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Implications of Global Financial Unrest on Monetary Policy in India

Gurpreet Kaur

(Assistant Professor, Head, P.G. department of Commerce and Management, Bebe Nanaki Guru Nanak Dev University College, Mithra, Kapurthala, Punjab, India)

Abstract: *In the past two decades the financial globalization has resulted in robust capital flows among the nations and has affected the economies in a large way. Many countries gained from global financial integration in terms of improved growth rate but many experienced significant financial crisis. The sufferers were the economies which could not assess the threats associated with the global associations for funds. The main objective of the paper is to highlight the threats of financial globalization and the role of monetary policy in tackling those risks. The paper particularly emphasizes on the various measures instituted by the Reserve Bank of India to deal with the financial stress imposed by the global financial unrest.*

Keywords: *Globalization, Financial Reforms, Monetary Policy*

I. INTRODUCTION

Financial globalization basically refers to the increased global linkages for finances across border. It is the free movement of finances among the nations all over the world. The inflows of global finances were initially through the intermediation of banks and other financial institutions with the cross border lenders. But the development of the capital market and opening up of the economies all over the world paved the clear way to new forms of financial integrations internationally. The last one decade witnessed the substantial growth in the global capital inflows particularly in the developing economies. The opening up of developing countries in the form of privatization and liberalization attracted the international investors. This accelerated the free movements of cross- country capital in the forms of borrowing and lending among the nations throughout the world and particularly to the developing nations. Various studies show that the financially open countries gained from the wave of financial globalization.

Till 1990s in most of the countries had a heavily regulated domestic financial markets which were subject to a number of restrictions in the form of quantum of foreign exchange allowed, role of banks and financial intermediaries, restrictions on the financial institutional investors and on the use of financial instruments. The Indian financial market was also segmented and tightly regulated with very complex interest rate structure. The major concern of the financial market had been the social concern. There was also the paucity of financial instruments in the Indian domestic market. This had led the Indian banks towards a situation of pilling up of Non-Performing Assets as the banks were providing easy loans without even assessing the paying capacities of borrower and the true value of the collateral. This necessitated the Reserve Bank of India to adopt the reform process for the revival of the banking system.

Over a period of time there has been a gradual relaxing of the restrictions on the domestic financial systems. The RBI policies started opening up the banking system towards global environment. The banks were given autonomy to decide their own interest rates and frame policies. The instruments to be used for raising funds in the financial market were also increased making it easier for the banks to channelize their excess funds. The private borrowers and lenders were allowed to raise or use their funds in the international market thereby increasing the liquidity of global funds.

The financial globalization also initiated the internationalization of financial services due to the active participation of financial intermediaries and use of modern instruments of raising global finances. More advanced financial instruments emerged in the scene which resulted in increased access to foreign capital and reduction in the cost of raising finances globally. The financial globalisation affected the economies in a large way- both positively and negatively.

The financial liberalization in India was initiated with the major objectives of reducing the complexities of interest rate structure in Indian banking system and to improve the operational and functional capabilities of Indian banks by providing them an environment conducive to their growth. The opening up of the Indian banking to the global competitive environment would enhance and upgrade the Indian financial system.

The financial sector reforms were initiated in four phases. A number of committees were constituted to analyze India's banking sector and to recommend legislation and regulations to improve the functioning of Indian Banking industry. One of the first such committee was set up under the chairmanship of M. Narasimham (an ex-RBI governor) first in 1991 and then in 1997.

The first phase of the reform of financial sector initiated in 1992, were based on the recommendations of Narsimham committe on Financial System popularly known as Narasimham Committee-I (1991) report. The committee worked on the study of all aspects relating to the structure, organisation, functions and procedures of the financial systems and to recommend improvements in efficiency and productivity of the Indian banking system. The Narasimham Committee had recommended bringing down the statutory pre-emptions such as SLR and CRR and strongly advocated the deregulation of the Interest Rates, so that banks can themselves set the interest rates for their customers.

