

## **Role of Central Bank in Managing Market Volatility and Preserving Financial Stability<sup>1</sup>**

Shri Jyoti Kumar Pandey, Senior Program Director, CAFRAL, CEOs and top executives, senior bankers, my colleagues from the Reserve Bank, Ladies and Gentlemen. A very good morning to everyone. At the outset, let me thank CAFRAL for hosting this program of contemporary relevance and inviting me to deliver the Keynote Address. I deem it an honour to be addressing the distinguished participants present in this virtual conference.

2. *“There are decades when nothing happens; there are weeks when decades happen.”* So said Vladimir Lenin just over a century ago. Past few years were marked by momentous developments in global economy and financial markets threatening the prospects of financial stability. The deleterious impact of pandemic, resultant supply chain upheaval along with decades-high inflation, Ukraine conflict - the most serious war in Europe since World War II - causing geopolitical tensions and geoeconomic fragmentation, and the aggressive tightening led to serious market turmoil worldwide.

3. Managing recurring financial storms of historic proportions posed formidable challenges to policy makers worldwide. The central banks globally announced both conventional and unconventional measures to head off wider market disruptions and economic apocalypse. RBI undertook a slew of innovative and unorthodox measures to help the Indian economy and financial markets navigate the storms resulting in restoration of market functioning and guiding the economic recovery catapulting the stature of the Indian economy as global growth driver. Under this backdrop, it is imperative to comprehend the scale of challenges and the underlying objective behind the regulatory action.

### **Global Conjuncture - Rebalancing of Economic Order**

4. The year 2020 stands out as an unprecedented period in modern economic history. The COVID-19 pandemic, with its three devastating waves, led to a global

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<sup>1</sup> Keynote Address delivered by Shri Radha Shyam Ratho, Executive Director, Reserve Bank of India at the virtual program on “Developments in Financial Market : Trends & Challenges” organised by CAFRAL on September 20, 2024. Contributions of Sabyasachi Sarangi are gratefully acknowledged.

health crisis and a significant loss of lives and livelihoods. This event echoes the 1918 influenza pandemic, which saw four waves and lasted until 1920. The lockdowns imposed during the pandemic caused severe supply breakdowns as the commercial establishments shuttered around the world.

5. Meanwhile government stimulus meant to keep the economy afloat drove a surge in inflation. As per the estimates of the IMF, fiscal support pledged during March 2020 to October 2021 stood at \$16.9 trillion or 16.4 per cent of global GDP, with \$14.5 trillion provided by advanced economies (AEs) and \$2.4 trillion provided by emerging market economies (EMEs). The total monetary support was \$19.0 trillion or 18.4 per cent of global GDP, \$16.1 trillion by AEs and US\$ 2.9 trillion by EMEs.

### **Global Supply Chain Upheaval**

6. In recent years, containerized trade, the backbone of global value chains, has experienced unprecedented disruptions. Later, surging trade demand surpassed shipping capacity, itself affected by massive operational disruptions in key ports. In 2023, there were two events of global relevance. First, a severe drought affected the operation of the locks in the Panama Canal, resulting in a reduction in throughput and restricting the size of vessels able to transit the canal. Later in the year, militant groups carried out attacks in the Red Sea, forcing shipping lines to reroute ships servicing the Asia-Europe and Asia-US East Coast trade routes through the Cape of Good Hope. These developments together with very loose fiscal policies as outlined earlier resulted in global inflation.

7. The cost-of-living crisis became the hallmark of the post-COVID-19 recovery and continued to cascade through the global economy. In advanced economies, the crisis manifested as high inflation and growing financial fragilities. In the developing world, import dependencies, boom - bust commodity cycles, trade disruptions, the war in Ukraine and climate-vulnerable food systems combined to destabilize finances, bringing countries closer to a debt crisis.

8. The monetary easing and fiscal stimulus unveiled by central banks and governments were not withdrawn in time as the “transitory narrative” gained momentum. Excessive fiscal stimulus, specifically in the US, coupled with the rock

bottom interest rates not being normalised in time resulted in the surging inflationary impulses remaining unabated.

