

# **Problems of Monetary and Financial Policy Under Globalization**

Dr. D. Subbarao  
Governor, Reserve Bank of India

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# India Growth Story

## Pleasant and Unpleasant Surprises

Before the crisis:

- What is driving this high growth and how can we accelerate it?

During the crisis:

- Is there a threat to the fundamentals that fuelled India's high growth?

After the Crisis:

- When do we get on to a double digit growth?

# Challenges of Monetary and Financial Policy under Globalization

- Why was India hit by the crisis?
- How do we exit from expansionary monetary stance in a global setting?
- How do we manage the cost-benefit calculus of volatile capital flows?
- How to implement Basel III without compromising on growth?

# Challenge of Globalization – 1

## Why Was India Hit by the Crisis? (1)

Dismay on two counts that India was hit by the crisis

First

- Indian banking system had no exposure to tainted assets or stressed institutions.
- Indian financial sector has only limited off-balance sheet activities or securitised assets.

Second

- India's growth emanates from domestic demand and domestic investment .
- India's exports are less than 15% of GDP.

# **Challenge of Globalization – 1**

## **Why Was India Hit by the Crisis? (2)**

Because

- More closely integrated with the rest of the world than acknowledged
- Financial integration deeper than trade integration

# Challenge of Globalization – 1

## Why Was India Hit by the Crisis? (3)

### India's Global Integration

(Percentage)

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	1998-99	2008-09
(Export+Import)/GDP	19.6	40.7
Two-way (capital+ current) flows/ GDP	44.1	111.9

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# **Challenge of Globalization – 1**

## **Contagion of the Crisis to India**

- Finance Channel
- Trade Channel
- Confidence Channel

# **Challenge of Globalization – 2**

## **Exit from Expansionary Monetary Stance**

- Unique growth-inflation dynamics
- Recovered sooner than other EMEs
- But inflation also caught up with us sooner

# **Challenge of Globalization – 2**

## **Dilemma for Reserve Bank**

- Premature exit will derail fragile growth
- Delayed exit will engender inflationary expectations

# **Challenge of Globalization – 2**

## **How to Calibrate Exit?**

- Arguments in support of quick exit
- Arguments against quick exit

# **Challenge of Globalization – 2**

## **How to Calibrate Exit?**

Interest rate differential will  
encourage capital flows

# Challenge of Globalization – 3

## Managing Capital Flows

- Capital flows to sustain excess of investment over savings
- But capital flows are volatile and complicate macroeconomic management

# Challenge of Globalization – 3

## India's External Sector

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	2007-08	2008-09	2009-10
CAD (% of GDP)	1.3	2.4	2.9
Net capital flows (% of GDP)	8.7	0.6	4.1
Capital flows in excess of CAD (\$ billion)	92	(-) 20	13
Rupee appreciation (+) / depreciation (-) vis-à-vis US\$ during the year	9	(-) 21	13

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# **Challenge of Globalization – 3**

## **Managing Capital Flows**

### **India's Policy on Capital Account**

- Gradual approach to capital account convertibility
- Prudent use of capital controls
- Stable policy on capital account
- Agnostic on the choice of instruments
- Exchange rate policy – flexible and pragmatic
- Reserve build-up yes, but not as self-insurance

# **Challenge of Globalization – 3**

## **Capital Flows**

### **Managing Impossible Trinity**

Every option is costly

- Don't intervene in forex market
- Intervene in forex market but don't sterilize
- Intervene in forex market and sterilize

# Challenge of Globalization – 3

## Managing Capital Flows

- Law of capital flows
- *Festina Lente* – Make haste slowly

# **Challenge of Globalization – 4**

Costs of implementation of Basel III