The recommendations of the Narsimham committee on Asset classification, Non performing Assets were the landmark in the history of Indian Banking system. Most of these recommendations were welcomed by the government and were adopted. To further strengthen the risk taking ability of Banks RBI introduced the CRAR or Capital to Risk Weighted Asset ratio in 1992. New prudential norms for asset classification and provisioning of the non-performing assets were introduced. The sound banks were allowed to raise capital in capital market and the weaker banks were decided to be recapitalised. The privete banks were given more autonomy in opening up new branches.

In the second phase the Narasimham-II Committee II was constituted and was assigned the task of reviewing the progress of implementation of recommendations in the banking reforms initiated since 1992 and to make further recommendations for strengthening the financial institutions of India. This committee submitted its report in 1998 and included the reforms like granting greater autonomy to the banks in recruitment, training and remuneration policies equivalent to their international counterparts. The Committee reviewed the dual role of RBI as and suggested the segregation of the roles of RBI as a regulator of banks and the owner of bank. RBI introduced a Liquidity Adjustment Facility (LAF) which works through repo and reverse repos rates to balance the money market interest rates. Asset Reconstruction Funds or Asset Reconstruction Companies was proposed to be created to take over the NPAs of banks, allowing them to start afresh**.** It was further decided to raise prescribed capital adequacy norms to make the capital base of banks stronger. This improved to a large extent the risk taking ability of banks. The committee also suggested to have stringent rules for the foreign banks willing to set up branches in India. These banks were required to have a minimum start-up capital of $25 million as against the existing requirement of $10 million. Any such brances or subsidiaries being operated by the foreign banks were decided to be treated at par with the Indian private banks.

Positive impact of financial Globalisation:

Beyond doubt the global financial integrations benefited the economies in a large number of ways. The inflows of funds increased money supply in the economy and access to foreign technology helped reduction of costs which in turn accelerating the growth rate of the economy. The domestic financial market was exposed to foreign competition resulting in the increased efficiency in the sector. The economies stepped forward and formulated policies to improve the conditions of domestic financial markets. This helped the nations in developing their own financial systems into more stable and better regulated financial markets.

Implications on the monetary policy

Monetary policy refers to the policy of reserve bank of india and deals with the controlling of money supply in the economy. The reserve bank of india assumes to be the primary authority responsible for regulating the money supply in the economy. The global financial crisis had highlighted the need of maintaining the price stability in the economy. Stable price environment is the essential requirement for improving the growth and productive potential of any economy. Thus the major challenge in the present economic scenario is to effectively deal with the financial unrest. The central bank through monetary policy is best suited in ensuring the price stability by making appropriate use of wide range of instruments available for liquidity management such as the Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) stipulations and open market operations (OMO) including the Market Stabilisation Scheme (MSS) and the Liquidity Adjustment Facility (LAF).

The monetary policy strategy of a Central bank depends on a number of factors that are unique to the country. The major factor that influences the monetary policy is the degree of openness of the economy. With this degree of openness, developments in international markets are bound to affect the Indian economy and policy makers have to be vigilant in order to minimize the impact of adverse international developments on the domestic economy. Mr. Bimal Jalan, Y.V. Reddy and D. Subbarao the next governors of Reserve Bank of India took further steps to widen and strengthen the process of opening up of the economy initiated by the Governor Rangarajan .

The threats imposed by the financial globalization in the country required RBI to ensure price stability as the liberalization process that started in the mid 1980s had the effect of price volatility. Thus India in the economic policy of 1991 initiated a number of economic, fiscal and monetary reforms. The recommendations of Narsimham committee were implemented and the banking sector was liberalized. The banks were given some degree of flexibility to decide on the interest rates on deposits. The CRR and SLR were reduced so as that the banks could have more funds to their disposal.

The Reserve Bank of india required the banks to implement the recommendations of the Basel II framework on the three pillars approach requiring banks to maintain minimum capital-to-risk-weighted asset ratio (CRAR) to be 9 per cent. Thus the banks were to achieve a CRAR of at least 6 per cent till March 31,

2010. All foreign banks operating in India and Indian banks having a presence outside India were also instructed to adhere to the provisions of Basel II.

The RBI recommended CRAR of 9% to be achieved till 2012 which is 1% more than the Basel recommendations to further strengthen the banks. Banks have been required to put in place appropriate stress test policies and relevant stress test frameworks for various risk factors by March 31, 2008.

