Inclusive growth and stability
Implications for financial regulation: the Indian experience

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India is currently facing what seems to be the worst economic situation since the BOP crisis of 1991. Many informed persons are wondering as to how a country that seemed to have got everything right, had escaped the Asian crisis and came out of the GFC fairly unscathed, has seen its currency depreciate by 20 per cent and growth down to 4.4 % from a rate of over 8 % for eight years from 2003 to 2011.

The charts will show the economy is fundamentally still strong, has huge potential and demographic advantage.

Period	GDP	Inflation	Savings	Investment	CAD	GFD	GFD (centre)	Debt/GDP	External De GDP Ratio
1991-1997	5.7	9.6	22.3	23.5	-1.0	7.0	5.6	72.6	32.1
1997-2003	5.4	4.6	24.6	25.0	-0.4	9.1	5.9	72.4	22.3
2003-2008	8.7	5.5	33.3	33.6	-0.3	6.3	3.6	81.5	17.7
2008-2013	7.0	7.5	32.7	35.7	-3.4	7.6	5.6	69.2	19.5

GDP - Gross Domestic Product

CAD - Current Account Deficit

GFD - Gross Fiscal Deficit

Period	Interest rate	CD Ratio	Credit-GDP ratio	CRAR	GNPA	NNPA	ROA
1991-1997	16.01	55.27	20.12	6.52	16.55	8.70	0.29
1997-2003	11.27	53.80	24.08	11.67	12.07	6.59	0.67
2003-2008	12.05	67.98	39.52	12.68	4.18	1.68	0.99
2008-2013	11.38	75.24	50.80	13.06	2.77	1.16	0.96