### **Synchronous Monetary Tightening**

9. Beginning in 2022, central banks around the world tightened monetary policy at an unprecedented pace to contain the rise in global inflation that began in 2021. With few exceptions, most central banks started their tightening phase with a conventional 25 basis point increase in their policy rate and progressively increased the size of their hikes when inflation proved to be more persistent and broad-based than expected. From a historical perspective, two features of the tightening episode stood out. First, it was the most synchronised tightening episode of the past 50 years. By August 2022, more than 95% of central banks had started to increase their policy rates, with many of them also having begun to shrink their balance sheets. By way of comparison, the percentage of central banks hiking rates was rarely above 50%, and it reached 90% only during the global inflation surge of the 1970s. Second, central banks raised policy rates at about twice their historical pace. In fact, for many countries the cumulative increase in policy rates significantly exceeded that during the early stages of all previous tightening episodes.

### **Global debt issue**

10. The global financial crisis of 2007, followed by the pandemic of 2020 and its enduring effects, has led to significant increases in the ratios of public debt to GDP in both high-income and emerging economies. By 2028, these ratios are projected to reach 120% and 80%, respectively<sup>2</sup>. For high-income countries, this would mark the highest levels since the Second World War, while for emerging markets, it would represent an unprecedented peak. For an extended period, the dynamics of debt were remarkably favourable, largely due to exceptionally low real interest rates. However, the landscape has shifted dramatically, as rising interest rates have rendered debt servicing increasingly burdensome for many nations posing risks to debt sustainability. Both public and private debt continue to mount in advanced economies and emerging

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<sup>2</sup> IMF Article - The Fiscal and Financial Risks of a High-Debt, Slow-Growth World – March 28, 2024

markets alike, posing the risk of exacerbating adverse shocks and heightening vulnerabilities to future growth.

### **Globalisation - The Shifting Contours**

11. Perceptions of the benefits of international trade and multilateral cooperation have been changing in the recent years. The Sino - US trade war during 2018-19 followed by the COVID-19 pandemic and the war in Ukraine have led to the sense that rather than making countries economically stronger, globalisation exposed them to excessive risks. As such these developments turned deglobalisation into a mainstream topic. Coupled with increasing geopolitical tensions, these perceptions have fuelled narratives arguing for localisation of supply chains and trade policy strategies based on geopolitical concerns. In the public debate, terms such as “offshoring” and “outsourcing” have been replaced by “re-shoring”, “near-shoring”, “friend- shoring” and “decoupling”.

12. However, the pattern of export growth across regions since the fourth quarter of 2019 contradicts the notion of deglobalisation<sup>3</sup>. Emerging market economies’ export growth (about 15 per cent) has far outstripped that of advanced economies (about 1 per cent), strongly suggesting that globalisation is in fact continuing - after all, it is exactly the process whereby EM economies gain export market share versus the historically dominant advanced economies. Further, as per the DHL Global Connectedness Report 2024<sup>4</sup>, globalisation reached a high in 2022 and remained close to that level in 2023.

### **Economic sanctions - Bigger global shocks than ever before**

13. During the 1971 G10 Rome meetings, the former US Treasury Secretary John Connally shocked the world when, after discussions with a group of European finance ministers, he famously remarked<sup>5</sup>, “*The dollar is our currency, but it’s your problem.*” In this context, Mark Craney, former Governor of the Bank of England, highlighted his

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<sup>3</sup> FT Article on “the myth of deglobalisation hides the real shifts” dated August 23, 2024

<sup>4</sup> Put together by DHL and New York University’s Stern School of Business analysed around nine million data points and ranked the connectedness of 181 countries, accounting for 99.7% of the world’s GDP.

<sup>5</sup> The Economist - The dollar is our currency, but it’s your problem - published on September 06, 2023

concern about the hegemonic role of US Dollar. He claimed that given the widespread dominance of the Dollar in cross-border claims, it was not surprising that developments in the US economy could have large spillover effects to the rest of the world. As a way of highlighting the severity of this point, he broadened the Nixon era dictum of “the dollar is our currency, but your problem” to “*any of our problems is your problem*”.

