

'The Present Economic Crisis and its Impact on India'

[Speech by Shri Yogesh Agarwal, CMD, IDBI Bank Ltd.,

at the Haryana Institute of Public Administration, Dec. 20, 2008]

Respected Dr. C. Rangarajan, Mr.M.C. Gupta and distinguished guests. At the outset, I would like to thank the Haryana Institute for Public Administration for giving me this opportunity to share my thoughts with you on this important issue confronting all of us. It is indeed an honour to be amidst you especially in the August presence of Dr. Rangarajan.

The keen observers of global economy, present in this room will surely agree that we live in interesting yet uncertain times. The fact that we have never faced such a situation makes it interesting. And uncertain, because the situation seems to change significantly within a matter of hours. Let me share with you, what I perceive to be the key challenges that confront the global and Indian economy today. I will also be sharing with you some of my views on the road ahead. However, before I begin I must put forward a caveat. When attempting to understand the situation we are facing, it is tempting to look at the past and draw lessons by mere analogy. My considered view is that today's situation is such that any comparison with the different which possibly needs innovative solutions going beyond traditional tools. With this backdrop let me now turn to the topic of discussion today.

The Global Economy

The global market melt down has shaken all of us. The crux of his issue is attributed to significant mis-pricing of risks in the financial system. The impact was compounded by relatively easy monetary policies at major financial centres and globalisation of liquidity flows, possibly without adequate safeguards. Complex and structured derivatives and inadequacy of majority of stakeholders in understanding these innovation also played thir part. The crises first emerged as a liquidity crisis whose first symptoms appeared at the beginning of August 2007 when serious disruptions surfaced in the . inter-bank market. More than a year later, tensions still remain. Recent weeks have witnessed abnormal levels of spreads, a shortening of maturities, and contraction of some market segments. Through linkages, these tensions are also affecting non-financial sector and, more broadly the financing of the economy.

The crisis also emerged as a crisis of securitisation. Securitisation, as we all know, is an old and tested technique used to refinance a range of loans. What was new about it is that it got used extensively in certain unstable financial structures, which were financing short-term assets that were illiquid, complex, and whose value proved to be uncertain. The instability of such structures was therefore largely masked. Indeed, cheap money allowed easy refinancing of poor quality debt and of assets with uncertain value. Also, favourable ratings and credit

enhancements artificially boosted the quality of loans underlying such structured products. The rise in defaults on such loans, first on sub-prime mortgages, followed by others, triggered a chain of reactions whose consequences are still unfolding.

In many developed countries, Banks have ceased to trust each other's creditworthiness and Liquidity has dried up. Governments and Central Banks have moved aggressively to support banks' solvency and resilience by infusing capital in the form of bailout packages. The challenge for the authorities is to assess whether and to what extent regulations reinforce these dynamics and impact the entire financial system. Some cases that are already in public domain include such big names as Citigroup, Bear Stearns, Merrill Lynch, Goldman Sachs, AIG, Lehman Brothers, Freddie Mac, Fannie Mae, RBS, ING Fortis, Deutsche, Barclays, BNP Paribas, Soc Gen, Swiss Re, the list seems endless ... Uncertainty about possible losses yet to be disclosed by others has not yet ceased. As they say, things are predicted to get worse, before they get better.

World growth is projected to slow from 5 percent in 2007 to 3.75 percent in 2008 and to just over 2 percent in 2009, with the downturn led by advanced economies. Weakening global demand is depressing commodity prices. Oil prices have now declined by over 70 percent from a record USD 147 a barrel in July 2007, reflecting the major global downturn, the strengthening of the US dollar, and the financial crisis. Similarly, metals and food prices have fallen from their recent peaks. While this eases the burden on households in advanced economies and emerging economies in Europe and Asia, it lowers growth prospects too.

Across the globe, markets have entered a vicious cycle of asset de-leveraging, price declines and investor redemptions. Credit spreads spiked to distressed levels and major equity indices dropped. Emerging markets came under even more severe pressure as spreads on sovereign debt doubled, returning to 2002 levels, with more than a third of the countries in the benchmark EMBI index trading at spreads above 1,000 basis points. Emerging equity markets lost about a third of their value in local currency terms and more than 40 percent of their value in U.S. dollar terms, owing to widespread currency depreciations.

Typical central banks' responses in major countries have been adjustment of interest rates for borrowing and lending followed by money market operations designed to inject liquidity in order to avoid a break-down in payment systems among banks. This has been supplemented by mechanisms for financial transactions among the largest of the financial intermediaries, which automatically impact the second and third rung intermediaries in appropriate proportions. Growth stimulus packages have supplemented monetary measures.

Issues and Lessons from the Crisis

The crisis has left us with many unanswered questions. I would like to delve upon a few of them. The first question that comes to my mind is how do we manage global market imperfection? One sure shot remedy for protection against such a crisis is building up of foreign exchange reserves. But how to do it is the big question? Is it through export-led build-up of current account surpluses or through

liability-led capital inflows? The answer is not simple due to the fact that a dent in competitiveness and lack of domestic demand could eventually hit exports. Also, how do we reform financial sector so that risks that might be perpetrated by complex derivative structures become transparent? This would enable better valuation of systemic risks. Also, crucial is how do we regulate the over-leveraged wholesale banking entities such as investment banks, hedge funds, brokers, PE funds? And finally, the question that is closest to my heart, how do we nurture the principle that value creation is more important than value enhancement through financial intermediation?