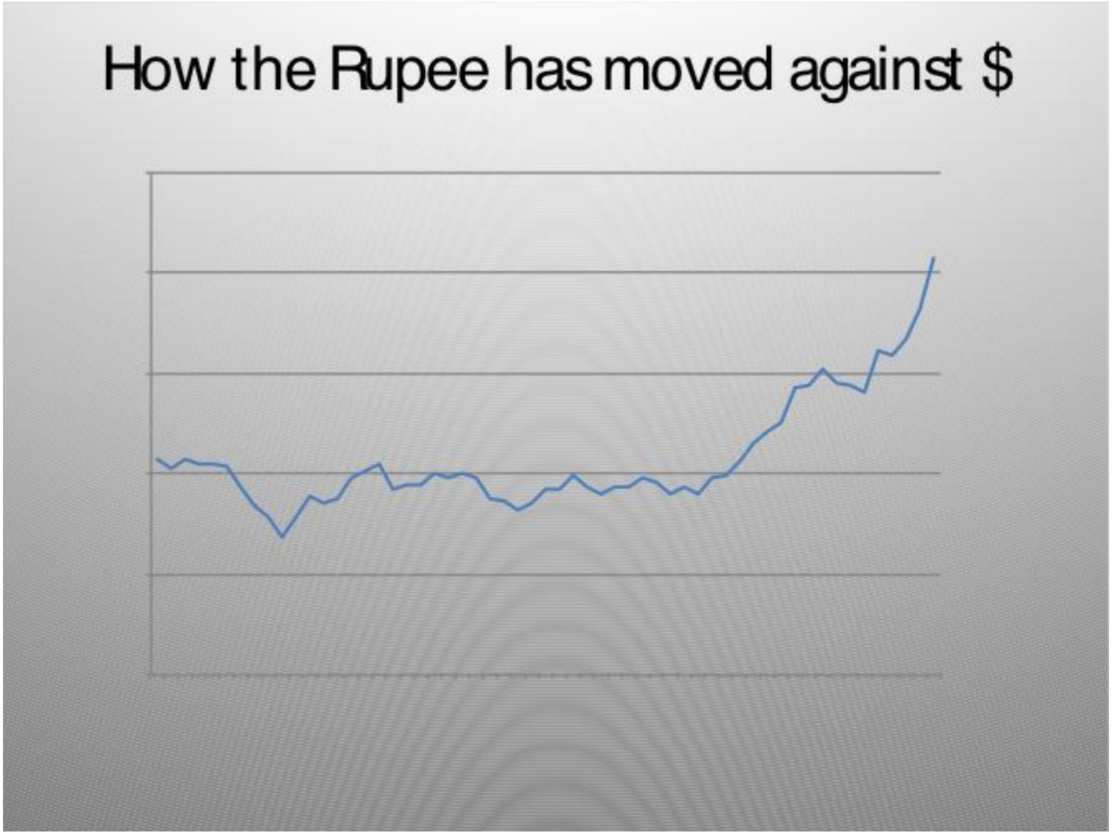
CD Ratio – Credit Deposit Ratio

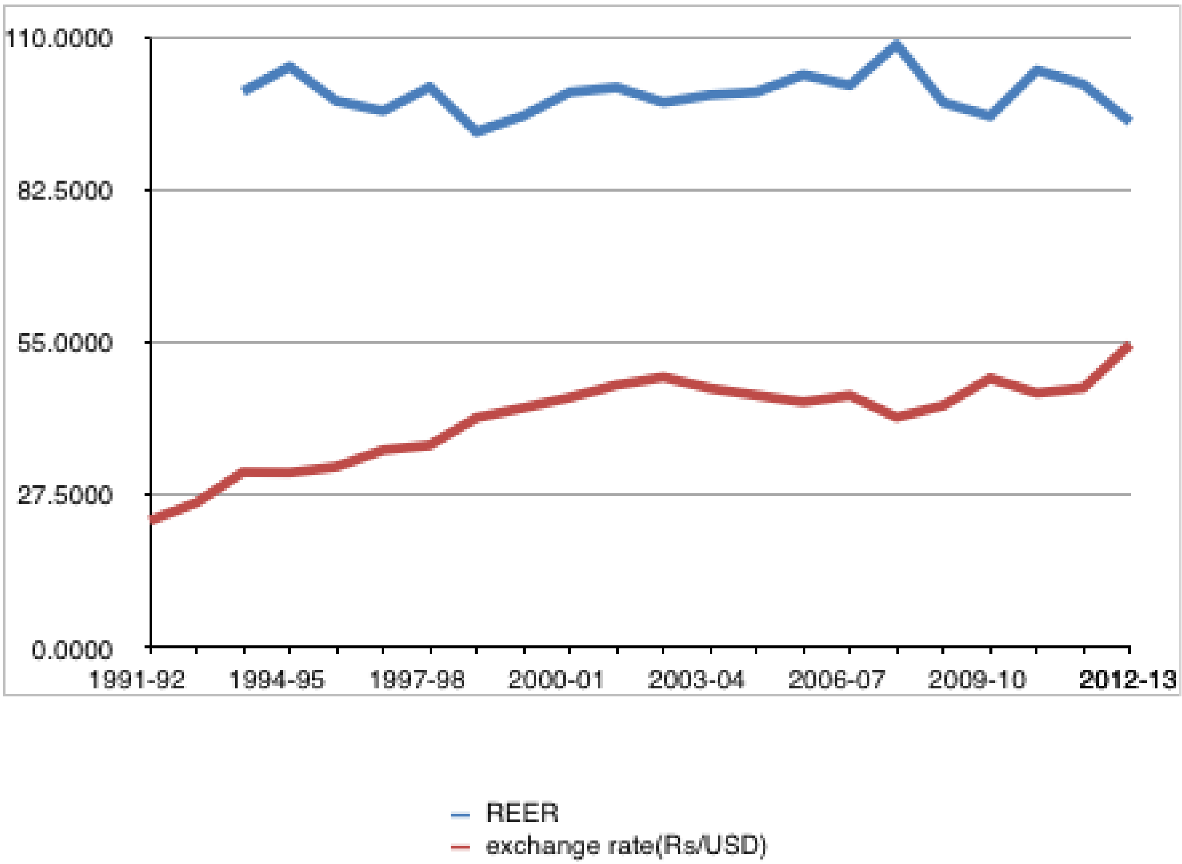
CRAR - Capital Risk Adequacy Ratio

GNPA – Gross Non Performing Assets

NNPA – Net Non Performing Assets

India's growth in the period since 2003 has been enabled by increase in domestic savings and investment, accompanied by low CADs till recently. The increase in CAD in the recent period, going up to as high as 4.8 per cent, coupled with slowing down in the economy, mainly due to inflation, domestic policy and infrastructure constraints, triggered a sell off in the currency in the wake of the hint of US tapering. Capital outflows and lower outlook for growth led to almost a free fall in the rupee from 55 in May 2013 to a low of 68 in the first week of September and has recently recovered to 64.