14. Russia certainly experienced that “Dollar problem” in response to the Ukraine conflict. The Western Alliance froze nearly half of the Russian Central Bank’s estimated \$630 billion in foreign exchange and gold reserves, approximately 35 percent of Russian GDP and severely limited Russia’s access to the SWIFT payment system. The sanctions package imposed against Russia is unprecedented - not only in its scope and magnitude, but also because it targets a major world power. These actions represent a tectonic shift from the policy of neutrality signalling to the world that each country’s access to their forex reserves could become contingent on their foreign policy.

### **Climate shocks**

15. “Three things exercise a constant influence over the minds of men,” wrote Voltaire<sup>6</sup> in the mid-18th century: “climate, government and religion.” The world is reeling from record-breaking heatwaves, wildfires, and rainfall. The uncertainty surrounding the impact of climate change on the economy and financial system has posed a formidable challenge and dominated policy discourses worldwide. Climate action is an urgent global imperative, presenting policymakers with a fundamental trilemma<sup>7</sup> between achieving climate goals, fiscal sustainability, and the political feasibility.

16. The costs of inaction on global warming are potentially vast. But they're often not sufficiently factored in to asset valuations. The big danger is the climate Minsky moment, the term named after US economist Hyman Minsky for a sudden correction in asset valuations as investors simultaneously realise those valuations are

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<sup>6</sup> Renowned French writer

<sup>7</sup> IMF publication: Climate Crossroads: Fiscal Policies in a warming world: October 2023

unsustainable. Despite such forecasts, many financial models omit climate change factors that could make economic outcomes far worse than predicted. Many assume that climate change does not slow gross domestic product growth. Climate tipping points such as thawing permafrost or an ocean circulation collapse are rarely included. More fundamentally, many base predictions on past data, which can be an unreliable guide to the future.

17. Further, the impact of climate change on global food prices has recently been observed to be material as adverse weather related developments can result in a permanent impact on the ability to supply food. Food price rises once considered temporary are becoming a source of persistent inflationary pressure. Globally, annual food inflation rates could rise by up to 3.2 percentage points per year within the next decade or so as a result of higher temperatures, according to a recent study by the European Central Bank and the Potsdam Institute for Climate Impact Research.

### **Technological Challenges - A Growing Concern**

18. I am sure all of you are aware of one of the largest **IT outages** in history that occurred on July 19, 2024 (*Microsoft outage due to CrowdStrike patch*), which disrupted businesses and governments around the world. This outage was a stark reminder of the importance of cyber resilience in an increasingly digital and networked world. The financial sector is highly exposed to cyber risk. Almost one-fifth of the reported cyber incidents in the past two decades have affected the financial sector, with banks being the most frequent targets followed by insurers and asset managers.

19. Emerging technologies and innovation in financial services could exacerbate cyber risks. Although advances in artificial intelligence (AI) could help improve the detection of risk and fraud, for example, by observing anomalous behaviour, AI could also be exploited for malicious activities. Most notably, through generative AI (GenAI), more sophisticated phishing messages or deepfakes could be used for identity theft or fraud<sup>8</sup>. In addition, AI exposes firms to the risk of data set leakages. Looking ahead,

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<sup>8</sup> For example, in January 2024, scammers tricked employees of a multinational firm into transferring HK\$200 million (US \$26 million) by creating a group video call using deepfake technology.

the advent of quantum computing and its potential ability<sup>9</sup> to quickly break encryption algorithms used in financial systems could also magnify losses from cyberattacks.

### **The Indian Conjecture - Pole of economic attraction**

20. Amidst a challenging global economic climate, the Indian economy stands resilient and stable, bolstered by robust macroeconomic fundamentals and financial stability. India has ascended as the fastest-growing major economy globally and a pivotal contributor to global growth. Inflationary pressures are receding, driven by steady core disinflation and declining fuel prices. However, food inflation remains susceptible to recurring supply shocks, hindering a swift alignment of headline inflation with the target. The external sector is gaining strength, evidenced by a narrowing current account deficit and foreign exchange reserves reaching unprecedented levels. The financial sector is sound and dynamic, fostering double-digit credit growth, supported by high capital adequacy, solid earnings, and enhanced asset quality.