I do not have answers to all these questions. But let me share a few of my takeaways from the global meltdown, which are more in the nature of perspectives rather than conclusions and solutions. There is an increase in integration of different segments of the financial market. Hence, it should be ensured that unregulated entity's operations do not jeopardise regulated entities entailing significant public cost. Linkages between financial sector developments and the real sector have become more worrisome than before, as the current financial turmoil is spilling over to the real sector with adverse implications for employment and growth.

The crisis has also revealed the need to adopt some of the tools and-practices by central banks to manage system liquidity in the light of banks' cross-border operations. The recent experiences have highlighted the differences in emergency liquidity frameworks of central banks, and the differences in central bank practices.

Most important, perhaps, is the reiteration that proper due diligence is still the best alternative. The traditional banking tools such as the loan to value ratio, debt service ratio, purpose of the loan, verification of documentary evidence of income and assets of the borrowers and ongoing monitoring of the borrowers' affairs have not lost their relevance. The bottom line: Do not sacrifice quality of the asset by succumbing to competitive pressures. Also, do not transfer or acquire risk without a proper understanding of how structured complex products work. One needs to understand how market liquidity (ability to sell with minimum impact cost) affects funding liquidity (ability to raise funds from the market). This in turn affects volatility and hence valuation. We should remember - structured products are not easy to value and are not freely tradable.

How this meltdown has impacted India

India has by-and-large been spared of global financial contagion for a variety of reasons. Our growth has been largely domestic demand driven with a comfortable level of foreign exchange reserves. The credit derivatives market in our country is at a nascent stage not comparable to the ones prevailing in advanced markets. There are significant restrictions on investments by residents in such products issued abroad and regulatory guidelines on securitisation do not permit immediate profit recognition. The macro effects have so far been relatively moderate; thanks also to the overall strength of the balance sheets of India Inc. and the predominant domestic financing of investment. Last, but definitely not the least, and possibly the most important reason being that thanks to proactive and pioneering steps

taken by policy makers in the RBI and the Government of India, of whom Dr. Rangarajan has always been in the forefront, we remain much safer compared to the developed nations.

Impact on Indian Financial Markets

While the impact on the financial markets is well-known, let me quickly present a synopsis of the effects. It is well-known that Indian growth story has been investment-driven and a decline in foreign investment will impact the growth prospects in the equity market. In the Corporate Bond Markets, the risks of Indian corporates measured by the spread on bonds, have increased significantly in recent months. Though the spreads have lowered in recent days because of numerous policy measures, they are still high compared to 2007 levels. The foreign investors have also withdrawn their monies to support their parent companies. As a result, in the forex market, Indian Rupee has depreciated and has touched all time lows. The capital flows in India were so buoyant that they posed a different set of problems for Indian policymakers - appreciating rupee, sterilizing the inflows via government bonds, rising asset prices etc. The situation has reversed now and foreign capital is expected to flow out from the Indian shores. The government bond markets have been in a mixed mode getting both favourable and non-favourable drivers. The favourable development was a decline in inflation due to fall in crude oil prices, food commodities and metals. Another favourable

development has been the ease in policy rates and projections of lower growth rates. The non-favourable drivers have been concerns over liquidity being deficient and a higher than expected government borrowing program as a result of higher than budgeted deficit.

Policy responses in India

The response to the situation by the RBI has been commendable. The pursuit of financial stability is being achieved through perseverance of prudential policies, which prevent institutions from excessive risk taking. It also checks financial markets from becoming extremely volatile and turbulent. The Reserve Bank has been effectively able to manage domestic liquidity and monetary conditions consistent with its monetary policy stance. This has been enabled by the appropriate use of a range of instruments available with RBI such as the Repo / Reverse Repo rates, Cash Reserve Ratio (CRR), and Statutory Liquidity Ratio (SLR), the Market Stabilisation Scheme (MSS) and the Liquidity Adjustment Facility (LAF). This has been complemented and supplemented by the fiscal stimulus package announced by the Government of India. More recently, as you all know, home loans have been made cheaper to

boost housing sector. I am confident that this would ensure an orderly adjustment to the meltdown and minimise the pain of its impact.

Conclusion

To conclude, let me reiterate my confidence that the Indian economy would soon come out of the current downturn. We at IDBI Bank will definitely be a partner in this process, since for us at the Bank, banking is not just about lending money, it is also about handholding those who are given financial support. Let me also mention that downturn in economy does not mean dearth of opportunities. There would be scope for business. More importantly, periods of slack business should be taken as an opportunity for introspection and improvement to put our house in better shape so that whenever up-trend begins, every business opportunity that emerges could be grabbed. May I also mention that the steps that we undertake today will lead to a better global financial architecture tomorrow in terms of a better operating environment for more efficient organisations. On this positive note I conclude my speech.

Thank you.