How the Rupee has moved against $


110.0000
82.5000
55.0000
27.5000
0.0000
1991-92
1994-95
1997-98
2000-01
2003-04
2006-07
2009-10
2012-13
REER
exchange rate(Rs/USD)

For those who are not familiar with India's 1991 crisis, let me recapitulate. It is important to do this as the 1991 crisis shaped the way we liberalised our economy in the last 20 years. This, we believe, has enabled us to withstand several global and national events, which could have been more disruptive.

In mid 1991, the forex reserves of the country were barely sufficient to pay for 3 weeks imports. Even these reserves were essentially borrowed reserves. The crisis was caused by large fiscal deficits, large current account deficits, and unsustainable savings investment gap coupled with an overvalued exchange rate in a highly protected, low productivity and non-competitive environment. The proximate cause was the Gulf War and the increase in oil bill.

While the Government had to resolve to fire fighting measures to deal with the crisis including taking a loan from the IMF, the crisis triggered the liberalization of the economy and its financial sector. India's approach to reforms was guided by five principles, *i.e.,* cautious sequencing of reform measures, introduction of mutually reinforcing norms, initiating complementary reforms across sectors (monetary, fiscal, external and financial sectors), development of financial institutions, and growth and integration of financial markets. All these reforms plus a positive global environment led to sustained increase in growth to more than 8.6 per cent in the period 2003-10 with inflation during this period at around 5 to 5.5 percent. India seemed poised to make the big break through and emerge as a global player as its nominal GDP touched $ 1.8 trillion in 2012 (10th in world) and $4.6 billion in PPP terms (3rd in the world).

The current challenges are reflected in the growth deceleration to 5 per cent in 2012-13 with manufacturing practically stagnant at 1 per cent, inflation close to double digit and CAD rising to a historical high of 4.8 per cent. While foreign exchange reserves are still high and represent seven months of imports, the ratio of short-term debt to total reserves has doubled from 17 percent in 2010 to 33 percent in 2013 and the ratio of volatile capital flows to the reserves has risen to 96 per cent. No doubt, the movements in the currency have been triggered by global developments of tapering and geo political events in common with many major EMEs; they have however, affected more severely those EMEs like India that are dependent on such flows to fund their CADs.

So what are the lessons for inclusive growth and stability from India's experience of last 20 odd years?

Liberalising in a globalised world

The first insight is that, as an economy liberalises and opens up, there is all the more reason to ensure sound macro economic policies and parameters. The degrees of freedom to manage the economy are considerably reduced as an economy is increasingly integrated with the global economy. The basic macro economic indicators of stability are inflation, exchange rate, sustainable fiscal and current account deficits and sound financial sector. Each economy has its own level of tolerance for these parameters and hence has to fashion its policies to ensure these are sustainable and do not threaten stability. To some extent there could be a trade off between growth and stability at lower levels of inflation and current account deficits, but after a critical maximum, higher inflation and current account deficits tend to threaten growth itself. The expectation that, for a growing economy, large current account deficits are necessary to achieve higher growth gets belied sooner or later. In particular if the current account deficits are growing in a period of exchange rate overvaluation (in real effective terms adjusted for productivity) the risks are much higher. Inflation and financial instability are the biggest threats to inclusive growth and hence even from point of view of inclusive growth, the stability objective is paramount.

