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MID-QUARTER MONETARY POLICY REVIEW: MARCH 2013

Mid-Quarter Monetary Policy Review: March 2013

Monetary and Liquidity Measures

Based on an assessment of the current macroeconomic situation, it has been decided to:

- reduce the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 7.75 per cent to 7.5 per cent with immediate effect;

Consequently, the reverse repo rate under the LAF stands adjusted to 6.5 per cent and the marginal standing facility (MSF) rate and the Bank Rate to 8.5 per cent with immediate effect.

Introduction

2. Since the Reserve Bank's Third Quarter Review (TQR) of January 2013, global financial market conditions have improved, but global economic activity has weakened. On the domestic front too, growth has decelerated significantly, even as inflation remains at a level which is not conducive for sustained economic growth. Although there has been notable softening of non-food manufactured products inflation, food inflation remains high, driving a wedge between wholesale price and consumer price inflation, and is exacerbating the challenge for monetary management in anchoring inflationary expectations.

Global Economy

3. Global economic developments over the last few months present a mixed picture. US GDP estimates for Q4 of 2012 indicate a tentative upturn on the back of improvement in housing and payroll employment. However, US macroeconomic prospects are clouded by the uncertainty surrounding the temporary appropriations and the debt ceiling. In the euro area, plagued by contingent risks of political uncertainty and adjustment fatigue, GDP shrank for the third successive quarter in Q4. Output in Japan too contracted in Q4, and it is as yet unclear how effective the emerging package of stimulus measures will be and how quickly they will turn around the economy. While some emerging and developing economies (EDEs), including China, are gradually returning to faster growth, activity is slowing in others, hobbled by weak external demand and slack domestic investment. International non-fuel commodity prices have softened in Q4, but fuel prices have remained firm, despite the growth slowdown, portending persisting inflationary pressures, particularly for net energy importers.

Domestic Economy

Growth

4. India's GDP growth in Q3 of 2012-13, at 4.5 per cent, was the weakest in the last 15 quarters. What is worrisome is that the services sector growth, hitherto the mainstay of overall growth, has also decelerated to its slowest pace in a decade. While overall industrial production growth turned positive in January, capital goods production and mining activity continued to contract. The composite purchasing managers' index (PMI) declined in February, largely reflecting slower expansion in services. In the agriculture sector, the second advance estimates of *kharif* production indicate a decline in relation to the level last year. However, that may be offset, at least partly, by the *rabi* output for which sowing has been satisfactory.

Inflation

5. The year-on-year headline WPI inflation edged up to 6.8 per cent in February 2013 from 6.6 per cent in January, essentially reflecting the upward revisions effected to administered prices of petroleum products. On the other hand, non-food manufactured products inflation, and its momentum, continued to ebb along the trajectory that began in September 2012, enabled by softening prices of metals, textiles and rubber products. Worryingly, retail inflation continued on the upward path that set in from October 2012, with the

new combined (rural and urban) CPI (Base: 2010=100) inflation at a high of 10.9 per cent in February 2013 on sustained price pressures from food items, especially cereals and proteins. Consequently, the divergence between wholesale and consumer price inflation continued to widen during the year.

Monetary and Liquidity Conditions

6. Money supply (M_3) and bank credit growth have broadly moved in alignment with their revised indicative trajectories. With government cash balances with the Reserve Bank persisting at a higher than normal level, the liquidity deficit, as reflected by the net drawals by banks under the liquidity adjustment facility (LAF), has remained above the indicative comfort zone. The reduction in the cash reserve ratio (CRR) of banks by 25 basis points, effective from February 9 and open market purchases of ₹200 billion since February have enabled money market rates to remain anchored to the policy repo rate. The Reserve Bank will continue to actively manage liquidity through various instruments, including open market operations (OMO), so as to ensure adequate flow of credit to productive sectors of the economy.

Fiscal Situation

7. The Union Budget for 2013-14 has made a firm commitment to fiscal consolidation. According to the revised budget estimates for 2012-13, the gross fiscal deficit (GFD)-GDP ratio, at 5.2 per cent, was contained around its budgeted level, mainly by scaling down plan and capital expenditures. The GFD-GDP ratio is programmed to decline to 4.8 per cent in 2013-14 and further down to 3.0 per cent by 2016-17, in line with the revised road map for fiscal consolidation.

External Sector

8. With merchandise exports recording positive growth for the second successive month in February and non-oil imports contracting, the trade deficit narrowed significantly. For April-February 2012-13, however, the trade deficit was higher than its level a year ago with adverse implications for the current account deficit (CAD), already at a record high. Although capital inflows, mainly in the form of portfolio investment and debt flows, provided adequate financing, the growing vulnerability of the external sector to abrupt shifts in sentiment remains a key concern.

Outlook

9. There are several risks to the global outlook. The impact of sequestration in the US on the global economy is likely to be muted in view of legislation initiated to avert the debt ceiling. Nevertheless, lead indicators point to sluggish global growth. Political economy risks that block or delay credible and determined policy actions in advanced economies (AEs) are inhibiting recovery. For EDEs, risks of spillovers from AEs remain significant. While global inflationary pressures are likely to be subdued, given still large output gaps, several EDEs could potentially face the threat of elevated energy prices.

10. On the domestic front, the key macroeconomic priorities are to raise the growth rate, restrain inflation pressures and mitigate the vulnerability of the external sector. These are briefly addressed in the following paragraphs.

11. The Central Statistics Office (CSO) has projected GDP growth for 2012-13 of 5.0 per cent, lower than the Reserve Bank's baseline projection of 5.5 per cent set out in the TQR, reflecting slower than expected growth in both industry and services. Key to reinvigorating growth is accelerating investment. The government has a critical role to play in this regard by remaining committed to fiscal consolidation, easing the supply bottlenecks and improving governance surrounding project implementation.

12. On the inflation front, some softening of global commodity prices and lower pricing power of corporates domestically is moderating non-food

manufactured products inflation. However, the unrelenting rise in food inflation is keeping headline wholesale price inflation above the threshold level and consumer price inflation in double digits. Also, there is still some suppressed inflation related to administered prices which carries latent inflationary pressures. All this complicates the task of inflation management and underscores the imperative of addressing supply constraints. From an inflation perspective, upward revisions in the minimum support prices (MSP) should warrant caution in view of their implications for overall inflation.

13. On the external sector front, the key challenge is to reduce the CAD, which is well above the sustainable threshold. This adjustment, requiring as it does, measures to improve the competitiveness of exports and wean away demand for unproductive imports, will inevitably take time. Meanwhile, financing of the CAD with stable flows remains a challenge.

14. The foremost challenge for returning the economy to a high growth trajectory is to revive investment. A competitive interest rate is necessary for this, but not sufficient. Sufficiency conditions include bridging the supply constraints, staying the course on fiscal consolidation, both in terms of quantity and quality, and improving governance.

Guidance

15. Notwithstanding moderation in non-food manufactured products inflation, headline inflation is expected to be range-bound around current levels over 2013-14 in view of sectoral demand-supply imbalances, the ongoing corrections in administered prices and their second-round effects. In addition, elevated food prices, including pressures stemming from MSP increases, and the wedge between wholesale and retail inflation have adverse implications for inflation expectations. Risks on account of the CAD remain significant notwithstanding likely improvement in Q4 over an expected sharp deterioration in Q3 of 2012-13. Accordingly, even as the policy stance emphasises addressing the growth risks, the headroom for further monetary easing remains quite limited.

March 19, 2013

INDIA-OECD-WORLD BANK REGIONAL CONFERENCE ON FINANCIAL EDUCATION

*Keynote Address**

Duvvuri Subbarao

RBI Partnership with OECD and World Bank

1. RBI is delighted to have this opportunity to partner with two premier international institutions – the OECD and the World Bank – on this very important conference on financial education.

2. Hearty welcome to all the delegates from around the world and across India.

RBI and Financial Literacy

3. Why is the Reserve Bank – a central bank, whose core concern is maintaining price stability and supporting growth – in the forefront on a quintessentially development issue like financial literacy?

    - Because of 2 reasons
    - First reason
    - RBI has a wider mandate than a typical central bank.
    - Historically RBI has played an important developmental role in the financial sector.
    - The Lead Bank Scheme initiated in 1969 whereby a bank is designated in every district of the country as the lead bank to coordinate the flow of credit from all banks in the district consistent with a district credit plan.
    - Priority Sector Lending - whereby banks are mandated to lend a minimum prescribed portion of their total lending to designated priority sectors.

- RBI has provided innovative leadership on financial inclusion initiatives.
- The Reserve Bank is in the forefront of financial inclusion and financial literacy campaigns because we believe that a banking regulator, particularly in a large developing economy like India, has a unique advantage and opportunity as also a distinct obligation to further these goals.
- GOI and RBI work together.

Financial Literacy and Financial Stability

- Why is RBI in the forefront? (Second reason)
- There is another important reason why central banks, not only in EMDEs, but even in advanced economies, are getting to play a role in financial literacy. This reason stems from the experience of the 2008-09 global financial crisis.
    - Many root causes and many proximate causes for the crisis.
    - One of the root causes is the lack of understanding of financial matters that led sub-prime borrowers into contracting teaser rate loans.
    - It is indeed possible to argue that the sub-prime problem would not have grown to explosive proportions that it did if people had been more financial literate.
    - Bernanke: 'Helping people better understand how to borrow and save wisely and how to build personal wealth is one of the best things we can do to improve the well-being of families and communities.'
    - In post-crisis reform measures across all advanced economies, there is a big thrust on consumer protection.
    - By far the best and most effective way of protecting consumers is to make them financially literate.

* Address by Dr. Duvvuri Subbarao, Governor, Reserve Bank of India at New Delhi on March 4, 2013.

- To summarise, the answer to the question: 'what is the locus standi of a central bank in financial literacy', the answer is that
- Part, indeed an important part, of the mandate of a central bank is to preserve financial stability.
- An essential prerequisite for financial stability is financial literacy.
- A central bank has a unique leverage in providing financial literacy

What Should I Say?

4. Struggled here to determine what I should say at this inaugural that will add value to the conference. Given the depth of frontline experience and subject matter expertise that all of you bring to this forum, it will be presumptuous on my part to lay out the agenda for the deliberations over the next 3 days. I feel distinctly inadequate. I will attempt something much less ambitious.

I will give you

i. The big picture of the challenge of financial inclusion and financial literacy – in general and in India.

ii. Tell you briefly about the Reserve Bank's accomplishments and challenges in the area of financial inclusion and financial literacy.

iii. Raise some introspective and important questions that we must be asking ourselves.

Financial Inclusion and Financial Literacy

5. This conference, I know, is on financial education. Nevertheless, you would have found me speaking about financial inclusion and financial literacy together, almost synonymously. That is not confusion. That is deliberate.

- Financial inclusion and financial literacy are integral to each other.
- They are two elements of an integral strategy.
- Financial inclusion provides access
  Financial literacy provides awareness
- Disadvantaged people need both - access to and awareness of financial services.
- Financial inclusion – supply side
  Financial literacy – demand side

Broader Question: Why are financial inclusion and financial literacy important?

6. Why are financial inclusion and financial literacy important?

They are important simply because financial inclusion is a necessary condition for sustaining equitable growth. There are few, if any, instances of an economy transiting from an agrarian system to a post-industrial modern society without broad-based financial inclusion.

7. As people having comfortable access to financial services, we all know from personal experience that economic opportunity is strongly intertwined with financial access.

8. World Bank – Attack on Poverty

- Seminal WDR on Attacking Poverty – 2000-01. Three dimensions of attack on poverty.
  - Creating opportunities for the poor to improve their lives.
  - Empowering the poor to demand more responsive state and social institutions.
  - Providing the poor security – to cope with risks.
- **Opportunity, empowerment and security**. Financial inclusion is important on all three dimensions.
- Development experience shows that the poor don't want doles. They don't want hand outs. What they want is opportunity.
- Financial inclusion and financial literacy are essential to give that opportunity. They enfranchise the poor in a very powerful way, and give them security against income shocks.

Financial Inclusion in India

9. Let me get a little more specific. Take India. Financial inclusion is good for all the stakeholders.

- Good for the poor. Opportunity to improve their incomes and their quality of life.
- Good for the banks. Steady low cost savings – ALM.
- Good for the government. Powerful tool of poverty reduction, it also cuts down leakage.
- Good for the economy, savings of the poor into the formal financial sector.

10. **Win-win** for the poor, banks, government and economy. Not just a public good but a merit good.

11. India – Big Picture

(i) 600,000 – 100,000 bank branches – just about 10 per cent

(ii) Only 40 per cent of the households have bank accounts

(iii) Financial exclusion is staggering

12. What has the RBI done?

Financial inclusion

- bank-led approach
- deregulated bank branch opening
- 25 per cent of new branches in rural areas
- Leveraged on technology to deepen financial inclusion through the BC model
- Delicenced ATMs
- Liberalised the KYC norms for basic banking account without any minimum balance

13. Financial Literacy

- RBI prepared a National Strategy on Financial Education catering to all sections of the population in the country.
- Simple, comprehensive and inclusive.
- Since the challenge is to link large number of financially excluded people to the formal financial system, the focus of the Strategy at the base level is to create awareness of basic financial products. For the purpose, the financial literacy efforts is primarily directed towards dissemination of simple messages of financial prudence in vernacular language through large campaigns across the country combined with vigorous roll out of financial inclusion plans by banks, insurance, pension funds and others.
- The strategy is inclusive – active, involves individuals, financial sector regulators, educational institutions, NGOs, financial sector entities, multilateral international players and the Government at both Centre and State.

14. Banks and Financial Literacy

- We have advised banks that there should be at least one Financial Literacy Centres (FLC) in all the districts (640+) throughout the country. These FLCs are required to conduct outdoor financial literacy camps at least once in a month. Banks have already set up about 650 FLCs till date.
- Further, every rural branch (35,000+) is required to conduct a financial literacy camp at least once in a month. Through these camps, we envisage imparting of financial literacy in the form of simple messages like why save with banks, why borrow from banks, why borrow as far as possible for income generating activities, why repay in time, why insure yourself, why save for your retirement *etc.*
- Starting from April 2012, we have been able to educate about 1 million plus people through these literacy programs.

15. Our strategy on financial inclusion and financial literacy

- Bank-led model
- More by moral suasion by asking banks to see their enlightened self-interest, than by regulation
- Let a thousand flowers bloom!

16. FIPs prepared and implemented by banks. Why not a more prescriptive model?

i. Innovative ideas

ii. Tailored to their business model

iii. Ownership of the plan

iv. India a diverse country. Let a thousand experiments take place.

17. Many accomplishments -

- Some of it in numbers
- Some of it in heart-warming stories that we have heard from across the length and breadth of the country
- Villages now having access to banking – 200,000-600,000 through branches + BCs
- Hundreds of millions of people, often illiterate, use smart cards with biometric identification, for bank transactions (Secretary Geithner)
- Tens of millions of people use mobile handheld electronic devices for banking
- 10 million SHGs across the country are credit linked to banks for income enhancing activities
- Villages ask for bank branches as they ask for schools and health centres [Neighbouring villages of Jalanga]
- Women voluntarily forming SHGs
- Outreach programmes – more than 50 per cent of participant attendees are women
- EBT – in several states
- Direct cash transfer in 50 districts

18. Challenge for RBI

- Banks see this as an obligation and not an opportunity.
- KYC (migrant labour) and UID – simplifying without compromising security
- Meaningful financial inclusion (Toilet, Bank a/c)

New Bank Licences

19. New bank licences. Strategy for financial inclusion will be an important criticism.

Criticism against RBI: RBI open-minded to innovation.