How domestic financial system survived in the Global financial turbulence

Indian banks in the pre reform era remained tightly regulated and controlled. Even in the post reform era amidst increasing international financial integrations the Indian banking was not unnecessarily exposed to the market risks. It was the farsightedness of the RBI that along with the liberalization it did initiated certain regulatory and supervisory measures which could prevent the Indian financial system from the global financial crisis that triggered many advanced countries.

Before the global crisis took place, RBI had issued such policy guidelines to strengthen the banking system. The implementation of CAMEL parameters, the Asset classification and prudential norms requiring banks to provide for 50% margin for advances against shares, restrictions imposed on the borrowings of banks from the call money market, limitations on the inter bank borrowings were some of the precautionary measures. The implementation of the recommendations of Basel I and II requiring banks to maintain a minimum level of CRAR further strengthen the resilience of Indian Financial System. In the pre reform period the monetary policy of RBI was primarily working through CRR and SLR as the major instruments to control money supply. But after the reforms were initiated in India, the Open Market operations (SMO) became an important part of the monetary policy. The provisioning requirements for sub standard and doubtful assets were further revised and were made at par with the international standards. The banks were instructed to maintain 6% capital adequacy of their risk weighted assets. In order to create liquidity buffer the banks were instructed to invest atleast 25% of their NDTL in the government securities.

In the post global crisis era Reserve bank of India in its monetary policy took a number of initiatives to tackle the issues that emerged out of the financial globalization. The liquidity adjustment scheme (LAF) was started in June 2000 for modulating liquidity and transmitting interest rate signals to the market. The banks were also allowed to make use of Liquidity under LAF upto 1% of their NDTL.

In 2003, the market stabilization scheme (MSS) was set up with the purpose of keeping the liquidity intact. Where on one hand the LAF and the OMO's were set up on day-to-day basis to manage liquidity, the MSS was set up to sterilize the liquidity absorption and make it more enduring. The regulations and supervisory requirements were further extended to the financial institutions including the NBFC and the co-operative societies. The board of financial supervision (BFS) was assigned the task of assessing the risk exposure of banks and to take corrective actions to ensure financial stability and risk management of the banks. The BFS also enhanced its focus on monitoring the mark-to-market (MTM) losses in credit derivatives and other investment portfolios of overseas operations of banks in India on a monthly basis. RBI also called the banks to submit periodic information regarding their financial condition and risk exposure in the prescribed format.

Committee on Financial Sector Assessment (CFSA) was set up to work on the self-assessment of India's financial sector based on three mutually reinforcing pillars – financial stability assessment and stress testing; legal, infrastructural and market development issues; and an assessment of the status of implementation of international financial standards and codes. The committee found that Indian banking system was sound and resilient and that the banking system of india was not significantly vulnerable to the credit and market risks.

The measures initiated by the RBI were directed towards strengthening the banking sector on one hand and making it aligned to the international standards on the other hand. Thus the financial sector was being opened cautiously. The banks were advised to make internal assessments of their risk evasiveness. More robust risk management systems were evolved to preserve the national financial stability. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act, 2002), Debt Recovery Tribunals (DRTs) and Lok Adalats, further helped the banks in managing their NPAs. The Prevention of Money Laundering (Amendment) Act, 2009 was passed to keep check on money laundering.

Banking Ombudsman Scheme, 2006 was further revised in 2009 to consider the deficiencies arising out of internet banking services, enabling customers to lodge complaints against banks for their non-adherence to the provisions of the Fair Practices Code for Lenders. The banks were instructed to charge uniform service charges for electronic payment products. Instructions were issued to banks to ensure that every branch conducting Government business of volume above a specified amount (say Rs.25 lakh) was covered by concurrent audit.

II. CONCLUSION

In brief, the India opened up its financial system gradually and cautiously and in line with the other economic measures. The objective behind the measures taken by RBI in the pre crisis period and during the economic global crisis period was not only to strengthen the Indian financial system but also to make it aligned to the international standards. The domestic financial system was prevented from excessive market exposure.

The strict regulations, supervisory measures, and ample foreign exchange reserves increase the resilience of domestic financial market and reduced the susceptibility of the Indian economy to global turmoil.

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