Liberalising the domestic financial sector

The second big insight from the Indian experience is that liberalising the financial sector has to be done in a calibrated well-sequenced manner. Liberalising the domestic financial sector before liberalising the capital account is one aspect. Allowing domestic financial markets to work in a system of market determined interest rates and exchange rates, greater competition, more efficient bankruptcy rules and processes, a well functioning rule of law, greater transparency and greater dissemination of information, sound regulatory framework and effective supervision are all positive for growth in the real sector and need priority in the process of liberalisation. At the same time our experience is that unfettered markets can create vulnerabilities. Many a banking crisis has been on account of booms and busts in the real estate and stock markets. In India, limiting banking exposures to the real sector and capital market have ensured that the banking system is not unduly exposed to the volatility of these markets. Thus the Indian banking sector is not allowed to finance the purchase of land and have to closely monitor their exposures in financing real estate developers and builders with a Board policy of capping exposures to commercial real estate. Banks are also restricted from financing mergers and acquisitions in India or granting loans against shares beyond certain limits. Consumer /retail credit when found to be growing excessively, has been curbed through additional capital and provisioning. An area where not much restriction was imposed till recently was credit for import of gold and loans against gold. In the recent past, when it was observed that unrestricted imports of gold tended to threaten macro economic stability through the impact on the current account deficit, restrictions have been imposed on such imports and credit for such import. Bank credit against commodities, particularly sensitive commodities, that influence consumer price inflation, is another case in point. Similarly, in case of derivatives, the general approach has been that end users are allowed to use them only for hedging their underlying exposures, exotic structured products with in built leverage features have been disallowed. A generally conservative approach has been taken in the introduction of securitisation and credit default swaps. The overarching principle has been to constantly assess how finance is being deployed; if the flow of finance to certain sectors or the volume of transactions in some financial products are perceived to be excessive, in that it could threaten financial and macro economic stability, the regulator tried to put in place measures to curb such excesses.

Capital account management

The third insight from the Indian experience is that as the economy gets more integrated to the global economy, the capital account needs to be actively managed keeping in view the main objective of financial stability. The liberalisation of the capital account has been carefully sequenced and calibrated. Preference has been given to equity flows as compared to debt flows, to foreign direct investment and foreign institutional investors rather than to non-residents in general. There are no restrictions for foreign institutional investment in equity markets. In foreign direct investment, on account of strategic and public policy reasons, there are limits in certain sectors such as defence, broadcasting, media, airlines, telecom, etc. Foreigners are not allowed to purchase land unless it is a part of the main business. A cautious policy has been adopted towards debt inflows. The limits on debt inflows have been operated through both quantitative and price based measures. Priority is given to longer-term debt and in shorter term credit, to trade credit. There are overall limits on FII investment in rupee debt both government rupee securities and corporate bonds. In case of outflows, liberalization of investment overseas by Indian business sector has been given priority. As capital inflows increased, the limits on outflows for overseas investments and to a certain extent for resident individuals were raised in stages and recently reduced when inflows turned into outflows. Banks and financial institutions are allowed to access overseas markets only for limited amounts. The main reason is that in case of financial entities, there is a likelihood of perception of an implicit sovereign guarantee which makes the inflows rush in the first place and are equally quick to move out. Similarly, dollarization of balance sheets of financial institutions and companies has been discouraged. At various points in time, there have also been pressures to allow a freer participation of non residents especially FIIs in the derivatives markets. The approach so far has been to limit such participation to hedging the exposure in the underlying and has served well. Views are expressed that restricting such participation will drive the market off shore and it is better to bring the market within regulatory control on shore. Equally concerns are expressed that unfettered access to overseas players in the domestic financial markets could create huge volatility, which could be potentially destabilising. While recognising that capital controls can be porous, our experience is that these in the margin do work and are better than if not in place.

Exchange rate management

The fourth insight follows from our experience with exchange rate management. The exchange rate policy till the early nineties was to maintain a stable REER. After the economy started liberalising and we moved to a flexible market determined exchange rate, with capital controls and some intervention to prevent undue volatility. The end users are allowed to access the forex markets only for hedging their underlying exposures; and the banks have to adhere to strict prudential limits on their open positions. As the capital flows increased in volume, the challenges were to limit inflows and liberalise outflows and also accumulate some reserves; as outflows commenced, the restriction on inflows were relaxed so as to increase supply. When there are large inflows and the currency strengthens, there is a tendency for domestic entities to access cheaper overseas debt and take the risk of keeping such exposures unhedged. Exporters on the other hand tend to hedge fully in anticipation of further appreciation. Exactly the reverse happens when there are large outflows and the market supply trickles down and demand increases. Administrative measures, intervention and liquidity tightening to prevent such rapid and sharp fall may work for a short period but cannot be sustained for long if the country has high current account deficits and there are continuing large outflows due to global and domestic as what happened after May 2013.

