest growing emerging market economies (EMEs) in the world. According to the IMF's database, India's contribution to world growth has risen from 7.6 per cent during 2000–2008 to 14.5 per cent in 2018. Multilateral agencies are further optimistic on this as far as the medium-term outlook is concerned. Most importantly, India's growth story is backed by strong domestic fundamentals. For instance, (i) inflation has eased, (ii) central government remains committed to the fiscal targets, and (iii) the current account deficit (CAD) is far less than its peak level during the stress period (i.e., taper talk period of mid-2013).

3. Indian economy has witnessed an accelerated pace of domestic reforms in recent years. These reforms include, inter alia, the flexible inflation-targeting monetary policy framework, the Insolvency and Bankruptcy Code (IBC), the Goods and Services Tax (GST) and steps for enhancing foreign investments by liberalising the FDI regime and undertaking efforts to provide a conducive business climate.

Let me dwell a bit more on some of these aspects.

Inflation

4. First, let me talk about inflation. Maintaining price stability in the economy is a basic mandate for a central bank. Delivering low inflation by the central bank induces greater confidence among both domestic and global investors. India has witnessed significant disinflation since 2012–13 – with headline CPI inflation moderating from an annual average of 10.0 per cent in 2012–13 to 3.6 per cent in 2017–18 and 3.7 per cent in 2018–19 so far (April-December). As per the latest reading, headline inflation stood at a low of 2.2 per cent in December 2018. The disinflation was marked by the commitment of the Reserve Bank to bring down inflation in a sequential manner – to 8 per cent by January 2015, 6 per cent by January 2016 and 5 per cent by Q4 of 2016–17 – which was called the glide path for inflation. This, in turn, paved way for the formal adoption of flexible inflation targeting (FIT) through a legislative amendment to the Reserve Bank of India (RBI) Act under which price stability has been mandated as the primary objective of monetary policy, while keeping in mind the objective of growth. Price has been defined in terms of a numerical CPI inflation target set by the government at 4 per cent with a tolerance band of ± 2 per cent. With the formal setting up of a Monetary Policy Committee (MPC), there has been a shift to a committee-based approach for determining the monetary policy. This has enhanced transparency and accountability of the decision making process.

5. Since the adoption of flexible inflation targeting in India, inflation has been reasonably range bound within the target band. I must add here that easing of global crude oil prices also augured well for our inflation outcomes.

Financial Sector

Let me elaborate on some of the major policy developments in domestic financial sector in recent years.

Banking sector

6. We all know that Indian banking sector had emerged largely unscathed in the aftermath of the global financial crisis. However, headwinds from international and domestic economic developments posed challenges to the banking sector in recent years. Indian banking system is on the cusp of a transformation, aided by recent policy measures to reduce vulnerabilities and improve its financial health. Several initiatives are underway to strengthen the regulatory and accounting frameworks aimed at increasing the resilience of the institutions. The Reserve Bank's initiatives in the recent period are aimed at ensuring better and timely recognition of stressed assets, sufficient provisioning and an efficient resolution process. Recent supervisory data suggests that these efforts are bearing some results and incipient signs of improvement in asset quality of banks are emerging. After reaching a peak of 11.5 per cent in March 2018, the gross non-performing asset ratio improved to 10.8 per cent in September 2018. As per the current assessment of the Reserve Bank, the ratio may further improve to 10.3 per cent by March 2019[1].

7. The new resolution framework with the Insolvency and Bankruptcy Code (IBC) as its lynchpin and RBI's regulatory framework as its facilitator, is a game changer. It endeavours to create an environment in which maximum value can be realised from troubled assets, bolstered by the early identification of incipient stress. The shift of power in favour of creditors in the IBC framework will facilitate speedier and impartial resolution process and help in improving the credit repayment culture. The framework has been providing a market-driven, time-bound process for insolvency resolution of a corporate debtor, thereby helping financial institutions to clean up their balance sheets. Most importantly, it is aiding a paradigm shift in the extant credit culture and discipline.