20. Introspective but Important Question:

- Do we know enough about the poor to deepen financial inclusion and further financial literacy?
- Do we understand enough about how the poor manage their finances in order to design products and services that meet their requirements?
- Are we approaching the problem with an open mind or are we too clouded by our stereotype views to understand why the poor behave in such seemingly irrational ways?
- Are we too patronising in our approach to be dismissive of the concerns and apprehensions of the poor?

Ela Bhatt [SEWA]: WDR 2000-01: We are poor but so many: 'Illiteracy is on the other side of the table'.

Portfolios of the Poor

21. Frame these questions in a more concrete fashion.

i. WB norm for poverty is $2/day.
One of the least understood problems of living on $2/day is that you don't earn $2 every day. That is the average over time. How do you cope with that?

ii. The poor not only have low incomes, but their income is irregular and unpredictable. Their savings are meagre. But, yet they have to cope with loss of employment, illness and death in the family, lumpy expenditure needs for education and for weddings and festivals?

iii. One stereotype view is 'How can the poor save – they have no money'. This is only superficially sensible. The poor should save because like everybody else they have a present and a future. They have little money today, but unless they stumble on a pile of cash tonight, they have little money tomorrow.

iv. Another stereotype view: The poor's savings are meagre. They don't need much financial management techniques. In fact, because the poor have low, irregular and unpredictable incomes, they need sophisticated financial management. $20/day vs $2/day.

(v) Portfolios of Poor by Daryl Collins, Stuart Rutherford

- India, Bangladesh and South Africa
- Need sophisticated financial management
- Diaries – fascinating how they cope with everyday finances.
- The truth is that money management is, for the poor, a fundamental and well understood part of everyday life.
- The stereotype view is that the poor are carefree or incompetent. Perish that thought. They are anything but.

(vi) Poor Economics – Abhijit Banerjee & Esther Duflo

i. Why are the poor simultaneously saving and borrowing at the same time?

ii. Why in some countries, the poor actually pay money to save money – *i.e.* they actually accept (-)ve interest rate

iii. Ernakulam – Survey. Dependence on money lenders.

iv. Seemingly irrational behaviour tells us a lot about how financial inclusion should be pursued.

22. **Fortune at the bottom of the pyramid** -

Shibboleth or cliché

- Fortune at the bottom of the pyramid is indeed there.
- Astounding success of millions of SHGs across the country – a heart warming success story
- Nascent capitalist inside every poor man and poor woman. Capitalists without capital as Banerjee and Duflo call them.
- The abundance of entrepreneurism among the poor is the least recognised part of our understanding.
- Purely in terms of stated occupations, most income groups in poor countries seem to be more entrepreneurial than their counterparts in the developed world – the poor no less so than others, an observation that inspired Harvard Business School professor Tarun Khanna's book, Billions of Entrepreneurs.

Financial Literacy and Inclusion – Challenge not unique to developing countries

23. Economist a couple of weeks ago. Feature on 'life on the edges of America's financial mainstream'..

- In December 2012, the Federal Deposit Insurance Corporation (FDIC) released a survey that found roughly one in 12 American households, or some 17m adults, are 'unbanked', meaning they lack a current or savings account.
- The survey also found that one in every five American households is 'underbanked', meaning that they have a bank account but also rely on alternative services – typically, high-cost products such as payday loans, cheque-cashing services, non-bank money orders or pawn shops.

- Not all the unbanked are poor, nor do all poor people lack bank accounts. But the rate of the unbanked among low income households (defined in the FDIC survey as those with an annual income below $15,000) is more than three times the overall rate.

Disturbing Questions about Financial Literacy

24. **[Economist] - Financial literacy**

- Here is a test. Suppose you had $100 in a savings account that paid an interest rate of 2 per cent a year. If you leave the money in the account, how much would you have accumulated after five years: more than $102, exactly $ 102, or less than $102?
- This test is so simple that you suspect there is a catch. There is no catch. But a survey found that only half of Americans aged over 50 gave the correct answer. If so many people are financially challenged, it is hardly surprising that they struggle to deal with financial decisions.

The solution seems obvious: provide more financial education.

But is it possible to teach people to be more financial savvy? A survey by the Federal Reserve Bank of Cleveland reported that: 'Unfortunately, we do not find conclusive evidence that, in general, financial education programmes do lead to greater financial knowledge and ultimately to better financial behaviour.'

So, is financial education programme a failure? Certainly not. The purpose of education is to teach people to deal with financial decisions more intelligently and with greater sense of confidence.

- make it interesting
- make it instructive
- make it relevant to the age and income group

Summary and conclusion

25. Let me summarise the point that I have been trying to make:

i. Problems of access and awareness in deepening financial inclusion and spreading financial literacy.

ii. Problem in poor countries. Problem also in rich countries.

iii. Perish stereotype views.

iv. Easy to attribute it all to sociological and demographic factors. But there is evidence to show that given the same sociological and demographic context, some countries have done better than others. So, strategies, policies and commitment do matter.

v. More importantly imagination and innovation are required.

vi. There is no one size fits all. On the contrary, we must let a thousand flowers bloom, let thousands of real life experiments take place. Learn from that collective experience to determine what works, what does not and why?

26. By the end of the conference, we have an improved and shared understanding on the challenge and opportunity of financial inclusion and financial education.

27. All the best for the success of the deliberations.

*Welcome Address**

K. C. Chakrabarty

Dr. D. Subbarao, Governor, Reserve Bank of India; Mr. Onno Ruhl, Country Director, the World Bank; Ambassador Richard Boucher, Deputy Secretary General, OECD; delegates from the OECD, the World Bank and from countries across the world; colleagues from Reserve Bank of India, other regulatory bodies and agencies involved in disseminating financial education in India; ladies and gentlemen, it is my proud privilege to welcome you all to India's capital city of New Delhi, a city of rich cultural and historical traditions, on the occasion of this Regional Conference on Financial Education jointly organised by RBI, OECD and the World Bank. As you might be aware, this conference is a part of a series of events organised to disseminate information about the activities of the Russia/OECD/World Bank Trust Fund on Financial Literacy and Education. Two other conferences in this series were held recently in Cartagena and Nairobi. We at the Reserve Bank of India, are indeed very proud to co-host this landmark conference, as it brings together all key stakeholders who are central to India's crusade for achieving universal financial literacy. We believe this conference provides an ideal platform, not only for us, but also for delegates from other jurisdictions in particular, the Asia Pacific Region, to exchange views and learn from the experiences of peers. We are also very happy and grateful, to have the World Bank and the OECD as partners for this conference; two organisations which have made immense contribution to spreading financial literacy and leveraging the financial systems to improve the quality of lives of the marginalised groups across the world.

2. Over the next three days, the participants can look forward to stimulating and enriching deliberations involving global experts having rich and varied practical experiences and learn from their experiences of implementation of financial literacy initiatives in different parts of the world. The conference sessions have been structured with focus on all the important pieces which constitute the jigsaw of financial education. For instance, keeping in view the importance of a well-articulated national level framework for financial education, an interactive panel discussion on experiences in developing National Strategy documents for Financial Education, has been planned. Further, in view of the need for assessing existing financial literacy levels in order to identify priority areas while rolling out a National level strategy, the conference includes a session dedicated to use of surveys for evaluating financial literacy levels and ground level feedback from such measurement exercises. The conference also seeks to emphasise on certain focus groups such as the youth and women with separate panel discussions dedicated to these groups. All sessions have been structured to involve sharing of experience by implementation experts from across jurisdictions and would encourage free participation by all delegates, in order to optimise the learning experience.

* Address by Dr. K. C. Chakrabarty, Deputy Governor, Reserve Bank of India at New Delhi on March 4, 2013.

Need for Financial Education/Literacy

3. Having given a brief outline of the Conference let me briefly touch upon the theme of the Conference. Over the past few years, particularly in the aftermath of the global financial crisis, the importance of Financial Education and Financial Literacy has come to be widely acknowledged. This recognition has led countries to initiate programmes to disseminate financial literacy among its citizens. As the OECD's definition of financial literacy indicates, it is 'a combination of financial awareness, knowledge, skills, attitude and behaviours necessary to make sound financial decisions and ultimately achieve individual financial wellbeing'. I would argue that financial literacy is not only important for financial well-being of the masses; it is also a *sine qua non* for the economic well-being of the nation as a whole.

4. Financial Illiteracy is not limited to the poor or to the less developed economies alone, it pervades all levels of society and economic strata. Only the manifestation of financial illiteracy varies depending upon the stage of development of the economy, and within the same country, upon the economic profile of the individual. I am a firm believer that everyone associated with the financial system needs to be financially literate. This includes the users of financial services; the providers of services; and even the policy makers and the regulators. For countries which successfully roll out financial education programmes, the benefits are significant.

For the Individual ...

5. At an individual level, financial literacy/ education is important because it helps in building financial capability. It makes people better informed, educated and more confident, able to take greater control of their financial affairs and to fully harness the benefits of accessing the formal financial system. People who understand their financial circumstances are more likely to make sensible choices and ensure adequate provision for their future. They are more likely to have an appropriate level of insurance and reach retirement age with comfortable pension plans. They won't pay more interest than they need to when borrowing, or settle for less than they should when saving. People with basic financial awareness would understand risk return trade-off and take better investment decisions, thereby being less vulnerable to frauds and dubious schemes. Financial education can help reduce levels of debt, poverty, repossessions, stress, illness and even crime. In sum, financial education improves the quality of people's lives and financial affairs and provides them peace of mind, by instilling in them a sense of confidence and security about matters of money.

For the macro economy ....

6. From a macro perspective also, financial literacy/ education has important implications. Financial literacy, together with financial inclusion and Consumer Protection form a triad which, collectively, has an important bearing on financial stability. The three legs of the triad have strong inter-linkages, with each element having a vital bearing on the

others. The absence of any one would make it difficult to attain the remaining goals. Financial literacy aids financial inclusion initiatives as it creates awareness about the benefits of connecting with the formal financial system and hence, creates demand for financial products. Financial literacy supports consumer protection as it helps consumers better understand the features and risks inherent in financial products, thereby reducing the risk of mis-selling. It also generates awareness and willingness to approach the grievance redressal system available, in case of disputes.

7. At a macroeconomic level, the cost of financial illiteracy is significant and is manifested through scourges such as unemployment, poverty, high personal indebtedness and financial exploitation through mis-selling. It results in avoidable leakages and wastages, which any resource-scarce country can ill-afford. The savings habit, which can be inculcated through financial education, can help channelise household savings into productive activities, thereby supporting economic growth. The increased demand for financial services, created as an outcome of financial education efforts, can help bring depth and diversification to the financial markets.

How are we doing in India ?

8. In India, financial education has been identified as a policy priority and a massive effort involving the Government, various financial sector regulators, financial institutions and civil society is underway. The Financial Stability and Development Council (FSDC), which is chaired by the Union Finance Minister, is mandated, *inter alia* to focus on spread of financial inclusion and financial literacy. Under the aegis of the FSDC, the draft National Strategy for Financial Education (NSFE) for India has been prepared. Further, we are focusing on financial education for school children and are involving various national curriculum setting bodies in order to seamlessly integrate financial literacy material into the existing course curriculum, without making it burdensome for the children. Over the course of this conference, my colleagues from the Reserve Bank and other agencies will be presenting the nuances of India's push towards universal financial literacy. We look forward to your views and suggestions on where we can do it differently, and better.

Conclusion

9. As I mentioned before, Financial Illiteracy is a global problem and the challenge before us is enormous. It calls for a collaborative partnership involving all stakeholders and all countries. While the experiences in individual jurisdictions would vary, there are important learning points that we can pick up from each country's journey. I hope this conference succeeds in valuable sharing of knowledge and experience among such a wide array of experts from across the world. I do believe that with our collective efforts towards universal financial education, individuals and institutions would be empowered to make informed financial choices and

in the process, the global financial marketplace would become a more stable arena, much less vulnerable to financial crisis, such as the one we are facing today. That is the ultimate goal of building financial capability in any society.

I wish the Conference great success and hope that you have extremely enriching deliberations over the course of the Conference. I once again welcome you all and wish you a pleasant and enjoyable stay in New Delhi. Thank you!

*Vote of Thanks**

G. Gopalakrishna

Respected Governor Dr. Subbarao, Ambassador Richard Boucher, Deputy Secretary General, OECD; Mr. Onno Ruhl, the World Bank, Dr. K.C. Chakrabarty and Dr. Urjit Patel, Deputy Governors, Reserve Bank of India, senior officials of Ministry of Finance, Government of India and State Governments, Ms. Flore-Anne Messy, OECD, distinguished delegates from OECD, the World Bank and SAARC countries, Chairmen and Managing Directors of banks, colleagues from the Reserve Bank, ladies and gentlemen.

2. First and foremost, I would like to thank respected Governor Dr. Subbarao, for taking time out to inaugurate this conference. Sir, your keynote address today was enlightening for its content which gave contours of the process of financial inclusion and financial literacy in India. Financial inclusion is a national mission for India. Your presentation today clearly reflected the commitment that you have towards the goals of financial inclusion and financial literacy. In fact, you might perhaps be the only Governor to have undertaken outreaches for financial inclusion and financial education. Your examples of the challenges that still remain towards achieving meaningful financial inclusion were indeed thought provoking. Sir, we are sure, that your profound thoughts, and perspectives, will set off debate and discussion over the next three days and will make this Conference a truly impactful event. Thank you very much.

* Address by Shri G. Gopalakrishna, Executive Director, Reserve Bank of India at New Delhi on March 4, 2013.

3. As the Governor so aptly put it, partnering with OECD and World Bank in hosting this Conference is a valuable learning experience for India. These two institutions have carried out work in the areas of financial education and financial inclusion which serves as a benchmark for other entities to emulate. Ambassador Boucher, your opening address today truly summed up coordinated initiatives that are being taken globally for advancing the cause of financial literacy and education. Thank you very much for partnering with us in the national agenda of financial literacy. I also thank Mr. Onno Ruhl, India Country Director, the World Bank for his opening remarks highlighting the importance of financial education and the credible work done by the World Bank in this area of financial inclusion. We sincerely hope that with the partnership with the OECD and the World Bank, we can make our financial literacy programme sharper so that we can make rapid progress in our pursuit of financial inclusion and financial literacy.

4. I also thank Dr. K. C. Chakrabarty, Deputy Governor, Reserve Bank of India, for steering us through the process of hosting this Conference and also agreeing to deliver the welcome address. Sir, we thank you for your guidance and innovative thoughts. Your address has clearly set out the essentials of effective financial inclusion and financial education and given a succinct account of the efforts taken by the Government, the Reserve Bank, other financial sector regulators and financial institutions towards this cause. I thank all the delegates in this Conference for making time to attend.

5. I thank the distinguished invitees present here for attending the function with warm enthusiasm. I thank all my colleagues from the Reserve Bank for

their participation. I also thank the media for covering this event.

6. It would not have been possible to hold an event of such scale and magnitude without the wholehearted support and commitment of our colleagues in the Reserve Bank of India, New Delhi office, ably led by the Regional Director. I thank them all for their support.

Thank you all, once again.