21. India has emerged as a focal point for global investors due to a confluence of factors that highlight its immense potential. In addition to the rapidly expanding economy and various structural reforms undertaken to enhance ease of doing business, the stability observed in the various segments of financial markets aided by robust financial health of banking system and external sector has paved the way for a more favourable investment climate. Additionally, expectation of policy continuity has also contributed to the decline in country risk premium as evidenced from narrowing of Credit Default Swaps (CDS) spread to 45 basis points from a peak of 300 basis points in 2013. While geo-political tensions linger and the world is becoming increasingly more fragmented, India's relative attractiveness has only increased.

I will elaborate on the health of external sector and banking system in a short while. Let me dwell upon the measures taken by RBI to address the concerns stemming from the vortex of global shocks in the recent years.

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<sup>9</sup> Dr. Michele Mosca, an expert from the University of Waterloo, has estimated a probability of ~15% that some of the fundamental public-key cryptography tools upon which we rely today will be broken by 2026 and a 50% chance by 2031.

## **Measures taken by RBI - Countering the Pandemic Impact**

22. The policy response included a combination of conventional as well as unconventional measures. Among the conventional ones, the policy repo rate was reduced by an unprecedented 115 basis points in two phases in 2020. The interest rate on the fixed rate reverse repo rate under the liquidity adjustment facility (LAF), under which market participants deposit their surpluses with the RBI, was reduced cumulatively by 155 basis points and it became the effective anchor for the evolution of money market rates and even longer-term interest rates. Banks' access to liquidity under the marginal standing facility, a lending window priced at 25 bps above the policy repo rate, was expanded. System level liquidity was also enhanced through large scale open market purchase operations and a one percentage point reduction in the cash reserve ratio (CRR) that freed up banks' resources.

23. Turning to unconventional measures, long-term repo operations (LTROs) and targeted long-term repo operations (TLTROs) were undertaken to augment systemic liquidity, lower the banks' cost of funds and influence longer-term interest rates more directly. While LTROs enhanced the overall liquidity in the system, TLTROs ensured the distribution of liquidity to specific sectors in need of funds. Additionally, when redemption fears gripped the mutual fund industry, a special liquidity facility for mutual funds (SLFMF) was crafted virtually over a weekend. When these liquidity measures encountered risk aversion among banks in on-lending the RBI's funds to troubled entities, special refinance facilities were provided to All India Financial Institutions (AIFIs) to mitigate sector-specific and small institution-specific liquidity constraints. On top TLTROs provided liquidity to banks for deployment in corporate bonds, commercial paper, nonconvertible debentures and bank loans to specific sectors.

24. In the first half of 2021-22, the RBI pledged its balance sheet to mitigating the impact of the pandemic and reviving the economy. From April through September 2021, the RBI engaged in asset purchases through a secondary market Government securities acquisition programme (G-SAP) which involved an upfront commitment on amounts to be purchased and impacted yields directly. In addition, special open market operations (OMOs) involving simultaneous purchase and sale of securities, which were liquidity neutral, were undertaken to distribute liquidity more evenly across the yield curve, thereby facilitating monetary transmission. Overall, liquidity



augmenting measures worth ₹17.2 lakh crore (8.7 per cent of nominal GDP of 2020-21) were announced since February 6, 2020<sup>10</sup>.

### **Uniqueness of RBI's measures**

25. There are some key differences between the actions taken by the RBI and the central banks in many advanced countries. In the process of liquidity injection the counterparties involved were banks; even liquidity measures for mutual funds, NBFCs and housing finance companies were largely channelled through the banks. There was no dilution of collateral standards which were primarily government securities, unlike the mortgage securities and commercial papers in the advanced economies. Despite large liquidity injection, the Reserve Bank's balance sheet did not show unusual increase, unlike global trend, because of release of earlier sterilised liquidity.

### **Indian Financial Markets - Stable and Resilient**

26. The domestic financial markets have weathered the recent shocks with resolute confidence and evolved in an orderly manner drawing strength from resilient economic activity and strengthening macroeconomic fundamentals.