8. The progress of IBC framework so far has been encouraging and has resulted in better recovery as compared to the earlier mechanisms. Data available till January 3, 2019 suggest that the resolution processes have been approved in 66 cases, involving around ₹800 billion as resolution value to creditors. The gradually building resilience of the banking sector is evidenced by the fact that banks have improved their profitability ratios and capital positions. Other soundness indicators such as the tier I leverage ratio at 6.7 per cent and the liquidity coverage ratio at 134.8 per cent as at end-September 2018 remain well above the minimum regulatory requirements. Provision coverage ratio also increased to 52.4 per cent at end-September 2018 from 48.3 per cent at end-March 2018. Bank credit is recovering from the risk aversion of recent years. Bank intermediation in the flow of resources to the commercial sector is regaining lost ground.

9. The growing size and complexity of the Indian financial system warrants strengthening of corporate governance systems in banks. Incidence of financial frauds in recent times further underscores the significance of sound corporate governance standards in banks. The Government, the Bank Board Bureau and the Reserve Bank are currently engaged in developing an objective framework for performance evaluation and this should redefine the contours of corporate governance in the public sector banks (PSBs) with a focus on transparency, accountability and skills.

10. On the consumer protection front, improvements in grievance redressal, introduction of innovative products for digital payments, and measures to improve cyber security in banking are all expected to expand financial inclusion and provide financial services efficiently and cost-effectively. The Reserve Bank is cognisant of the fact that deepening of digital payment systems will facilitate greater access to institutional finance by the informal sector, furthering the cause of

financial inclusion. We have very recently constituted a High Level Committee on Deepening of Digital Payments with Shri Nandan Nilekani as Chairman to suggest measures for increasing digitisation of payments and enhance financial inclusion through digitisation.

11. The regulatory approach of RBI has been and will be aimed at ensuring that the banking system withstands the transitory difficult phase and keeps playing a positive intermediation role in supplementing the financial needs of our growing economy.

Non-banking financial sector

12. Non-banking financial sector is another segment that plays an important role in the Indian financial system, given its unique position in providing complementarity as well as competition to banks. This sector, with a size of around 15 per cent of combined balance sheet of scheduled commercial banks (SCBs), has been growing robustly in recent years, providing an alternative source of funds to the commercial sector. However, the sector has faced challenging times recently.

13. The debt default of a systemically important NBFC highlighted the vulnerability and need for strengthening regulatory vigil on the sector in general and on asset liability management (ALM) framework in particular. The Reserve Bank intends to strengthen the ALM framework for NBFCs and harmonise it across different categories of NBFCs with the objective of enabling the NBFCs to play a vital role in our economy. In order to allow additional access to funding for the NBFC sector in the wake of the recent crisis, the Reserve Bank has relaxed the norms for NBFCs to securitise their loan books. In addition, banks have been allowed to provide partial credit enhancement to bonds issued by the systemically important non-deposit taking non-banking financial companies and Housing Finance Companies. This measure will enhance credit rating of bonds and enable the companies to access funds from the bond market on improved terms. We are keen to foster a well regulated, well-functioning and vibrant NBFC sector.

External Sector

14. India's external sector has remained resilient in recent period despite terms of trade losses due to the firming up of international crude prices and uncertain global demand conditions. The current account deficit since FY 2013–14 (i.e., period after the taper talk) has been below 2 per cent of GDP, though it rose to 2.7 per cent in the first half of the financial year 2018–19 reflecting elevated crude oil prices. Modest current account deficit in recent years was accompanied by robust flows of foreign direct investment (FDI). Strong FDI inflows and build-up of foreign exchange reserve buffers have helped India meet its external financing requirements despite domestic capital market facing sizeable outflows of foreign portfolio investment.

15. As a few advanced economies are on the path of monetary policy normalisation, there has been global portfolio rebalancing away from EMEs, including India. Another factor that has repercussions for India's external sector is the recent developments around Brexit. There are consequential policy challenges for India which enjoys strong trade and investment relations with UK and the EU. We will carefully weigh the challenges and opportunities that lie ahead and undertake appropriate policy responses.

16. As regards policy environment relating to the external sector, sectoral norms for Foreign Direct Investment have been eased gradually and now 100 per cent FDI is permitted in all sectors, barring a few prohibited sectors. In recent years, the focus has been to simplify the FDI policy regime by abolishing the Foreign Investment Promotion Board, rationalising various procedures, introducing e-biz portal as a single window for obtaining clearances from the central government and using information technology as enabler to make governance more effective. Two days ago, we have also substantially rationalised and liberalised the regulations governing the External Commercial Borrowings by the Indian entities to improve ease of doing business. The full impact of all these reforms and a stable domestic macroeconomic environment will

fructify in coming years. In fact, gross FDI inflows in India were at a record high of US$ 61 billion in 2017–18.