Closing Remarks*

Deepali Pant Joshi

- RBI Governor Dr. Subbarao set the tone for this conference by providing us the analytical framework.
- He explained how in the wake of the financial crisis our efforts had gathered greater salience.
- He also explained how the equation of financial literacy from the demand side and financial inclusion from the supply side work in tandem. He pointed to the numerous challenges, in the Indian context, liberalised Know Your Customer norms with a unique identity number would help spur financial inclusion. Banks however must treat it as a business opportunity and not an obligation thrust on them.
- Dr. K. C. Chakrabarty brought into very sharp focus how financial literacy, financial education and financial stability are inextricably linked and form part of a continuum.
- Mr. Onno Ruhl, India country director of the World Bank explained the seminal work of the World Bank in addressing issues of building financial capability through financial education and also referred to the work of the RBI in this regard.
- *Ambassador Boucher* expressed how in October 2011, G-20 finance Ministers agreed to new principles on financial consumer protection developed by an OECD led task Force integrated with financial inclusion and financial education policies.
- During the financial crisis, people who did not know any better borrowed beyond their means, not in Africa, not in Nigeria, Papua New Guinea, Japan, India but in the USA because appraisers inflated the value of properties that prospective buyers were interested in.
- Borrowers were led to believe that they had undertaken a standard fixed rate mortgage only to learn later that their mortgage was a complicated variable rate contract which with their income streams they could not honour.
- Brokers, mortgage companies, *etc.*, took the financially illiterate borrower for a ride risky lending practices proliferated.
- There was no consumer protection. Different jurisdictions had their own sets of lending policies.
- A large part the financial crisis was a result of financial illiteracy and lack of financial capability. We are meeting to ensure that this does not happen again this is the first commitment we must make and pledge ourselves to.
- Appropriately our introductory session dwelt on developing National Strategies for Financial education OECD/INFE principles and practical examples from Asia and the Pacific.
- Ms. Flore-Anne of the OECD set the tone. Country experiences were shared by Mr. G. P. Garg, Mr. Pungky Purnomo from Indonesia, Ryoko Okazaki from Japan shared the South, South East Asian and Asian experiences and as Dr. K. C. Chakrabarty explained Helena Kolmanova balanced the picture through the European perspective.
- *It is a truism that whatever gets measured gets done that statistics and empirical experience alone hold certitudes the rest are platitudes.*

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* Address by Dr. Deepali Pant Joshi, Executive Director, Reserve Bank of India at New Delhi on March 5, 2013.

So fittingly Dr. Urjit Patel capably steered the session on developing surveys to measure Financial literacy and capability. Surveys as a diagnostic tool can inform policy.

- Valeria Perotti, social protection specialist of the World Bank spoke on Measuring Financial Capability in Low and Middle Income settings and Adele Atkinson competently walked us through International Comparative measures of Financial literacy and evidence from the OECD/INFE Measurement pilot.
- Douglas Randall of the World Bank expounded on the FINDEX in which several of our countries have participated.
- The third fascinating session was on financial literacy and financial inclusion Findings and experience from – Asia and the Pacific region.
- Flore Anne Messy OECD capably moderated the session where Ryoko Okazaki, Director head of Promotion of Financial Education Group Central Bank of Japan Ms. Rufina Peter, Senior research officer Papua New Guinea made her presentation.
- She explained how difficult it was to run the questionnaire in two languages Tok Pisin and Hirin Motu in Papua New Guinea imagine how in India we manage with 22 official languages and 398 living languages the mind boggles but we need to do this. The last engaging presentation of the day was from Temitayo Adebiyi, Principal Statistics officer National Statistics office, Nigeria.
- This morning we have had a series of hands on sessions Richard Hinz and Flore Anne Messy provided us a valuable and insightful introduction to the programme Knowledge products and website of the Financial Literacy and Education Trust fund.
- There is currently limited evidence and little consensus on the types of programmes which are effective in raising the capacity for and level of financial capability.
- Effective impact evaluation is essential but often serves as a forgotten half in this context the presentations made by Richard Hinz, Trust Fund Program Manager, World Bank OECD High level Principles for evaluation of financial education programmes were particularly valuable.
- Adele Atkinson Policy analyst of the OECD presented the OECD High Level Principles for the evaluation of financial education programmes and Joanne Yoong from the National University of Singapore presented a toolkit for evaluation of financial capability programmes in middle and low income countries.
- This was followed by the session on Youth Developing financial skills and Competencies OECD/INFE guidelines on Financial Education in schools and PISA financial literacy.
- Financial education in schools, innovative tools, examples and evaluation findings was presented by Ms Amara Sriphayak,Bank of Thailand, Ms. Luciana, Consultant, World Bank gave us extremely valuable insights.
- The session on Women empowerment through Financial Education, especially close to the heart was moderated by Mr. Prashant Saran, whole time member, SEBI and there was valuable experience sharing through presentations by Ms. Chiara, Consultant, OECD and Ms. Sushma Kapoor of the UNWOMEN.
- The session on innovative methods for financial capability enhancement, in which doorstep banking and financial education in India were

presented by Mr. Leopold Sarr of World Bank was very useful. We all enjoyed Prof. Billy Jack, Associate Professor, Georgetown University presentation on Comic Books.

- We thank Florentina Mulaj of the World Bank for the serial melodrama to improve debt management of South Africa and Martin Kanz of the Economic Development Research Group of the World Bank for sharing the experience on Lotteries and Savings in Nigeria.
- We thank all the speakers for acquainting us with the range of evaluation of new methods and tools to enhance financial awareness and capability evidence suggests that innovative methods can bring positive outcomes on the target audience. The hardcore and asset less poor who are hard to reach due to low literacy levels and Geographical Locations. In sum, through the cross country experience sharing of the conference we have learnt a lot.
- Some of you may also have visited our stalls and picked up some comics to take back.
- We have covered a lot of ground but with distance still to go. Building financial capability through financial literacy is a key component of the financial Inclusion process. On this we are all agreed that every country has to tread its own path to financial inclusion and literacy depending on its particular situation literacy levels, per capita income, levels of financialisation of the economy.
- We have all reached consensus on the need for financial literacy and on National strategies engaging all stakeholders including Central and State Governments, financial regulators civil society public private partnerships, *etc.*,
- We have agreed that financial literacy, financial education lead to customer protection which leads to financial stability.
- You have come to India to the mystic East so I will give you a mantra, Our collective global goal is higher growth leading to inclusive and sustainable development. Our Finance Minister terms this the 'mool mantra' of Growth.
- Economic growth is essential but growth with equity is an imperative.
- Ladies and gentlemen, We must unhesitatingly embrace the need to build financial capability which leads to growth as the highest goal. It is growth that will lead to inclusive development without growth there will be neither development nor inclusiveness.
- The finance minister, presenting the Indian Budget quoted Stiglitz said 'There is a compelling moral case for equity but it is also necessary if there is to be sustained growth. A country's most important resource are its people'. You will all agree it is financially literate, financially educated and financially included people.
- At the end of the day, there will be no dissent that it has been a great conference.We have indeed covered a lot of ground but several challenges remain, with distance still to go.
- Our first Prime minister Jawaharlal Nehru often recalled the words of Robert Frost:

  'The woods are lovely dark and deep
  but I have promises to keep
  and miles to go before I sleep
  and miles to go before I sleep'.
- As Dr. Subbarao explained 'A part, indeed an important part, of the mandate of Central Banks

is financial stability and an essential prerequisite for financial stability is financial literacy and the central bank has unique leverage in providing financial literacy'.

- We all agree on the need to build financial capability of our people. We need to empower people. Now it is the time to get down to do it and together we know we can.

SPEECHES

*Is There a New Normal for Inflation?**

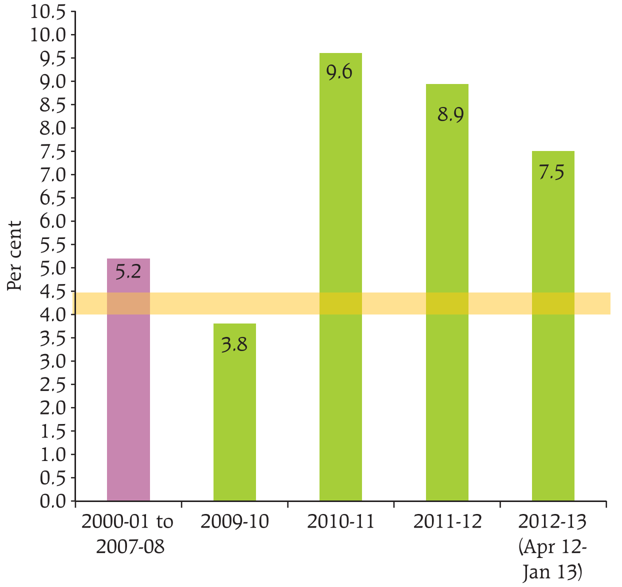
Duvvuri Subbarao

India recovered from the global financial crisis ahead of most other countries, but inflation too caught up with us sooner than elsewhere. As measured by the wholesale price index (WPI), inflation went marginally into negative territory for a few months into the crisis in 2009 and started rising sharply thereafter, clocking a peak rate of 10.9 per cent in April 2010[1]. Average WPI inflation was 9.6 per cent in fiscal year 2010-11, 8.9 per cent in 2011-12 and 7.5 per cent during the first ten months of 2012-13 (Chart 1).

New Normal Hypothesis

2. Despite this high episode of inflation playing out over the last three years, the Reserve Bank has consistently maintained in all its policy reviews that its objective is to '… condition and contain perception of inflation in the range of 4.0-4.5 per cent. This is in line with the medium-term objective of 3.0 per cent inflation consistent with India's broader integration into the global economy.'

Chart 1: WPI Inflation



3. In recent months, some analysts have questioned the Reserve Bank's resolve to bring inflation down to this level given the trend of stubborn and persistent inflation. Their main contention is that average WPI inflation over the last three years for which data are available (February 2010 – January 2013), at 8.8 per cent, is significantly higher than the average inflation of 6.0 per cent in the three years before the Lehman collapse (September 2005 – August 2008) suggesting that India's inflation rate has undergone an upward phase shift owing to a host of domestic and global developments. Monetary policy calibration, it is argued, can get flawed unless the Reserve Bank acknowledges this new normal.

4. The Reserve Bank does not agree with this 'new normal' argument. Indeed it is this intellectual conviction that informed our efforts to rein in inflation over the last three years as we brought inflation from double digit levels to below 7 per cent. The central task of this speech is to present the Reserve Bank's position on the 'new normal' debate.

Arguments in Support of a New Normal

5. In order to make my case, let me first summarise the arguments put forward by various analysts in support of a new normal.

(i) Wage-Price Spiral is a Permanent Shock to the Inflation Path.

6. The first argument for a 'new normal' stems from the steep increase in rural wages over the last few years that has set off a wage-price spiral. Nominal rural wages increased at double digit rates over the last five years. Indeed they increased so rapidly that despite high retail inflation, real wages too surged at close to double digits in the last three years (Table-1).

* Speech delivered by Dr. Duvvuri Subbarao, Governor, Reserve Bank of India at the Bankers' Club, New Delhi on March 8, 2013.

1 The last time India experienced more than three successive years of inflation above 7.5 per cent was during 1990-96.

Table 1: Increase in Rural Wages

Year	Nominal Wage Increase*	Average CPI (RL) Inflation	Real Wage Increase
	(Per cent)		
2007-08	8.9	7.2	1.5
2008-09	15.9	10.2	5.1
2009-10	18.0	13.8	3.8
2010-11	20.0	10.0	8.9
2011-12	19.9	8.3	10.6
2012-13 (Apr-Dec)	18.1	9.4	8.0

* Daily wage rate for rural unskilled labourer (male)
Source: Labour Bureau, Shimla

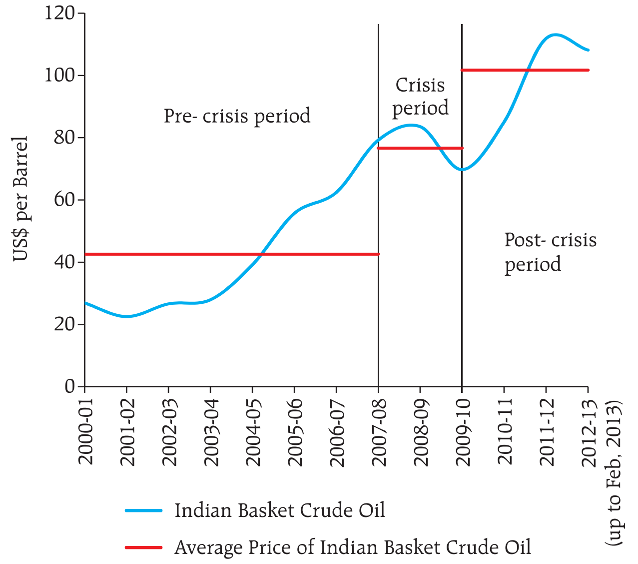
7. By far the most dominant driver of rural wages has been the Government's affirmative action programmes, both by way of transfer payments (subsidies) and welfare programmes, which have significantly raised the demand for wage goods while also restraining supply of labour at low wages. Two other factors exacerbated the wage-price spiral. First, the large public employment programme has not only pushed up wages, but also exerted upward pressure on agricultural input prices and thereby on food prices. Second, even as wages have increased, there has been no corresponding increase in productivity – a recipe for inflation.

8. The 'new normal' argument drawing from this is that it will be politically difficult to reverse these entitlement programmes, they are here to stay, and that India should accept wage-price pressures as a structural feature and adjust its inflation goal accordingly.

(ii) Commodity Price Pressures will Persist

9. Given the tepid recovery of advanced economies from the crisis and consequent sluggish demand, the expectation was that global prices of commodities, especially of crude, would remain soft. On the contrary, commodity prices have surged compared to the pre-crisis period (excluding the highly volatile two years of the crisis) and have remained firm at that level (Chart 2).

Chart 2: Average Price of (Indian Basket) Crude Oil



Source: IMF and PPAC, Ministry of Petroleum and Natural Gas

10. Several forces that will extend into the medium-term, it is argued, will work to keep commodity prices firm. First, oil producers, notwithstanding assurances to the contrary, will calibrate supply to ensure a minimum floor price for crude. Second, 'financialisation of commodities', a catch phrase used to describe a spike in commodity prices quite unrelated to fundamentals, that gathered momentum thanks to the buildup in global liquidity provided by the unprecedented quantitative easing (QE) in advanced economies is here to stay. This creates an asymmetry between financial market conditions and the real economy that will remain a structural feature of the global economy. The third argument in support of higher commodity prices is made on the basis of long-term fundamentals. These will stem from several factors: a larger world population, up from 7 billion in 2012 to over 9 billion in 2050, higher per capita energy consumption as emerging and developing economies 'catch up' on GDP levels, and the recovery of advanced economy growth to normal levels.

11. The new normal argument in this context is that these global price pressures will transmit to Indian prices either because of actual imports or because of

largely import parity pricing, thereby stoking inflation pressures.

(iii) The Positive Supply Shock of the Great Moderation Has Run Out

12. The world enjoyed an extended period of extraordinary price stability during the Great Moderation of the pre-crisis years. As we now know, this was largely the benign influence of the integration of emerging economies, especially China, into the global economy. Through the 80s and 90s, China alone added over a billion people to the global labour pool. This raised global production, but without commensurate increase in demand, and hence prices remained low.

13. The world, it is argued, will not return to the 'Great Moderation' situation post-crisis. As China goes forward on its 'rebalancing' from external demand to domestic demand, the global economy will see shrinking of low cost supplies from China and hence higher prices. The era of cheap imports is over and done forever.

14. The new normal argument in this context runs as follows. Because the positive supply shock from China has all but waned, global inflation will shift to a new normal once the recovery is complete. The Reserve Bank's implicit formula is to calibrate its comfort level of inflation some 2-3 percentage points above the average rate of inflation in advanced economies, while also aiming to converge to the world average inflation in the medium-term. If so, it should recognise the new global normal for inflation and recalibrate its comfort level for domestic inflation accordingly.