27. Domestic Government security yields have exhibited signs of decoupling with the global yields highlighting inherent stability. The rangebound movement despite sharp sell-off in the emerging market peers and major countries' yields (upheaval in the global bond markets) has fostered a conducive atmosphere for attracting foreign capital. Even, a string of record GoI borrowing programme has failed to dent the sentiments. While India's inclusion in the JP Morgan's Government Bond Index - Emerging Markets (GBI-EM) has become a reality, the increasing interest of foreign participants is reflected through significant net FPI inflows amounting to USD 16.2 billion in the debt segment<sup>11</sup> so far this year.

28. As regards the trends in the Indian Rupee, it's a *tale of two eras* - one related to the Taper Tantrum in 2013 when India was infamously dubbed as one among the "Fragile Five" as the Rupee significantly depreciated against the US Dollar, and the other one, that we are witnessing currently - a period of broader stability covering

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<sup>10</sup> RBI Monetary Policy Report - October 2021

<sup>11</sup> Source: NSDL

various asset classes engendering congenial market conditions. Despite broad gains in the Dollar Index, the Rupee has exhibited range-bound trend aided by improved macro-economic fundamentals, strong portfolio flows and robust forex reserves. Rupee's historical volatility remained the lowest amongst major currencies in CY 2023 as well as CY 2024. This low volatility coupled with high carry (interest rate differential) has resulted in steady inflows. It is notable to highlight here that judicious forex intervention by the RBI has been aimed at containing undue volatility while anchoring exchange rate expectations with the overarching goal of letting the Indian Rupee find its value in the market.

29. Indian equity market has been scaling new peaks with market capitalization at an all-time high level of USD 5.5 trillion at end-August 2024<sup>12</sup>, up 323 per cent from the low of USD 1.3 trillion in March 2020. It is noteworthy to highlight that in the past, our equity market was largely influenced by the movements of foreign institutional investors (FIIs). Over time, however, domestic institutional investors (DIIs) gradually increased their presence and collectively held a larger share of the market at 18.9% at end-August 2024 than FIIs at 18.2%<sup>13</sup>. This ebullient trend has spurred analysts opining that "India remains in the early stages of the growth of what could be termed the cult of equity"<sup>14</sup>.

### **India's External Position - Strong and Ebullient**

30. India's external sector vulnerability indicators remain robust and much better as compared to earlier stress periods. India has the fourth largest foreign exchange reserves in the world with the latest data coming at US\$ 689 billion as on September 06, 2024. The ratio of short-term debt (original maturity) to foreign exchange reserves stood at 19 per cent at end-March 2024 as against 34 and 26 per cent at end-June 2013 and end-September 2018 respectively. The ratio of foreign exchange reserves to external debt was comfortably placed at 97 per cent as against 70 per cent and 79 per cent during the above periods. Import cover was at 11 months at early-August 2024<sup>15</sup> as against 9.5 months and 6.7 months during the above periods.

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<sup>12</sup> Source: CEIC Database

<sup>13</sup> Source: NSDL

<sup>14</sup> Chris Wood, Global equity head, Jefferies: Business Standard article dated July 19, 2024

<sup>15</sup> RBI Bulletin - August 2024 : State of the economy

## **Indian Banking Sector - Robust Cradle for Economy**

31. Scheduled commercial banks have continued to exhibit sustained improvement across various financial parameters. Gross Non-Performing Assets (GNPA) ratio of banks was 2.7 per cent at end-June 2024, the lowest since end-March 2011. The annualised slippage ratio, which measures new NPA accretions as a percentage of standard advances, continued to decline to reach at 1.3 per cent at end-June 2024. The provision coverage ratio (PCR) continued to improve to reach at 76.5 per cent by end-June 2024. Capital to risk-weighted assets ratio (CRAR) stood at 16.8 per cent at end-June 2024, much above the regulatory threshold. The annualized profitability indicators, namely, return on assets (RoA) and return on equity (RoE) stood at 1.4 per cent and 14.5 per cent, respectively, at end-June 2024, showing continued improvement. The financial health of NBFCs has also exhibited improvement.