Another aspect of exchange rate management is the adequacy of reserves. Various measures are used to gauge the adequacy of reserves. The infirmity in the international financial architecture has made Asian and other EMEs build up large reserves at times of large inflows. Similarly, RBI built up large reserves in the period 2004 up to 2008 as a buffer against reversal of the flows. The liquidity impact of these inflows was sterilised through market stabilisation bills and bonds. The use of reserves for prolonged intervention is also severely limited as the market then views the drop in reserves as a negative sign and the rush on outflows can get accelerated. The lesson is that it is wrong to assume that prolonged current account deficits can be sustained through capital inflows especially when the exchange rate adjustments have not taken place. At times of sudden and large outflows, even seemingly large reserves can be inadequate.

Banking Regulation

The fifth insight is that long-term stability and inclusive growth in an increasingly globalizing country needs a more resilient and efficient financial sector, compared to that in a fairly closed and controlled financial system. The reasons for this are several.

- Globalisation brings in access to overseas capital and debt. Hence the better-rated companies would tend to move away from the domestic financial system leaving the lower rated and riskier projects to be financed by the domestic banks.
- The currency mismatch of companies increases as they use overseas credit-trade credit or longer term credit- on account of interest rate differential. If unhedged, the apparent gains seem higher and even if fully hedged there are substantial arbitrage opportunities in substituting local currency debt by foreign currency debt due to forward premium in such markets not reflecting interest differentials. In the event of outflows or negative sentiment of the country, the repricing and refinancing of such overseas debt could be difficult and if unhedged, the resultant liabilities on account of the currency movement could make the firm vulnerable. The exposure of domestic banks to such firms has the additional risk on account of currency mismatches and volatile exchange rates.
- The interest rate volatility of domestic bonds and debt also tend to increase in

a more globalised environment leading to higher interest rate risk. Such risk is increased in EMEs as banks necessarily have higher asset liability mismatches in their balance sheets, being principal intermediaries that undertake maturity transformation .

- Capital flows tend to go towards assets that are likely to yield higher return in relatively shorter time. Typically, such assets are real estate, shares, commodities and even gold. In fact, the opening of the derivatives market in such assets leads to further financialisation and can exacerbate the volatility in these markets. These assets are very often the main collateral for bank lending financialisation of the asset markets increases the risk for the banks. At such times the pro-cyclical behaviour of banks could lead to further problems.
- Only strong and resilient financial institutions can undertake large-scale financial inclusion required for inclusive growth. Apart from the capital needed for the technology and putting n place a proper delivery mechanism, banks need higher capital for the risks in lending to the SME sector which is critical for inclusive growth.
- As mentioned earlier, the restrictions on exposure to the asset markets through caps or lower LTV ratios can be one way to provide the necessary cushion to the financial sector.
- The dominance of foreign banks in the domestic banking system which follows globalisation can also increase the risk to the local economy. This was underscored in the wake of the global financial crisis, when foreign banks tended to restrict credit and shrink assets in the host countries where they were operating. This has made several countries rethink their policies towards foreign banks.

Volatile capital flows hence require several buffers in the banking system, which can be built only during times of boom. It is at such time precisely that there will be resistance to tightening prudential measures. India's experience in 2004-08 is a case in point. Seen as the darling of investors, there were huge inflows, which fuelled the credit boom to real estate stock markets and retail lending. To avoid overheating, monetary measures were adopted along with prudential measures to contain lending to the real estate sector and to retail sector. These measures had the effect of slowing down credit and real estate values. When the GFC hit the world in 2008, these measures could be reversed as countercyclical policy.