(iv) Quantitative Easing will Lead to Higher Inflation in Advanced Economies

15. Advanced economy central banks have battled the global financial crisis with an unusual show of policy force by resorting to unprecedented levels of 'Quantitative Easing'. It is argued that this excess will haunt their economies through higher and persistent inflation once they recover to an equilibrium level.

16. Will advanced economies have an incentive to battle those inflation pressures? Possibly not. Given their extraordinary fiscal pressures and consequent heavy obligation of public debt servicing, they may in fact find it a convenient way to inflate their way out of debt.

17. The Indian dimension of this global outlook is as follows. If higher level of inflation in advanced economies on the way forward is inevitable, India should recognise this, and factor it into its policy calculus consistent with its goal of inflation a few percentage points above the average inflation in AEs.

(v) India should Exploit the Positive Relationship Suggested by the Philips Curve

18. Macroeconomists have long struggled with the dilemma posed by the Philips Curve relationship. The Philips Curve is just an empirically observed positive relationship between inflation and growth (or an inverse relationship between inflation and unemployment). Notwithstanding subsequent economic research, some of it rewarded with Nobel Prizes, which showed that the Philips Curve trade-off has no theoretical basis, there is a school of thought that monetary policy can exploit this inflation-growth trade-off to achieve higher growth (or lower unemployment) by tolerating slightly higher inflation.

19. For those who believe in the Philips Curve trade-off, India presents a persuasive case for bargaining away a bit of inflation to secure higher growth because the multiplier impact of higher growth on poverty reduction will be larger in the case of India. But wouldn't higher inflation hurt the poor? The proponents argue that it will not because higher real incomes will raise purchasing power to more than offset the impact of higher inflation.

20. It should be noted that the new normal inflation argument deriving from the Philips Curve is different from the earlier arguments in one important way. The earlier arguments have an involuntary dimension. India cannot influence these forces; it has to perforce adjust

to them. In contrast, the Philips Curve argument involves a voluntary policy choice of accepting higher inflation to secure higher growth. Should that choice be made, it will require the Reserve Bank to recalibrate its inflation goal at a higher level.

(vi) PPP Convergence on Account of India's Integration into the Global Economy will Imply Accepting a New Normal for Inflation

21. This argument is based on the Balassa-Samuelson effect which says that the absolute price level in a developing economy needs to converge with those of developed economies as it integrates into the global economy on account of 'PPP' (purchasing power parity) catch up. In the process of this catch-up, wages may increase ahead of productivity levels, especially in the non-tradeable sector, leading to inflation.

22. India's integration with the global economy over the last ten years has been much more rapid than we tend to acknowledge, and over the next ten years, it will be much more rapid than we tend to believe. The Economic Survey of 2011-12 had argued that this PPP convergence process for India over the next 30 years would involve an additional inflation of 2 percentage points with no exchange rate adjustment and 1.5 per centage points if the rupee is allowed to appreciate. The counsel to monetary authorities accordingly is to acquiesce in this 'new normal' and support growth to hasten the process of PPP catch up.

Debate About a New Normal not Unique to India

23. Interestingly, the debate about a new normal for inflation is not unique to India; it is playing out in several countries in the post-crisis context in, of course, different ways.

24. As early as in 2000, Bernanke[2] had argued that the Bank of Japan's (BoJ) monetary policy had hit the Keynesian liquidity trap, and that the BoJ should raise its inflation tolerance to 3 to 4 per cent in order to flog the deflationary forces.

25. As the global financial crisis unfolded, Bernanke found himself at the receiving end of similar advice when Blanchard *et al.*[3] and Krugman[4] had, separately and independently, argued that the Federal Reserve should raise its inflation target from 2 per cent to 4 per cent in order to give itself larger head room for conventional monetary easing and thereby avoid, or at any rate delay, recourse to unconventional monetary easing. Quantitative estimates have reinforced this argument by showing that at an inflation target of 4 per cent, the probability of the Fed Funds Rate touching zero is less than 1 per cent. The Fed has, however, resisted this call for a higher inflation target by arguing that this exposes the economy to the risk of higher inflation by unhinging inflation expectations.[5]

26. More recently, a higher inflation target debate played out in Japan in a more high profile fashion. In deference to the electoral commitment of the incoming government to provide a growth stimulus, the Bank of Japan raised its goal of 1 per cent inflation to a target of 2 per cent inflation which it hopes to achieve through unlimited bond purchase.

27. In the UK, a battle of ideas is playing out on how to revive the sagging economy. The Government has firmly embraced a fiscal consolidation plan, but the private sector is yet to take up the slack left by the Government and demand is yet to revive. The burden of stimulating the economy has therefore fallen on the Bank of England (BoE), an inflation targeter, which found itself consistently overshooting its inflation target over several successive months till mid-2012.

28. This policy context has triggered a debate in the UK on whether inflation targeting is an appropriate

2 Ben S Bernanke, 'Japanese Monetary Policy: A Case of Self-induced Paralysis', Institute for International Economics, Special Report 13, September 2000.

3 Olivier Blanchard, Giovanni Dell' Ariccia, and Paolo Mauro, 'Rethinking Macroeconomic Policy', IMF Staff Position Note, February 12, 2010.

4 Paul Krugman, 'Earth to Ben Bernanke: Chairman Bernanke Should Listen to Professor Bernanke', New York Times, August 24, 2012.

5 Esther L George, 'The US Economy and Monetary Policy', Federal Reserve Bank of Kansas City.

policy stance in the face of unyielding recession. One option as suggested by Mark Carney, soon to be BoE Governor, is that central banks could consider targeting nominal GDP instead of inflation. Nominal GDP targeting, by reducing uncertainty about how long monetary policy will stay easy, allows a central bank to persist with an accommodative monetary stance to stimulate growth even if inflation is above its comfort level. This is not costless though. It increases uncertainty about future inflation and can therefore potentially unhinge inflation expectations from their anchor around the targeted inflation.

29. Even as these debates about a new normal for inflation are becoming more commonplace around the world, the context similarity between India and advanced economies should not be stretched. The concern in advanced economies is about how to continue with the stance of monetary easing even after the policy interest rates have hit the zero lower bound so as to minimise loss of employment and output. The concern in emerging economies in general, and India in particular, on the contrary, is an aspiration for higher growth aimed at poverty reduction, even if it entails higher, *albeit* not much higher, inflation. It is important to acknowledge this vital difference in evaluating the arguments for and against a higher 'normal for inflation'.

Why is it Important to Recognise if There is a New Normal for Inflation?

30. It is important because not recognising an upward long-term structural shift in 'normal inflation' can lead to a flawed monetary policy stance with potentially heavy macroeconomic costs.

31. This can be understood in the paradigm of type-I and type-II errors in statistical analysis. If indeed there is a new normal and it is not recognised, this could lead to an overtightening of monetary policy, a type-II error. But there could be a type-I error too if the new normal is wrongly recognised and monetary conditions are kept accommodative for too long, thereby fuelling higher inflation. Theory also tells us that efforts to minimise one type of error result in maximising the other type of error. So, where should the balance lie? Even if there is arguably a new normal for inflation, wouldn't it be more prudent to err on the side of caution? And what will be the price to be paid for that prudence on the inflation front in terms of lost growth?

32. Central banks face a complex policy choice in managing the growth-inflation balance. Experience shows that policy mistakes cannot easily be reversed in short order, and typically not before heavy costs have been paid by way of welfare loss. At the same time, the probability of policy mistakes is high because it is difficult to get an accurate estimate of the potential growth rate of the economy in real time.

33. Economic history of the last 50 years, especially of the US, contains several instances where central banks are alleged to have made costly errors. The best known example is the Volcker disinflation policy of the early 1980s. Paul Volcker, the Fed Chairman of the time, is largely credited with restoring price stability in the US, but subsequently there have been questions about whether too high a price was paid for it by way of two recessions and a surge in unemployment. Was there, in fact, a new higher normal for US inflation that Volcker did not recognise? If indeed there was, how does it square with the low inflation experience of the US over the last two decades? This is a debate that is yet to be settled.

34. The importance of having an accurate estimate of the 'normal values' of the fundamental economic variables of an economy – potential growth rate, natural rate of unemployment and threshold inflation – in order to accurately calibrate policy got reinforced recently in the context of the US Fed's announcement in December 2012 that it will maintain its current easy monetary policy stance 'as long as the unemployment rate remained above 6.5 per cent' provided inflation is only slightly above its target and long-term inflation expectations remain anchored. This has raised a question about whether the Fed has accepted 6.5 per

cent as the new normal for unemployment. It has raised an even more important question about whether 6.5 per cent unemployment is, in fact, an underestimate in which case the Fed would run the risk of maintaining its easy stance for far too long, thereby stoking inflation.

New Normal – Counter Arguments

35. Let me now put across the Reserve Bank's assessment and position on each of the arguments for new normal as summarised earlier.

(i) Wage-Price Spiral cannot Sustain Indefinitely

36. The thrust of our response to the wage-price spiral argument is that even if inclusive growth policies, liberal fiscal entitlements and heightened inflation expectations – driven primarily by food inflation – trigger a wage-price spiral, it cannot be sustained in the absence of an accommodative monetary policy. Admittedly, wage pressures, unaccompanied by productivity increases, start off as demand shocks, but soon transform to act more like supply shocks.

37. Like any other supply shock, exogenously imposed higher wages can be inflationary in the first round, but the bargaining power of labour will erode in time, and the necessary adjustment will take place to bring wages back in line with productivity levels. The recent high growth in rural wages also reflects a catch up with minimum wages, a necessary adjustment intended by the Government. After the initial catch-up, however, wage growth cannot be sustained without corresponding productivity increases. If not, firms will gradually lose their power to translate higher input prices to higher output prices, inevitably leading to a correction in the wage pressures.

38. Furthermore, we must recognise that the Government does not have the fiscal capacity to continue entitlements and welfare programmes at this level. The Government's embrace fiscal responsibility will act as a self-limiting check on the wage-price spiral.

(ii) Commodity Price Shocks are Unlikely to Persist

39. Even as the arguments in support of continued upward pressure on global commodity prices are compelling, there are some credible arguments to the contrary, drawing mainly from an alternate energy scenario going forward. The global energy scenario will change on three dimensions – efficiency, demand and supply.

40. On the efficiency front, regulatory and competitive pressures will ensure that gains from energy efficiency will continue to roll in, possibly at an accelerated pace. From the demand perspective, the impact of these efficiency gains on emerging economies will be larger, in the sense that the energy intensity of their GDP growth will be lower than that of advanced economies when the latter were at similar levels of GDP. China is, in fact, projected to move onto a less energy-intensive development path by 2020.

41. From the supply perspective, the shale revolution, first for gas and then for oil, is expected to contribute almost a fifth of the increase in global energy supply by 2030. A roughly similar positive contribution is likely from renewable sources of energy – expected to treble by 2030. Growing domestic production and near flat consumption may see the US become self-sufficient in energy by 2030. Supply from Iraq is projected to increase steadily, and by 2030 it is likely to become the second largest global oil exporter, overtaking Russia.

42. Add to all this, the lessons of experience. For over a century now, commodity prices have been prone to mean reversion. There is no reason why this time it should be very different.

43. Admittedly, gains on the energy front will translate to gains on the inflation front only if other policies are managed intelligently. In particular, demand for land from industrialisation and urbanisation should not be allowed to crowd out bio-fuel production. Simultaneously, agricultural productivity needs to increase so as to meet the food requirements of a growing population even if some land is ceded for bio-fuel cultivation.

44. The thrust of the Reserve Bank's argument is that the current and projected trends for the global energy

scenario do not provide a persuasive case for raising India's 'normal inflation'.

(iii) Global Rebalancing will Ensure Benign Inflation

45. The new normal argument that I cited earlier is that China's ability to exert downward pressure on global prices will wane. It certainly will, but only gradually. Given the size of China's economy, it will continue to be the world's cheap manufacturer for at least the next decade, thereby keeping global inflation under check. Even as China moves up the value chain, the space vacated by it will be occupied by other emerging and developing economies. All this suggests that multiple poles of global growth and competitive pressures will ensure that global inflation remains benign for at least the next decade. The argument that India must recalibrate its inflation higher because global inflation is going to be higher loses its potency if, in fact, higher global inflation is not a credible threat.

(iv) QE – No Risk to Global Inflation in the Medium Term

46. Let me now address the argument about advanced economies suffering higher inflation down the road because of QE. There is a view that this threat is being exaggerated. Advanced economy central banks, especially the US Fed, have repeatedly asserted that they have in place well thought through plans to unwind QE in a non-inflationary way. Also note that long term inflation expectations in advanced economies do not suggest any risk to price stability.

47. Most importantly, nothing hurts the election prospects of a democratic government more than rising prices. Political economy compulsions will therefore ensure that governments do not resort to inflating their way out of debt.

(v) The Philips Curve Relationship does not Provide a Realistic Policy Option

48. Experience since the 1990s demonstrates that the secular growth-inflation trade-off suggested by the Philips curve does not hold at all levels of inflation. The relationship is indeed non-linear and reversible. There is a threshold level of inflation, below which it might be possible to exploit the growth-inflation trade-off. However, if inflation is above the threshold, it is decidedly inimical to growth as higher inflation does not raise, but actually lowers the growth rate.

49. Mohanty *et al.* (2011)[6] have estimated that the threshold inflation for India is in the range of 4.0 per cent to 5.5 per cent. Updated estimates, using the same methodology, yield a range of 4.4 per cent to 5.7 per cent, implying a mid-point rate of about 5.0 per cent. Even though an estimated threshold inflation rate need not be the optimal inflation target for a central bank, it nevertheless provides a reference point for calibrating the 'normal inflation'. The surmise is that empirical research does not support the case for a new normal.

(vi) New Normal on Account of PPP Convergence is not Inevitable

50. Apart from all the empirical arguments, there is also an important conceptual argument against the 'new normal' hypothesis. As India's integration with the world picks up pace over the next decade, it is important also that our inflation rate is in line with global inflation. A new normal based entirely on domestic considerations will result in a permanent wedge between domestic and global inflation which means a persistent real appreciation of currency. Real appreciation is unambiguously contractionary and militates against our growth aspiration. To support sustainable growth during a period when the economy is globalising, our inflation rate needs to converge with the global inflation rate. This is the rationale behind the Reserve Bank's policy of calibrating its medium term inflation goal to global inflation.

51. This is an appropriate context for me to respond to the argument for a new normal based on the PPP

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[6] *Deepak Mohanty, A B Chakraborty, Abhiman Das and Joice John,* 'Inflation Threshold in India: An Empirical Investigation' W P S (DEPR) : 18 / 2011.

convergence argument. Our view on this is that PPP convergence cannot be a policy goal, and accepting higher inflation to aid PPP catch up will be both futile and indefensible. As India's per capita income rises, PPP convergence will happen automatically. We need to make sure that rise in incomes is accompanied by productivity gains so that the process of PPP catch up is non-inflationary.

52. There is also no *a priori* reason to believe that the entire burden of adjustment on account of integration with the global economy will have to come by way of the price differential closing. Part, if not all, of the burden can be borne by exchange rate adjustment too as evidenced by the experience of Japan starting the 1960, when the yen appreciated by over 300 per cent to close the price gap. How the burden of adjustment is shared between price levels and exchange rates will depend on country circumstances – in particular the economy's structural constraints and market rigidities.