## **The Impending Global Challenges**

32. Growth has held up in many countries including US because the labour market has not been much affected. The recessionary fears have not yet materialised in a meaningful manner. Across G10 economies, breaching the Sahm rule threshold<sup>16</sup> has only reliably signalled recession when other indicators such as employment growth, GDP, and retail sales were weak, not when they were still reasonably strong as currently in the US. The increase in US unemployment since April 2023 mostly reflects strong labour supply and continued expansion, not weak labour demand and a high risk of recession. Major central banks are now lowering rates in response to indication that the biggest inflationary surge for a generation has faded. However, Inflation is unlikely to go back to target in major countries on a sustained basis. Hence, the rate cuts have to be well thought through.

33. While the US economy has averted recessionary risks, the Chinese economy is still not out of the woods amid mounting concerns that deflationary forces are taking root in world's second-biggest economy. Analysts are concerned that if deflation becomes too entrenched, companies will reduce investment and cut costs, wages and

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<sup>16</sup> It signals the start of a recession when the three-month moving average of the unemployment rate rises by 0.5 percentage points or more relative to the minimum of the three-month averages from the previous 12 months.

hiring as falling prices erode their profits. This will in turn hit salary earners, which will reduce consumption. China's deep property downturn, now in its third year, has depressed domestic demand while intense competition in manufacturing is pushing down prices.

34. Incidentally, the price of crude oil has tumbled out of its year-long trading range as investors grow increasingly nervous about the impact of a slowdown in the world's largest economies on the demand for crude. The main reason for the slower growth of the oil market is China. In the last 10 years, around 60 per cent of global oil demand growth has come from China. Now the Chinese economy is slowing down. China's rapid embrace of clean energy was also weighing on fossil fuel demand. There is a very strong deployment of electric vehicles and improvement in fuel efficiency.

*Is the Chinese economy being characterised by “weaker for longer” narrative amid subdued consumer sentiments and treading the path of Japanification?*

35. While US economic growth has repeatedly proved to be much more robust than many had expected, the potential for continued “economic exceptionalism” must be weighed against the intensifying pressures felt by lower-income households. There is no agreement on whether this weakness will remain concentrated at the bottom end of the income ladder or migrate up. At the same time, the influence of the Fed's forward policy guidance, another traditional analytical anchor, has been eroded by a mindset of excessive data dependency - this started to affect policymakers after the central bank characterised inflation as transitory. The resulting narrative volatility in the consensus view on markets, which has been moving back and forth has fuelled a misalignment between the central bank and markets on basic policy influences.

36. The year 2024, dubbed the “Great Election Year,” is significant as 88 economies or regions, representing over half of the world's population and GDP, are holding elections. These elections span various continents and political systems. Notably, the US elections are pivotal, with potential global economic and market impacts. Investors are closely watching for shifts in economic policy, which could lead to market volatility. The interconnected global economy means the effects of the elections will be felt worldwide, influencing global trade and markets.

37. The Bank of Japan's decision to raise interest rates at the end of July 2024, for the first time in 17 years, signifies a pivotal moment in the nation's quest to escape its prolonged deflationary trap. For decades, Japan's economy has been characterised by stagnation and persistent deflationary pressures, with the central bank resorting to ultra-loose monetary policies to spur inflation and economic growth. This policy shift carries profound implications for businesses and investors, both within Japan and throughout the broader Asian region. The allure of more attractive bond yields in Japan may entice Japanese investors, who have amassed substantial foreign assets in pursuit of higher returns, to repatriate their funds. This could exert upward pressure on the yen and global bond yields, particularly in markets where Japanese investors hold significant stakes, such as Australia, the eurozone, the United States, and various emerging markets in Asia.

38. In the end, we should not forget the fact that there are two parallel wars going on. As the macroeconomic cycle adjusts to policy actions by central banks, the world remains in an era of profound geopolitical change. Conflict escalation in the Middle East and Ukraine remain major risks to financial stability. The Russia-Ukraine conflict continues to unsettle European energy security, while the Israel-Hamas war fuels regional instability. Disruptions to global supply chains and inflationary pressures are among the challenges faced.

Thank you very much. Namaskar.