The Indian regulator has gradually but steadily introduced strict prudential norms- in some cases even higher than global standards- and ensures that banks adhere to these norms. The compliance is monitored closely through off site and on site supervision. The current major policy issues in regulation include the policy towards foreign banks, systemically important banks, development of financial markets especially corporate bond market, consolidation of the banks, dilution of government ownership, deposit insurance and resolution, universal banking and regulatory architecture. Implementation of advanced approaches under Basle 2 and Basel 3 are also challenges being faced on account of data, people and technology.

Public Debt Management

The sixth insight is from managing the public debt. When the economy started liberalising in the 90s, two important steps were taken. There was a move to market determined interest rates on government borrowing and at the same time the practice of government borrowing from the central bank was stopped. Widening and deepening the government securities markets was seen as an essential component of RBI policy. As manager of the government debt, we took several initiatives to improve the market infrastructure, increase the players, instruments (including interest rate swaps and futures) and calibrated the entry of overseas investors in government debt, as well as creating enabling conditions for development of the secondary market. Elongation of the maturity profile to minimise refinancing risk, larger share of fixed rate instruments so as to stabilise the cost of debt and using the external debt headroom to allow private sector more access to global debt rather than go for sovereign borrowing have been key features of this policy. In the more recent period, there is active discussion on whether public debt should be managed by the RBI or should be entrusted to an independent entity under the sovereign. So far, this function continues with the RBI.

Financial Inclusion

The seventh insight I would like to share is on financial inclusion. The experience has been mixed. The challenge is huge as when we started only one of two adult Indian had a bank account and very few had a loan from the formal system. Driven by RBI and the Government, banks (most of which are public sector banks) have taken several steps for increasing access to banking and these are impressive. However, the banks still seem to regard this as something they are being mandated to do and perhaps are not able to perceive a viable business model. One reason for this could be the high cost of mainstream banking as opposed to micro-finance. There is some public policy pressure on the public sector banks (and to some extent on the private sector banks as well) not to raise interest rates commensurate with costs and risks in financing agriculture, SME and other priority sectors, despite RBI having freed all interest rates even for small loans. The micro finance industry in India appeared to have found a revenue model but became unsustainable on account of aggressive increase in volumes, multiple lending /over-lending, extremely high interest rates and harsh recovery practices. This has led to the sector reinventing itself with sounder risk management practices and introduction of a special regulatory framework by the RBI. Ultimately, as MFIs neither form part of payments system nor are they allowed to offer savings products, they may not be able to achieve financial inclusion in the true sense. In this context, the current discussion is whether small local banks with simpler regulatory structure would be more suitable. We are also debating the use of non-banks for payments services without interface of a bank account as in case of Kenya. The policy initiatives taken by RBI for financial inclusion include:

- Mandating that 25 per cent of new branches opened by banks should be in unbanked rural centres
- Allowing branchless banking through agents or business correspondents as we call them. The BC model allows banks to do ‘cash in - cash out’ transactions at a location much closer to the rural population, thus addressing the last mile problem
- Relaxed KYC norms for small accounts and use of the Unique identification called Aadhar – an ambitious scheme for providing biometric identity to all residents, for opening bank accounts
- Using bank accounts for transferring government benefits
- Priority sector lending norms which direct 40 per cent of credit to farmers, SME, affordable housing and education – but with no cap on interest rates or relaxation in prudential norms

Conclusion

Today, EMEs are confronting the issue of whether the new regulatory framework that is being forged internationally serves the objectives of the emerging and developing economies that still need to focus on growth and equity to be able to lift millions of their population above the poverty line. Given the operations of global companies and global banks across borders, the scale and nature of global financial flows, and the difficulties in administering capital controls, it is apparent that countries cannot evolve their regulatory mechanisms in isolation or evolve a framework which is not in sync with the globally evolving standards. While the focus of the new regulatory framework is on stability and rightly so for the developed North Atlantic world, in countries like India we need the financial sector to grow to provide the intermediation for economic growth. This requires fashioning the regulation to give the right incentives to facilitate equitable growth in the real sector without compromising on financial stability.