53. To support sustainable growth during a period when the economy is globalising, our inflation rate needs to converge with the global inflation rate. We need to manage this convergence by calibrating the 'inflation differential' over time rather than acquiescing in a new normal for inflation.

Conclusion

54. Admittedly, the average inflation rate in India over the last three years has trended up. Nevertheless, the context presents neither a necessary nor a sufficient condition for the Reserve Bank to revise its inflation goal. Not a necessary condition because, as indicated earlier, much of our inflation is driven by supply constraints which can be corrected by appropriate policies and their effective implementation. Accepting a new normal for inflation not only has no theoretical or empirical support, but entails the moral hazard of policy inaction in dealing with supply constraints. Not a sufficient condition because there is no empirical evidence to establish that the benefits of higher growth outweigh the costs of welfare loss associated with higher inflation.

55. Key to our collective national aspiration for sustained high economic growth is low and steady inflation. It is only under such an environment of price stability that investors and consumers can make informed choices and contribute to growth. The responsibility of the Reserve Bank in this regard is to anchor inflation expectations and ensure price stability. Neither theory nor empirical evidence presents a credible case for acquiescing in a new normal for inflation in India.

*India's Macroeconomic Challenges: Some Reserve Bank Perspectives**

Duvvuri Subbarao

First of all many thanks to the London School of Economics (LSE) for inviting me to deliver the fifth I.G. Patel Memorial Lecture. It is an honour to which I attach immense value.

Dr. I. G. Patel

2. Dr. I. G. Patel represents a special bond between our two institutions – the Reserve Bank which I represent and the LSE where this lecture is instituted. Dr. Patel led both these institutions with great dignity and distinction, and is loved and respected by both our institutions.

3. Because the occasion demands it, I must repeat what I said at the Reserve Bank's Platinum Jubilee celebrations in 2010.

4. Those of you who have an interest in the history of science would know that Sir Isaac Newton was known, among other things, also for his intellectual arrogance. When his friend and rival, Robert Hooke wrote to him, lauding his theory of gravity, Newton, for all his arrogance, wrote back with uncharacteristic humility:

> 'If I have been able to see a little farther than others, it is because I am standing on the shoulders of giants.'

5. That is a statement I can relate to. As the Governor of the Reserve Bank in these exciting times, I owe an intellectual debt of gratitude to the extraordinary men who led the Reserve Bank through several challenges, and made a mark in the economic history of India. Among the most distinguished of them is Dr. I. G. Patel. I am privileged to be in the same lineage as him.

6. During his long and illustrious career in India, Dr. Patel made very significant and lasting contribution to economic governance of India. He was Governor of the Reserve Bank at a critical time when the Indian economy had to battle a balance of payments crisis triggered by the second oil price shock in the late 1970s. He played an active role in securing accommodation for India from the IMF's Extended Fund facility, an arrangement that was the largest in the Fund's history at that time.

7. Indeed, Dr. Patel was the intellectual force behind resolving some of our biggest macroeconomic challenges of his time. As the Governor of the Reserve Bank today, I am involved in addressing some of India's current macroeconomic challenges. The leadership that my predecessors provided in confronting these challenges always remains a source of motivation and inspiration for me in navigating through these challenges. I thought the best way I can honour the memory of late Dr. I. G. Patel is to talk about India's current macroeconomic challenges from the Reserve Bank's perspective.

India – Current Macroeconomic Context

8. India clocked an average growth of 9.5 per cent in the three year period before the global financial crisis (2005-08). For a nation that once believed that the 'Hindu Rate of Growth' was its destiny, this remarkable growth performance was cause for celebration. It was also a trigger for setting off an aspiration for double digit growth.

9. Today, there is a sharp reversal. Growth has decelerated, inflation is still high and stubborn, the investment rate has declined sharply and the external sector is beset with a record high current account deficit. This downturn has caused widespread anxiety that we may have got derailed from the high growth trajectory. It has also raised a number of questions. Is

* Fifth I. G. Patel Memorial Lecture delivered by Dr. Duvvuri Subbarao, Governor, Reserve Bank of India at the London School of Economics on March 13, 2013.

our growth story faltering? Has India's potential growth rate declined? Are the growth drivers that worked our way during 2003-08 still intact? Has the world lost confidence in India's growth promise? When will we reach double digit growth, and what indeed should we be doing to get there?

10. My short answer to all these questions is that the India growth story is still credible and that the long term growth drivers are still intact. If we do the right things, we can get back on a high growth trajectory. Equally, there is nothing inevitable about the India growth story. We can accelerate growth and improve welfare only if we effectively implement wide ranging economic and governance reforms. Slipping up on this will amount to a costly and potentially irreversible squandering away of opportunities.

11. The Government has to be at the center of this and lead the process of economic revival. As the central bank and as the regulator of large segments of the financial sector, the Reserve Bank too has an important role to play in this. What I propose to do today is to discuss some important macroeconomic challenges from the Reserve Bank's perspective.

12. In particular, I will discuss three challenges:

i. Managing growth-inflation dynamics

ii. Mitigating the vulnerability of external sector

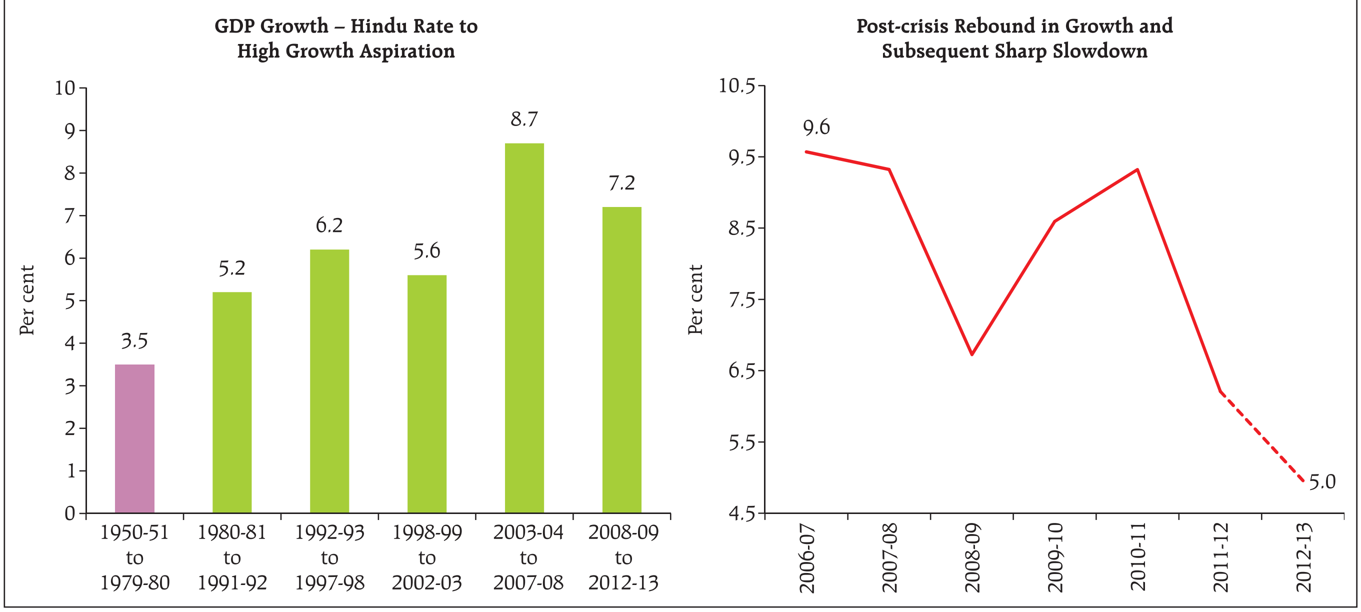
iii. Managing the political economy of fiscal consolidation

First Challenge: Managing Growth-Inflation Dynamics

Growth

13. The global financial crisis affected virtually every economy in the world, and India was no exception. But we recovered from the crisis much sooner than even other emerging economies. In the crisis year of 2008-09, growth dropped to 6.7 per cent, but it recovered smartly thereafter. In fact, in the two years after the crisis, 2008-09 and 2009-10, growth averaged 9.0 per cent which compares favourably with the average growth of 9.5 per cent in the three years before the crisis. However, last year, 2011-12, growth moderated to 6.2 per cent, and the first advance estimates suggest that growth this year may drop further to 5.0 per cent, the lowest in a decade (Chart 1).

Chart 1: Sharp Deceleration in GDP growth



14. To understand the latest downtrend, it is important first to understand the pre-crisis growth surge. Several explanations are offered for India's growth acceleration in the pre-crisis period: the impact of economic reforms of the 1990s; India's rapid integration with the global economy; rise of entrepreneurism; and increase in productivity.

15. Underlying all these factors was the massive increase in capacity as investment jumped from 26.9 per cent of GDP in 2003-04 to 38.1 per cent in 2007-08 (Chart 2). This increase in investment was financed by growing domestic saving, and was accompanied by an increase in productivity driven by improvements in technology, organisation, financial intermediation and external and domestic competitiveness. The current account deficit (CAD) during this period averaged just 0.3 per cent of GDP suggesting that the contribution of foreign savings to domestic investment was relatively modest. But to the extent foreign saving came by way of foreign direct investment (FDI), it raised the productivity of overall investment and resulted in higher exports.

16. In the immediate post-crisis period, even as investment slowed, private consumption demand, which accounts for about 57 per cent of GDP, held up as rural incomes grew robustly on the back of the crisis driven stimulus as well as the expanded safety-net programmes of the government. This kept growth up but also fuelled inflation reflecting excess of demand over supply.

17. So, what explains the downturn in growth over the last two years? The answer would be a slowing of demand across the board. Private investment decelerated sharply, in part reflecting the global downturn, but largely owing to domestic factors. Business profitability was dented by tightening infrastructure constraints and increasing input prices stemming from high food and fuel inflation. Business confidence was hit by a rising fiscal deficit, vacillating commitment to reforms and governance concerns, all of which dampened investor perceptions on returns to investment.

18. On top of the decline in private investment, private consumption demand, which was the bulwark

Chart 2: Domestic Saving and Investment (% of GDP)

Chart 3: Annual Growth in Private Consumption and Investment

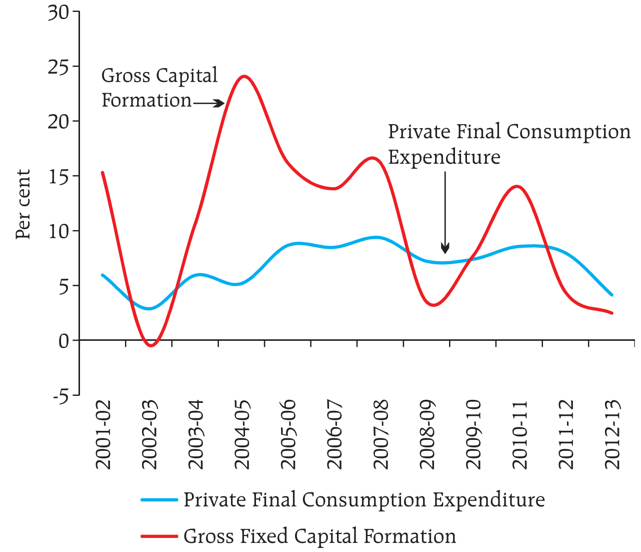
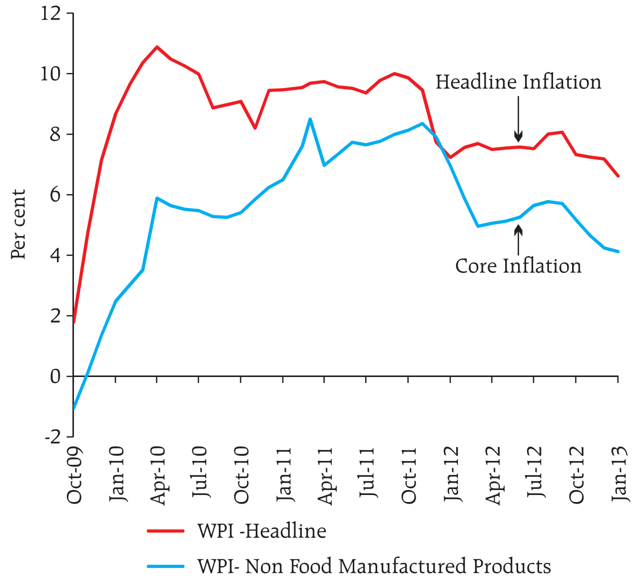


Chart 4: Year-on-Year Inflation Rates



of the quick recovery from the crisis, too started slowing in recent years exacerbating the growth slowdown (Chart 3). It is estimated to have slowed to 4.1 per cent during the current year, down from an average of 8.3 per cent in the previous two years.

Inflation

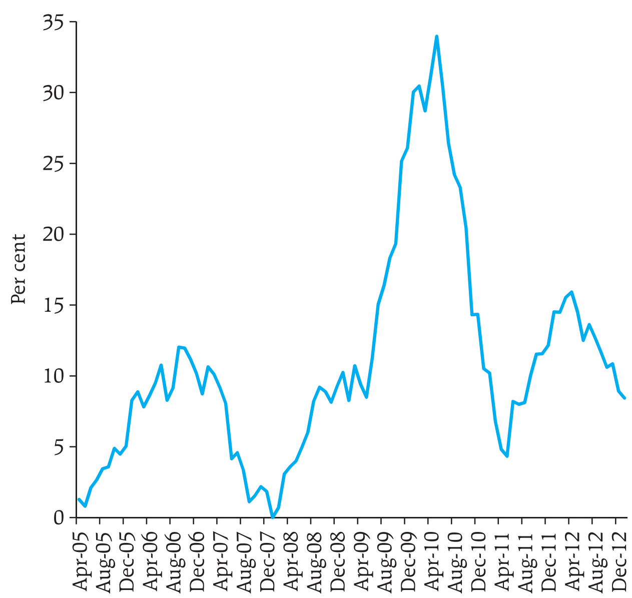
19. Just as India recovered from the crisis sooner than other countries, inflation too caught up with us sooner than elsewhere. Inflation, as measured by the wholesale price index (WPI), went briefly into negative territory for a few months in 2009 but started rising sharply thereafter, clocking a peak rate of 10.9 per cent in April 2010. Average WPI inflation was 9.6 per cent in fiscal year 2010-11, 8.9 per cent in 2011-12 and 7.5 per cent during the first ten months of 2012-13 (Chart 4). The story therefore is that at 8.7 per cent, the average inflation over the last three years has been higher than the average inflation of 5.4 per cent during the previous decade (2000-10)

What is Driving Inflation?

20. Both supply side and demand side factors have contributed to the buildup of inflationary pressures.

21. A major driver from the supply side has been food inflation, which has both structural and cyclical components. The structural component arises from rising incomes, especially in rural areas, which is leading to a shift in dietary habits from cereals to protein foods. Inflation of protein food prices remained in double digits for much of the last three years barring a few months (Chart 5). The cyclical component of food

Chart 5: Protein Food Inflation (Y-o-Y)



inflation arises from the monsoon related spike in prices of food items such as vegetables. Notwithstanding all the talk of drought proofing the economy, the timely onset of the monsoon and its spatial and temporal distribution continue to influence the inflation outlook in India.

22. The second major factor driving the current episode of inflation has been global commodity prices, especially the price of crude oil. India imports 80 per cent of its oil demand. The global price of oil is therefore an important variable in determining the inflation outlook. The depreciation of the rupee, starting October 2011, has compounded the inflationary impact of oil prices.