17. Further, external debt to GDP ratio has fallen from 22.4 per cent at end-March 2013 to 20.8 per cent at end-September 2018. Other external indicators, viz., import cover and short-term debt to reserves ratio are also better, relative to the taper talk period of mid-2013 when the Indian rupee had come under severe pressure).

Table: External Sector Indicators

(Per cent, unless indicated otherwise

Indicator	End-Mar. 2013	End-Mar. 2017	End-Mar. 2018	End-Sep. 201
1. Current account deficit/GDP ratio*	4.8	0.6	1.9	2.7*
2. External Debt to GDP ratio	22.4	20.0	20.5	20.
3. Ratio of Reserves to Total Debt	71.3	78.5	80.2	78.
4. Ratio of Short-term Debt to Reserves	33.1	23.8	24.1	26.
5. Reserves Cover of Imports (in number of months)	7.0	11.3	10.9	9.

*Average during the Financial Year; **: Average for H1 of 2018-19

Challenges and Outlook

18. India is widely believed to remain world's fastest-growing major economy in the medium to long term. The growth projections of several global agencies rank India at the top among the G-20 economies. In the medium term, annual growth is projected at around 7.5 per cent by the IMF and the World Bank. It is likely that growth will be more sustainable now, propelled by investment and private consumption. The latest estimates of national accounts suggest that investment activity has accelerated by 12.2 per cent during 2018–19 as compared to 7.6 per cent in 2017–18. Investment activity is expected to strengthen further as the benefits of recent structural reforms begin to materialise.

19. Going forward, the foremost priority is to preserve domestic macroeconomic and financial stability, especially in a global environment that is clouded by high uncertainty. Not only downward risks to global growth, trade and investment have risen, the spill over effects on emerging markets due to increase in global interest rates could also be profound. We, therefore, need to brace ourselves for any sudden bout of global financial market turbulence that domestic economy and financial markets may face in the period ahead. In such a milieu, domestic macroeconomic policy framework needs to be supported by sound financial supervision and regulation.

20. Let me highlight the key policy challenges that the Indian economy confronts at the present juncture.

(a) Inflation

- Although headline inflation has moderated significantly in recent years, as discussed earlier, its major components – inflation in food, fuel, and inflation excluding food and fuel – are exhibiting wide divergences this year. While food inflation has turned negative since October 2018 and fuel inflation has been highly volatile, inflation excluding food and fuel remains sticky at close to 6 per cent. Such wide divergences and large volatilities in inflation across major groups pose challenges for inflation assessment. Balancing the objectives of inflation and growth under a flexible inflation targeting framework would warrant careful analysis of every new data.

(b) Financial Sector

- There is need for continued vigil on the asset quality of banks as well as resolution of stressed assets with a focus on implementation of the new resolution framework. It will remain critical to ensure that further slippages are contained.
- While technology provides opportunities for growth and innovation in the banking sphere, it also involves newer challenges and risks. Cyber risk is a major challenge. Formulation of comprehensive cyber risk and resilience policies and diligent implementation is critical.
- Another area where policy action is required is corporate governance in banks with a focus on transparency and accountability.

(c) External sector

- While positive policy settings and continued macroeconomic stability helped contain India's external vulnerabilities, a close monitoring of external sector is required, given the sharp movements in global crude oil prices and global financial market volatility. These are the two global shocks that have implications for our CAD and financial flows.
- Another challenge that Indian companies may face pertains to developments around Brexit. Indian companies and policy makers need to suitably weigh all opportunities and challenges, and accordingly re-strategise to respond appropriately.

21. Let me conclude by saying that at the RBI, we are committed to play our role as the monetary authority for maintaining mandated price stability objective while keeping in mind the objective of growth; and as the regulator and supervisor of the banking sector and payment systems. We will take necessary steps to maintain financial stability and to facilitate enabling conditions for sustainable and robust growth.

22. In October 2018, when I had absolutely no clue that I would be landing up in the Reserve Bank in December 2018, I had tweeted, "Central Banks across countries have a very critical role at the current juncture. The challenge is to try and read the situation and take decisive steps in pursuit of their multiple responsibilities." As Governor of the Reserve Bank of India, it would be my endeavour to act according to these principles.

Thank you.

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[1] Financial Stability Report, December 2018.