23. If the domestic petroleum sector was a free market and if global prices passed through to domestic prices, demand would arguably have declined in response to rising prices. But such a demand adjustment was blocked by the administered (subsidised) pricing regime of petroleum products.

24. Subsidisation did not, however, protect us from inflation pressures – the cost of subsidies raised the fiscal deficit which fuelled inflation. So, any softening of inflation that we gained through subsidisation was offset by a larger fiscal deficit.

25. There is a debate in India about the macroeconomic and welfare dimensions of subsidies financed, not by government surpluses, but by government borrowing. An argument against de-subsidisation is that it will be inflationary. Sure, it will be inflationary in the short-term, but price pressures will even out over the medium term. Also, the inflation impact should not be overstated. To the extent lower subsidies result in a lower fiscal deficit, there would be some disinflationary impact even in the short-term. Finally, reduction in subsidies will remove price distortions, improve efficiency and provide a much better investment environment.

26. The third major factor fuelling inflation has been wage pressures. Nominal rural wages increased at double digit rates over the last five years. Indeed, they increased so rapidly that, despite high retail inflation, real wage growth surged close to double digits in the last three years (Table 1). The Government's social safety-net programmes contributed to, and sustained, the wage-price spiral. In an economy with a per capita income of about US$ 1500, any increase in income quickly translates into increase in consumption demand and that is exactly what was witnessed in India. Producers were able, until very recently, to pass on the higher input prices in the form of higher output prices without sacrificing their margins.

Growth-Inflation Dynamics

27. India's growth-inflation dynamics pre-crisis and post-crisis present a study in contrast. In the three year period before the crisis, the economy expanded by 9.5 per cent on average, aided by growth in fixed investment above 15 per cent per year. This expanded production capacity to match growing demand and kept core inflation in check. Post-crisis, the story reversed. Investment declined to half its pre-crisis rate whereas consumption demand remained at the pre-crisis level until last year, owing partly to the government's entitlement and welfare programmes, opening up a positive output gap during 2009-11 and stoking core inflation.

Table 1: Increase in Rural Wages

Year	Nominal Wage Increase*	Average CPI (RL) Inflation	Real Wage Increase
	(Per cent)		
2007-08	8.9	7.2	1.5
2008-09	15.9	10.2	5.1
2009-10	18.0	13.8	3.8
2010-11	20.0	10.0	8.9
2011-12	19.9	8.3	10.6
2012-13 (Apr-Nov)	18.1	9.4	8.0

* Daily wage rate for rural unskilled labourer (male)
CPI (RL): Consumer Price Index for Rural Labour

Two Questions About Growth-Inflation Dynamics

28. The growth-inflation dynamics of recent years that I briefly summarised above raise two interesting and related policy questions. The first is about India's potential growth rate and the second is about why inflation is persisting at an elevated level even in the face of steeply moderating output growth. Let me briefly address them.

What is India's Potential Growth Rate?

29. There is considerable evidence from research done at the IMF and the Bank for International Settlements (BIS) that potential growth rates may have declined significantly in both advanced and emerging economies. India too, despite being less integrated with the global economy than other EMEs, has seen a drop in its potential growth rate. The Reserve Bank estimates show that the potential growth before the crisis was in the range of 8.0-8.5 per cent. This estimate was scaled down to 7.0 per cent after the crisis owing to a host of factors – decline in the pace of capital formation, supply constraints, especially of infrastructure, pressure on factor productivity because of tepid progress on reforms and a high fiscal deficit.

30. Some analysts contend that the potential growth rate may have dipped even below the Reserve Bank's post-crisis estimate of 7 per cent. The argument is that with growth dipping below 7 per cent last year and projected to dip even lower this year, we should have seen inflation and current account deficit soften. On the other hand, inflation persists at an elevated level and the current account deficit is likely to be the highest ever, suggesting that the economy is growing beyond its capacity and that the potential growth may be lower than even 7 per cent.

Why are India's Growth-Inflation Dynamics contrarian?

31. The second and related question is about why India's macroeconomic dynamics are contrarian. In particular, over the last two years, many of our peer EMEs have also experienced a growth deceleration, but in line with standard theory, several of them have also seen a moderation in their inflation rates. In India, however, inflation has not come down in line with growth deceleration. Several idiosyncratic factors are put forward to explain this uniqueness of our macroeconomic situation: supply bottlenecks, particularly in infrastructure, sectoral imbalances, rise in wages without a corresponding increase in productivity, higher fiscal deficit and larger depreciation of the exchange rate than in the case of our peers.

Reserve Bank's Action to Curb Inflation

32. To control inflation, the Reserve Bank reversed the crisis period's accommodative monetary stance in quick order. We raised the policy interest rate (repo rate) 13 times, cumulatively by 375 basis points (bps) – from 4.75 per cent to 8.5 per cent. Also we raised the reserve requirement on banks – the cash reserve ratio (CRR) – by 100 bps from 5 per cent to 6 per cent. Monetary policy is known to work with lags, and as a consequence of the tight monetary policy, WPI inflation which peaked at 10.9 per cent in April 2010, has come down to 6.6 per cent in January 2013.

33. In response to deceleration in growth and decline in inflation, the Reserve Bank eased the monetary policy stance starting January 2012 cutting both the repo rate (by 75 bps) and the CRR (by 200 bps).

Criticism Against Reserve Bank's Monetary Policy Stance

34. The Reserve Bank has been criticised for its anti-inflationary stance. Let me address some of the main strands of that criticism if only to illustrate the dilemmas that we face in managing the growth-inflation trade-off.

Monetary Policy has Only Stifled Growth, But has not Tamed Inflation

35. By far the most common criticism has been that tight monetary policy has stifled growth but has not tamed inflation. My response to this criticism is the

following. First, inflation has come off from its peak by over about 4 percentage points. Admittedly, growth too has moderated. However, the Reserve Bank's anti-inflation stance is motivated by the dictum that inflation is inimical to growth and that only in a situation of price stability can consumers and investors make informed choices.

36. It is important also to note that in order to contain inflation, monetary policy seeks to curb demand which, in turn, restrains growth. As per this logic, reduction in growth is an inevitable outcome of tight monetary policy. But this sacrifice is only in the short-term. In the medium term, there is no growth-inflation trade off; on the contrary, low and stable inflation secures sustained high medium term growth. And this is what the Reserve Bank is aiming at.

37. It is important to note in this context that the relationship between growth and inflation is non-linear. At low levels of inflation and stable inflation expectations, there is a trade-off between growth and inflation – some inflation can be tolerated to grease the wheels of growth. But above a certain threshold level of inflation, this relationship reverses, the conventional trade-off disappears, and high inflation actually starts taking a toll on growth. Estimates by the Reserve Bank using different methodologies put the threshold level of inflation in the range of 4 to 6 per cent. Inflation above 6 per cent would therefore justify, indeed demand, tightening of the monetary policy stance. It is this understanding that informed the Reserve Bank's monetary policy stance.

Monetary Policy Tightening is Inappropriate to Combat Supply Shock Driven Inflation

38. A second and related criticism of the Reserve Bank's anti-inflationary monetary policy stance has been that India's recent inflation is driven by supply shocks in food and fuel items and that monetary tightening does not help restrain inflation in such a case. It only results in avoidable sacrifice of growth.

39. I have several responses to this criticism. The first is that inflation was driven not just by supply shocks but by demand pressures as well, as evidenced by output expanding faster than the potential growth rate in the immediate post-crisis years of 2009-10 and 2010-11, the large and growing current account deficit and rapid growth in consumption demand.

40. Admittedly, there were supply shocks too, in addition to demand pressures, that were stoking inflation pressures. Monetary policy response to supply shocks is a deliberate balancing act because errors can be costly in terms of lost growth. If the judgement is that the supply shock is transitory (such as cyclical increase in vegetable prices), the preferred policy response should be to not respond by monetary tightening. If on the other hand, the judgement is that the supply shock is structural in nature and will persist, monetary policy has to respond since persistent inflation, no matter what the driver, stokes inflation expectations. Monetary policy is inevitably the first line of defence to guard against inflation getting generalised through unhinged inflation expectations. The Reserve Bank's policy response has been guided by the above consideration.

41. To sum up, the surmise from the challenge posed by the growth-inflation dynamics is the following. Today's investment is tomorrow's production capacity. India needs to not only reverse the investment downturn but also increase it significantly to raise production to match the growing consumption demand. Increase in investment is necessary also to raise production for exports and thereby create jobs at home. Making this happen requires a supply response from the government by way of providing public goods and creating a conducive environment for private investment. Meanwhile, the Reserve Bank has to ensure that inflation is brought down to the threshold level and is maintained there.

Second Challenge: Mitigating the Vulnerability of the External Sector

42. Over the last two years, India's balance of payments (BoP) has come under growing pressure as evidenced most clearly by a large and increasing current account deficit (CAD). The CAD last year (2011-12) was 4.2 per cent of GDP, historically the highest; the CAD during the current year is expected to be even higher.

43. Many will recall that India went through a balance of payments crisis in 1991 which, in fact, triggered wide ranging structural reforms that gave a market orientation to the economy. Despite India's growing integration with the global economy, the external sector remained robust for over 15 years after that. The current episode of BoP pressures, when the CAD is higher than it was at the peak of the 1991 BoP crisis (3 per cent of GDP) is, therefore, causing apprehensions about whether we have the capacity to stem the pressures and restore the BoP to a sustainable path.

44. The increase in CAD is quite evidently a consequence of imports growing faster than exports. (Table 2)

Table 2: Balance of Payments

	2010-11	2011-12
	(US$ billion)	
Exports	250.5	309.8
(y-o-y growth)	*37.4*	*23.7*
Imports	381.1	499.5
(y-o-y growth)	*26.8*	*31.1*
Of which		
- Oil	105.1	155.6
(y-o-y growth)	*20.6*	*48.1*
- Gold	40.5	56.5
(y-o-y growth)	*41.4*	*39.5*
Trade Balance	(-) 130.5	(-) 189.8
Current Account Deficit	(-) 45.9	(-) 78.2
Capital Flows	62.0	67.8
Reserve Charge	(-) 13.1	12.8
As % of GDP		
Exports	14.6	16.5
Imports	22.3	26.7
Trade Balance	(-) 7.6	(-) 10.1
CAD	(-) 2.7	(-) 4.2
Excluding gold (net)	(-) 0.7	(-) 1.5
Excluding oil and gold (net)	3.0	3.8
Capital Flows	3.6	3.6

45. The increase in imports is largely accounted for by oil and gold imports. To understand the pressure these two items have put on the BoP, it is instructive to note the following. Net of oil and gold imports, CAD last year would have been in surplus of 3.8 per cent of GDP in contrast to a deficit of 4.2 per cent of GDP. The surge in gold imports is explained largely by the erosion in real returns on other assets owing to inflation. The reason oil imports have been price inelastic is due to the fact that nearly 60 per cent of petroleum products pass through an administered price regime; oil demand to that extent does not adjust to price increases. On the other hand, exports were not helped even though the real exchange rate depreciated, reflecting the fact that in a subdued global economy, exports are more sensitive to income (*i.e.*, global demand) than to price.

46. Reflecting the current and capital accounts in the BoP, the exchange rate depreciated both in nominal and real terms (Table 3)

Three Concerns About CAD

47. There are mainly three concerns about the CAD in the balance of payments: (i) the quantum of CAD; (ii) the quality of CAD; and (iii) the financing of CAD. Let me briefly address each of these.

Table 3: Exchange Rate Movement

	Nominal Change	Real Change
	(Percentage)	
2011-12 (March 31, 2012 over March 31, 2011)	(-) 12.7	(-) 17.4
2012-13 (Feb. 28, 2013 over March 31, 2012)	(-) 4.9	(-) 2.8

Quantum of CAD

48. Reserve Bank's estimates show that the sustainable CAD for India is 2.5 per cent of GDP. A CAD above the sustainable level, year after year, is a clear macroeconomic risk as it raises concerns about our ability to meet our external payment obligations and erodes the confidence of potential lenders and investors.

49. An additional concern is that we are having a large CAD even in the face of slowing growth. This is perplexing because economic logic suggests that the CAD should improve in a slowing economy due to a decline in import demand. Cross country evidence in fact supports this hypothesis. Such an adjustment has not manifested in India though because: (i) oil and gold imports are relatively inelastic to income changes; (ii) on non-oil imports, domestic supply is still unable to compete with imports, and (iii) supply constraints and subdued external demand are impeding exports.

Quality of CAD

50. The concern about the quality of CAD arises from the composition of imports. If we were importing capital goods, we can may be countenance a higher CAD because investment in capital goods implies building production capacity for tomorrow. On the other hand, import of gold, largely as a hedge against inflation, is a deadweight burden, especially at a time when the CAD is beyond the sustainable level.

Financing of CAD

51. Even as the CAD has been high, we have been able to finance it because of a combination of 'push' and 'pull' factors. On the push side is the amount of surplus liquidity in the global system consequent upon the extraordinary monetary stimulus provided by advanced economy central banks. On the pull side are the measures taken by us to attract capital flows such as liberalising FDI, expanding the limits for foreign investment in corporate and government debt and easing restrictions on external commercial borrowing by corporates.

52. In trying to finance such a large CAD, we are exposing the economy to the risk of sudden stop and exit of capital flows. This will be the case to the extent capital flows in pursuit of short-term profits. Should the risk of capital exit materialise, the exchange rate will become volatile causing knock-on macroeconomic disruptions.

Monetary Easing in the Context of a Large CAD

53. While the external sector vulnerability is a cause for concern on a number of counts as I indicated above, it also poses a special challenge for calibrating the monetary policy stance.

54. In our quarterly policy review at the end of January this year, the Reserve Bank cut the benchmark repo rate by 25 bps in response to the growth-inflation dynamics that I outlined earlier. Several analysts and commentators have questioned the wisdom and logic of monetary easing at a time when the CAD is rising. There are two elements to this argument: (i) an interest rate cut raises aggregate demand, and hence demand for imports, and will aggravate an already elevated CAD; and (ii) an interest rate cut will narrow the interest differential between India and the advanced economies which are the source of capital, and could potentially lead to capital exit.

55. Let me respond to both these strands of criticism:

56. The risk of the CAD widening further because of the stimulus offered by the rate cut is much less than apprehended for a host of reasons. First, when growth is sluggish as is the case now, the rate cut is unlikely to translate into import demand. Second, the rate cut was a response to softening inflation. Lower inflation will improve the competitiveness of our exports. Third, the rate cut was effected during a phase of easing

commodity prices – particularly of oil – which will reduce the pressure on the CAD. Finally, empirical evidence shows that in emerging economies such as India, import demand is less a function of lower interest rate than of increased income. In other words, the marginal propensity to import by borrowing money is small.

57. On the other criticism about the impact of capital flows required to finance the CAD, it must be noted that interest rate differential is only one of the several push and pull factors that influence capital flows. Moreover, debt and equity flows have traditionally responded differently to a rate cut. While debt flows may be more sensitive to a narrowing of the interest rate differential, equity flows may actually increase because they see in this a signal of lower inflation and better investment environment. This has been the experience of India leading some analysis to all this, the 'Indian exceptionalism'.

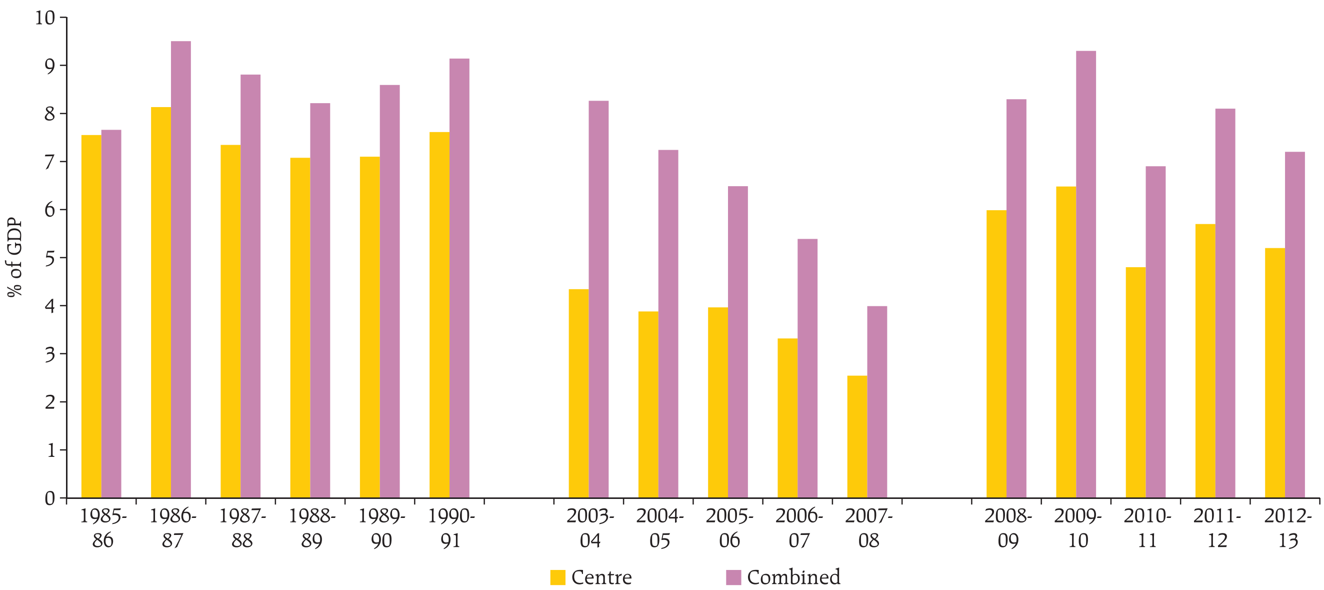
58. The last thought I want to leave with you on the issue of managing the external sector vulnerability is that gone are the days when monetary policy could be calibrated on entirely domestic macroeconomic considerations. As India integrates rapidly with the world in the years ahead, it will perforce have to take into account the spillover from global situation in determining its monetary policy stance.

Third Challenge: Managing the Political Economy of Fiscal Consolidation

59. The large fiscal deficit of the government remains one of India's biggest macroeconomic challenges. Received wisdom today is that it was the fiscal profligacy of the 1980s that spilled over into the external sector and fuelled the balance of payments crisis of 1991. In 2011-12, the combined fiscal deficit of the centre and state governments was 8.1 per cent, quite close to the figure of 9.1 per cent in the BoP crisis year of 1990-91 (Chart 6). Quite understandably, there are concerns about the adverse macroeconomic consequences of the twin deficit problem – a large and persistent fiscal deficit along with a high CAD.

60. There has been some very welcome, although much delayed, action on correcting both the CAD and the fiscal deficit over the last six months. The Government has raised customs duty on gold imports

Chart 6: Gross Fiscal Deficits – Three Distinct Phases



in an effort to restrain gold imports. More notably, the recent budget has firmly embraced fiscal responsibility by restraining the fiscal deficit next year consistent with the road map recommended by the Kelkar Committee.

61. In the pre-crisis period, India's fiscal consolidation was largely on track, consistent with the targets adopted under the Fiscal Responsibility and Budget Management (FRBM) Act, 2003. However, this consolidation got interrupted by the crisis induced fiscal stimulus. Thereafter, the government adopted a revised road map for getting fiscal consolidation back on track, and adhered to the target in 2012-13. Nevertheless, the combined fiscal debit of the centre and states, budgeted at 7.2 per cent of GDP during 2012-13 is still high. Notwithstanding political economy compulsions, credible fiscal adjustment along a transparent, predictable road map is an imperative for growth and macroeconomic stability.

Why is Fiscal Deficit Bad?

62. Fiscal deficit is bad for a number of reasons. Large and persistent fiscal deficit threatens the government's debt sustainability. The growing interest burden eats into the resources available for discretionary expenditure. Importantly, it crowds out the private sector from the debt market, inhibits private investment and affects future production capacity. Fiscal deficit can also spill over and trigger balance of payments pressures as indeed happened in India in 1991.

63. By far the biggest concern stemming from a large fiscal deficit, especially from the Reserve Bank's perspective, is that it adds to aggregate demand and thereby to inflation pressures. By crowding out the private sector, fiscal deficit could also inhibit, if not impair, monetary policy transmission to the private sector. Credible fiscal consolidation is, therefore, a necessary pre-condition for stabilising inflation and securing non-inflationary growth.

Fiscal Consolidation and Growth

64. There are some concerns, admittedly marginal, that fiscal consolidation in a sluggish growth environment will only dampen growth further thereby adversely impacting revenues and pushing the economy into a vicious downward spiral. There is some validity to this argument. But a growth slow-down on account of fiscal consolidation is not unavoidable. Growth slow-down can be mitigated, indeed growth can be aided, provided attention is paid, along with the quantum of fiscal adjustment, also to its quality. Experience demonstrates that even if total expenditure as a proportion of GDP is curtailed, it need not dampen growth; on the contrary, if there is switching from current expenditure to capital expenditure, fiscal consolidation can actually stimulate growth by 'crowding in' private investment.

65. Empirical estimates for India validate this finding – even in a context of decline in total public expenditure as a proportion to GDP, fiscal consolidation can improve medium-term growth prospects if government increases capital spending, offsetting the moderating impact of growth in the short-term. These results reflect the higher long-run fiscal multipliers for capital expenditure and very low long-run multipliers for current expenditure.

66. The economics of fiscal consolidation are quite straight forward. The complexity arises from the political economy. Tax increases and expenditure compression – the two strands of fiscal consolidation – are never politically popular, especially in democracies where political executives, virtually everywhere in the world, are characterised by high discount rates. They are much more tempted by short-term political pay offs rather than long-term sustainability. Fiscal consolidation, by definition, is a long-term game. In the short-term political costs may exceed benefits; in the long-term, the economic and political benefits far outweigh any costs. It is this congruence of economic and political virtue that must inform fiscal consolidation.

Summing-up: India Growth Story Intact

67. Let me now sum up. I have spoken to you about the following three macroeconomic challenges confronting India and I have given you the Reserve Bank's perspective on them.

i. Managing the growth-inflation dynamics

ii. Mitigating the vulnerability of the external sector

iii. Managing the Political Economy of Fiscal Consolidation

68. These are formidable challenges, but by no means insurmountable. For people who despair, it is important to remember that the drivers of the India growth story – get up and go entrepreneurism, the demographic dividend, a large and growing middle class, the opportunity for productivity catch up, democracy and a decent legal system – are all intact.

69. The 12th Five Year Plan aims at a growth rate of 8.2 per cent for the Plan period (2012-17). Growth at this pace is the minimum necessary. Indeed, India needs to grow even faster, at a sustained double digit pace, if it has to pull hundreds of millions of people out of poverty. The India growth story has all the ingredients to deliver on this promise.

70. But the India growth story is not inevitable. It will not materialise in the absence of vigorous and purposeful structural and governance reforms. It is those reforms that must continue to engage our attention.

*Financial Consumer Protection**

K. C. Chakrabarty

Madam Anne Le Lorier, First Deputy Governor, Banque de France, Senior executives from the Banque de France, Shri G. Padmanabhan and Smt. Deepali Pant Joshi, Executive Directors and my other colleagues from the Reserve Bank of India, Principal and the staff at College of Agricultural Banking, Pune, participants to the seminar, ladies and gentlemen! At the outset, I extend a warm and hearty welcome to all of you, and especially to our guests from France, I say '*bienvenue*'. I am pleased to be here this morning to flag off a journey of joint-learning, discovery and exploration by RBI and BdF on a subject that has engaged the time and attention of governments, regulators, policy-makers, academics, NGOs, consumers, etc. for the past three years and more and which quite aptly is also the theme of this Seminar – 'Consumer Protection'. We are privileged to have the First Deputy Governor, Madam Anne Le Lorier here and are sure that the seminar deliberations would be enriched by her presence. The seminar has been structured to cover various dimensions of consumer protection with separate sessions on building consumer awareness, customer rights and duties, emerging regulatory approach for consumer protection (Twin Peaks), legal aspects of consumer protection, etc. In view of the growing use of IT in the financial sector, the seminar would also devote time to deliberate on consumer protection issues in retail and electronic payment systems and the impact of information technology on consumer protection. We also have sessions devoted to the co-operative sector and to linkages between financial inclusion/literacy and consumer protection. Keeping in mind the exhaustive seminar schedule, I feel that my role here today is to set the tone for the Seminar and this; I intend to do by presenting a few random thoughts on various dimensions of consumer protection.

Introduction

2. It is, indeed, deplorable that in spite of access to financial services being universally recognised as an important ingredient to the growth and prosperity of people and nations, over half the adult population in the world remains 'unbanked'. In the wake of the Financial Crisis and widespread discontent among the poor and the vulnerable sections of the society, access to financial services, their governance and their development have emerged as the prime objective for policy makers in rich and poor countries alike. We must appreciate, however, that the dimensions of consumer protection in the rich and poor countries are very different. While the focus in developed countries is more on protection of consumers' rights, in the developing world, provision of access to financial services to the consumers is the immediate priority. Consumers are not some endangered species in need of protection and the issue of consumer protection is not limited to specific acts of consumption. The consumer as depositor, saver and borrower is not just another link in the chain, but the central actor in the financial marketplace and as such, he is most impacted by the ill-effects of macro and micro-economic problems that have gripped the financial sector.

3. Let me raise a fundamental issue here. The financial services sector is essentially driven by commercial intent and the actions of service providers

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and the issue of consumer protection should be taken care of by competitive market forces. Why are we then discussing the issue of financial consumer protection? It is because the barriers to entry for the service providers in the financial sector, especially banking, are quite stiff. In view of regulatory restrictions on number of market players, consumers are forced to receive services from a limited set of service providers. Furthermore, in view of rampant information illiteracy, the self regulating market behaviour does not work especially for the poor and vulnerable and hence, ensuring consumer protection becomes a regulatory obligation.

4. In addressing the issue of financial consumer protection, the important thing is to be able to identify the section of consumers who are most vulnerable. Who are these consumers and what is consumer vulnerability? The Consumer Affairs Victoria, a Government agency in the state of Victoria, Australia has explained consumer vulnerability as the 'exposure to the risk of detriment in consumption due to the interaction of market, product and supply characteristics and personal attributes and circumstances'.

5. While this definition highlights a number of vulnerability elements that a consumer is confronted with, I feel that Information Vulnerability is the key challenge faced by consumers. The other vulnerability elements are more of an outcome of the information asymmetry that exists between the providers of financial services and the consumers. This information asymmetry gives rise to opportunities for consumer exploitation and hence, creates a need for protecting consumers. Let me emphasise that the problem of information vulnerability has multiple dimensions. The most common manifestation is the lack of access to information, which results in sub-optimal decision making. Information vulnerability can also arise due to limited ability of consumers to analyse the information available to them. This problem is greatly accentuated in case of the uneducated and excluded sections of the population, who neither possess the tools nor the skills to effectively utilise the available information. Another dimension is the problem of information overload, wherein the consumer is unable to distinguish the 'message' from the 'noise', thereby prompting him/her to ignore the entire information and end up in a state of what I call, 'analysis-paralysis'.

Addressing causes of Consumer Vulnerability

6. The possible solution to insulate consumers from vulnerabilities is by ensuring that the financial service providers treat their customers fairly. The financial institutions must understand what fair and equitable treatment of customers means and then align their business practices to achieve the desired outcomes. The fair treatment to customers is seen as being synonymous to consumer satisfaction and following a consumer-centric approach. Simply put, fair treatment of customers involves ensuring that the products and services offered by financial institutions are suitable for the customers and appropriate to their risk profile, pricing is transparent and non-discriminatory and that the service is delivered in a speedy, safe and secure environment. For instance, while banks are justified in levying reasonable charges for services provided, are they justified in levying charges without providing any specific service (*e.g.*, customers not conducting any transaction in the account)? An attendant aspect of consumer protection in the financial services industry is the provision of efficient grievance redressal machinery which should be 'quick' and 'just'. I will return to this aspect a little later.

7. A documented Treating Customers Fairly (TCF) policy seeks to regulate the design and marketing of financial products and services, the system of information dissemination, facility for after-sales support and the grievance redressal procedure. Effectiveness of the TCF framework in organisations would depend upon the extent to which it is integrated into the organisation's DNA. At the individual level, effective implementation of TCF requires that the TCF goals are embedded into the employee performance measurement and rewards systems.

8. Ensuring fair treatment to consumers would also mean that behavioural and cultural changes would have to be brought about in organisations. This cannot be achieved merely by ring-fencing consumer protection within the compliance function. Instead, the entire institution – right from the Board to the frontline managers – have to be responsive to this objective.

Need for a Credible and Effective Regulatory Regime

9. The presence of a credible and effective regulatory regime acts as a source of confidence and comfort in the financial system. This helps in attracting more participants to the market place, thereby making the financial system inclusive and efficient. The experience from the global financial crisis is that self-regulation, often, does not work. The presence of a strong, intrusive and hands-on regulator/supervisor gives the confidence that markets will operate as per sound principles and would be free from unfair and unethical practices. This trust forms the basis of functioning of the entire financial system and any dent in this trust can have a significant destabilising influence. The series of measures initiated by global standard setting bodies and individual regulators in the aftermath of the financial crisis clearly underscore the imperative of having a credible and effective regulatory regime. Consequently, the effort is on to leverage these regulatory initiatives to rebuild trust and confidence in the global financial system. It is now globally accepted that in order to earn the trust of the consumers/market participants, it is important that the regulatory system is seen and perceived to be fair and transparent.

Twin Peaks Approach to financial sector regulation and supervision

10. The pre-crisis financial sector regulatory and supervisory architecture across various jurisdictions placed overarching emphasis on the financial strength and soundness of banks. Commentators generally presumed that there were strong synergies between prudential regulation and consumer protection and, therefore, an integrated supervisor could take care of both objectives. However, the crisis highlighted that the integrated supervisors are more likely to give precedence to safety and soundness mandates, as these are closely intertwined with financial stability, rather than focusing on consumer protection issues. The Twin Peaks Approach helps in resolving this conflict. The Market Conduct Regulator is focused on ensuring that the institutions design the products and services in line with the customers' needs, maintain integrity of the markets and conduct their businesses keeping the primacy of the customers' interests in the forefront.

Product design, financial innovation and consumer protection

11. One of the reasons for the perpetuation of the global financial crisis was that financial innovation resulted in creation of products that were not suited to consumer requirements. Also, these products had risk profiles that were not fully understood by consumers or financial market participants. The crisis

was an instance of financial innovation growing beyond consumer expectations and hence, contributing to financial system vulnerability. Let me emphasise that the basis of all product design and financial innovation should be consumer need. Products and processes should be created only to meet specific expectations of consumers. The ability to orient the products and services to consumer expectations would determine the success and sustainability of organisations and markets.

12. As I mentioned earlier, very often financial engineering creates complex products out of inherently simple products. This is very common in the world of structured financial derivatives, where the payoff profile and risks inherent in the structure are significantly different from those of its underlying constituents. When such product design is combined with aggressive sales practices led by perverse compensation systems, it leads to mis-selling to gullible consumers. The end result is a slew of consumer disputes, resulting in loss of reputation for the financial service providers.

13. The Sergeant Review of Simple Financial Products in the UK has identified four attributes for financial products to be classified as 'simple' *viz.*,

- The products should help consumers benchmark and compare with other products in the market.
- The product must be understandable and accessible to the mass market.
- The product must not be tailored to meet individual needs, but provide consumers with confidence that the product will meet their basic needs and offer them a fair deal; and
- The product will be a viable commercial proposition for the provider.

14. Financial sector regulators/supervisors and consumer protection bodies need to keep a close watch on product design and financial innovation in order to ensure that these are oriented towards consumer needs and expectations. Market intelligence mechanism should also focus on identifying products which could, potentially, expose consumers to unintended outcomes. Individual financial service providers should also have internal frameworks for vetting new product offerings so as to ensure that they are in alignment with regulatory requirements and consumer expectations. In fact, an assessment of the financial products and services for their reasonableness and suitability to customers is going to be one of the main planks for the Financial Conduct regulators under the Twin Peaks structure.

How to ensure that the consumer voice is heard

15. Though consumers are the core around which the entire financial services business revolves, the consumers' voice is the feeblest and, very often, not heard. This inability to understand the consumer and his needs is the genesis of all consumer protection issues. There are a number of ways in which the consumer voice in the financial regulatory system could be strengthened, not just in the interests of the consumer, but also in the interests of the sustainability of the financial system.

- We have to encourage a culture of openness towards consumers, their aspirations and expectations. Our products and processes should have the inherent flexibility to adjust to changing consumer needs. Successful consumer-focused organisations inculcate the ability to constantly learn and improve, both at the individual level and at the organisational level. Success in the mission of customer service depends on the flexibility demonstrated by service providers in constantly re-learning and re-orienting their business operations based on evolving market dynamics and customer expectations.

- As I briefly touched upon earlier, having an effective communication strategy is important, including for regulators, to regain the confidence of consumers and the financial system. Importantly, we need to leverage the power of the media, including the newer channels, to get across our message of consumer awareness and protection. The media needs to be seen as an ally in generating consumer awareness and in implementing an effective framework for consumer protection.
- The institutions must have their ears to the ground so as to get a feel and understanding of evolving trends and practices. For commercial institutions, having this ability lends them a competitive edge over others as they can evolve their product offerings in line with changing trends. For regulators, this is a vital input in anticipating build up of risks and taking proactive measures.

The holy trinity – financial inclusion, financial education and consumer protection

16. Post the global crisis, financial sector regulators and policy makers have been focusing on the objective of 'financial stability' to bring back sanity and normalcy to the global financial system. That financial inclusion, financial education and consumer protection, form the three essential pillars on which financial stability rests, has been universally endorsed and accepted. Banking the unbanked, providing access to financial services, educating the consumers and creating a sense of safety in their minds are necessary for the governments and regulators alike, both in India and elsewhere. With nearly 4.5 billion people on this planet owning a mobile phone, there is a very strong likelihood of financial inclusion being pushed through the mobile phone and mobile payments medium. This is likely to be more so in the developing countries where mobile phone penetration is 8 – 10 times the penetration of the basic bank account. The lack of formal financial services infrastructure and widespread financial activity limits market exchanges, increases risks and curtails opportunities to save. Without access to formal financial services, the households are forced to rely on informal sources that are high costs. The protection, safety and security of this important class of customers cannot be wished away. In this context, the regulators and governments can play an important role by providing an efficient infrastructure for mobile payments. This framework might include regulation of low – risk money transfer services, enabling non-bank organisations to facilitate low-risk/low value transactions and wherever possible, implementing regulations at the system level (without interfering with the customer interface). On the part of banks, rather than treating mobile payments as a threat, they need to see it as an opportunity to access otherwise unprofitable low-income segments market. Banks will need strong partners and a strong platform to succeed. In India also, we have been proactively pursuing the three objectives and are even exploring the possibility of enshrining financial inclusion in the Code of Banking Practices (in India referred to as the Code of Commitments).

17. In terms of financial education, while the thrust would continue to be on the basics in terms of products, services, risk profile and suitability, we need to think ahead and look at the scenario where self –

service banking is on the rise. The evolution of ATMs in India is only the beginning of the self-service menu. We are yet to witness the full range of products and services where the customers will be helping themselves (and of course the banks) with gadgets and apps that they may not be very familiar or comfortable with. So, welcome customer education and hand holding!

Retail distribution of financial products

18. The retail distribution of financial products and services was subject to review in Australia and United Kingdom alike and the issues thrown up by these reviews have great lessons for consumer protection. The retail distribution, as is now being carried out, may not necessarily be in the best interest of the consumers. There are certain issues, particularly from the perspective of incentive structures for sale of financial products, monitoring of AML requirements, risks of mis-selling, inadequate understanding of risks by the sales persons, etc. that make it important that financial service providers and regulators to have a close look at the practices followed in retail distribution of financial products.

19. As regards regulating the activities of the financial advisers, it is very important that the people with small means get proper advise at the right time and at least cost. The regulators, perhaps, have to take this responsibility upon themselves with a view to empowering the consumers and helping them protect their life savings.

Regulation and market failure

20. There have been a number of essays, writings and chronicles on the global financial crises of 2008. Nobel Laureate Dr. Joseph Stiglitz also extensively covered these events in various articles which have been compiled and published as a book under the title 'Price of Inequality'. In his essay on 'Regulation and Market Failure', Dr. Stiglitz says and I quote ***'It is clear that our regulatory structure failed. Evidently, there was market failure, but there was also government failure. The primary reason for the government failure was the belief that markets do not fail, that unfettered markets would lead to efficient outcomes, and that government intervention would simply gum up the works. Regulators who did not believe in regulation were appointed, with the inevitable outcome that they did not do a very good job of regulating'***. This has, perhaps, been one of the most significant lessons from the financial crisis and is reflected in the fact that there is a global clamour for tightening regulation and supervision of markets and market practices. The evolving regulatory and supervisory initiatives are expected to have a significant positive impact on protection of consumer interests.

Compensation schemes and redress mechanism

21. The financial services industry must have well articulated and clearly defined compensation schemes that are easy to access, adequate in quantum and effective in implementation. The roles and responsibilities of the consumers and service providers in different situations need to be spelt out up-front. I always believe that to err is human but from an institutions' point of view, to confess is divine. If an institution is in the wrong, why should it wait for the consumer to approach it for compensation? Would it not be righteous if the bank or financial institution on its own initiates actions to undo the wrong inflicted on customers, some of whom may have not even complained? Imagine the impact such an approach would have on the faith and confidence consumers have on the financial system.

22. Another important aspect is the existence of a robust, responsive and reliable grievances redress mechanism in the banking/financial services industry, something I have alluded to earlier. The credibility of the banks' redressal systems needs to be reinforced by constant follow up by the regulator. The very fact that often bank customers find it safer and simpler to get their grievances resolved by routing them through the regulators or the Ombudsman Offices is a reflection on the quality and effectiveness of redress mechanism put in place by banks. We have a long way to go to improve the credibility of the system. People will access the redress mechanism only when they are assured of an impartial outcome. It requires a lot of courage, persistence and knowledge to pursue and follow up grievances with banks/financial institutions. It will be in our own interest to usher in a culture where people are encouraged to complain if anything is amiss. The felt attributes of consumer protection are a result of the customer care policies that banks promise to have in place. But, many a times, the same are not implemented at the ground level mainly due to ignorance and lack of sensitivity on the part of the frontline managers. Skill building and knowledge enhancement of bank staff is necessary, if we wish to have a pro-active consumer protection policy in the banking industry.

Conclusion

23. As a part of my inaugural speech I have tried to set the tone of the Seminar, by touching upon different facets and attributes of consumer protection, drawing from the global as well as the Indian experience. I am tempted to refer here to the comments made by the World Bank – IMF team in its report on the Financial Sector Assessment for India (2012) about consumer protection: ***'India has comprehensive policies and compliance mechanisms for the protection of banking consumers, and is ahead of most countries in this area. Going forward, including non-banking financial companies (NBFCs) in the mandates of the Banking Codes and Standards Body of India and of the Banking Ombudsman System (BOS), ensuring consumer protection of the entire financial system, and devising a strategic consumer awareness program, will further strengthen the system'.*** I accept this feedback with all the humility at my command, and I am fully aware that much more needs to be done to improve the consumers' lot. Even in a free market economy with competition as the necessary pre-condition, it is not necessary that the consumer is treated as the king. But what we must strive to bring about is a culture where the consumer is treated as a good human being by focusing on the values of fairness, transparency, and non-discrimination. Going forward, customer-centricity will be a must for the regulators and the regulated entities alike in the wider interest of financial stability, an essential cornerstone of which is consumer protection.

24. I hope that this joint seminar between the Banque de France and the Reserve Bank of India lays down the foundation of a long and fruitful partnership between the two institutions and that such seminars become a regular event. Considering the impressive list of experts from both institutions who are scheduled to speak over the course of the next two days, especially Madam First Deputy Governor, I am sure that the Seminar will prove to be very useful in sharing of knowledge and experience among the participants. I wish the Seminar all success and hope that our guests from the Banque de France have a pleasant stay in India and do find time to get a feel of the rich cultural cocktail that this country presents.

Ladies and gentlemen thank you for your patience. Merci

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*Transitioning from Student to Professional Lives: Some Reflections**

K. C. Chakrabarty

Dr. M. Narendra, CMD, Indian Overseas Bank; Dr. (Smt.) P. Selvameenakshi, Principal, V.V. Vanniaperumal College for Women; Shri S.M.S. Manickavasagam, Secretary and Smt. M.M.N Jikki Mathavan, Joint Secretary, V.V. Vanniaperumal College for Women Managing Board; distinguished members of the audience and dear students. It is, indeed, a great honour and pleasure to be here in your midst today to deliver the Convocation address at this college of eminent credentials. I am proud of the fact that I have been handed this opportunity to deliver this convocation address at a college, which was inaugurated by one of the leading freedom fighters and statesmen of our times/Bharat Ratna Hon. K. Kamaraj, someone whom I deeply admire. The academic excellence achieved by your college over the past five decades is a glowing tribute to the vision of the man who introduced free mid-day meal scheme in schools and free education upto 11th standard for poor children during the 1950s.

2. To be amongst bright young students is always a refreshing and feel-good experience and whenever such an opportunity comes up, I quite look forward to it. Let me begin by congratulating all the students of the college who have successfully graduated in their respective academic disciplines and are receiving their degrees today. Convocations are special as they simultaneously signify both – a conclusion as also a commencement. They logically conclude a formal learning exercise and hence, provide an occasion for relief, fulfilment and joy for the graduating students as well as the faculty members. They are, however, even more special, because they commence a lifelong informal learning as graduates step out into the University of the World – step out with dreams, hopes and expectations into the *terra incognita* of life. In our days, when we passed out, it was not a dream but a nightmare, because of the difficulty in getting employment. Though over time, considerable employment opportunities have come up across various sectors, especially the services sector, finding a fulfilling job remains as big a challenge as ever. However, I am confident that this venerable institution has prepared you to face and surmount all challenges that life throws at you. I am privileged to share this special day with a bright set of youngsters, who, I hope, would turn out to be the highly successful financial and social entrepreneurs of the future.

3. This convocation ceremony marks a major milestone in your career. It not only indicates the culmination of the hard work you have put in over the years, but also marks your transition from students to professionals. I know only too well the time, effort and dedication that are needed to acquire such important academic qualifications. I would also like to take this opportunity to congratulate members of your families who are present here on this very important day in your lives. I am sure they have contributed greatly to your success and fully share your moment of glory. You should always remember that, but for the support and love of your parents and families and the dedication and commitment of your

* Convocation Address by Dr. K. C. Chakrabarty, Deputy Governor, Reserve Bank of India at the V.V. Vanniaperumal College for Women, Virudhunagar on March 24, 2013. Assistance provided by Shri Suddhasattwa Ghosh in preparation of this address is gratefully acknowledged.

faculty members here, it would not have been possible for you to reach this milestone in your lives.

4. In a country like ours, education is not only the key to a brighter future; it is, often, also a key to survival. Using education as a primary strategy, our visionaries and pioneers have aimed to harness, particularly the potential of girls and women, to learn, lead and act on their vision of change for themselves, their families, their communities and the nation. Pandit Nehru famously remarked, 'You can tell the condition of a nation by looking at the status of its women'. The Beijing Declaration at the Fourth World Conference on Women (1995) noted that, 'Women's empowerment and their full participation on the basis of equality in all spheres of society, including participation in the decision-making process and access to power, are fundamental for the achievement of equality, development and peace'. In India, there has been a perceptible increase in literacy rate amongst women from 53.67 per cent (Census 2001) to 65.46 per cent (Census 2011). However, there is still a large gender gap in literacy at 16.68 per cent which needs to be bridged. In this context, it is extremely gratifying to note that your college has been doing a remarkable work in empowering women of this region by providing them access to quality higher education ever since its inception about half a century ago. I am glad to learn that this institution has received the best women's college award consecutively for the last seven years. However, let me hasten to remind that such accolades place even greater responsibility upon the college, its teachers, administrators and students to work harder and keep up the good name of this august institution.

5. For years, women in India have almost silently supported the stability of our society's cultural institutions and the continuities and consistencies of their ethos. However, today, the contours of the world we live in are changing dramatically. The space for growing up and living has new co-ordinates. Educated, armed with knowledge and skills, women are entering in a big way the world of occupation, career, profession, competition and achievements in their own right and are creating a space where the emphasis is on expressing themselves and being accepted as independent, autonomous beings.

6. Our women are now more confident about their ability to discover and identify their personal capabilities as also to discover a vision of life beyond that defined by social structures and the network of relationships. Today, they encounter the possibility of creating a world beyond their visible horizons and boundaries.

7. Empowerment of women, gender discrimination and violence against women have become subjects of serious public discourse as also sociological research in India in recent times. Several attempts have been made through the years to study the status of women in India and these studies have clearly brought out that the participation rates of women in economic activities are very low. The Draft 12th Five Year Plan document released in December 2012 has noted that there has been a consistent decline in workforce participation rate (WPR) of women since 1980s but the decline seems to have accelerated between 2004–05 and 2009–10. The decline in female labour force participation has occurred in both rural and urban areas, though the decline is much sharper in rural compared to urban areas.

8. The Human Development Report, 2013 presents the Gender Inequality Index, which is a parameterised

indicator of the inequality in status and opportunities for the women in the population. Its assessment is based on three parameters *viz.,* Labour Market, Empowerment and Reproductive Health. It is disappointing to note that on the status of gender inequality, the report places India at a lowly 132, which is a fall of three positions from the previous report. Our ranking on gender inequality is in stark contrast to our claims to being a progressive society and a developing nation. It brings into sharp focus the urgent need to implement effective measures for quickly reversing this position. Each one of us, cutting across professions and positions in life, have an important role to play in making this transformation.

9. Prior to independence, the gender divide within our labour force was an accepted norm. Especially since the 1970s, scholars and activists have challenged the inequalities that had been established and have fought to reverse them. These inequalities included unequal wages for women, relegation of women to unskilled spheres of work, and restricting women as a reserve army for labour. These scholars and activists have also sought to focus on class-consciousness in this discourse, recognising the inequalities not just between men and women but also within social structures such as caste, tribe, language, religion, region or class. In recent years, the focus of such deliberations has gone beyond treating women as useful members of society and now also focuses on empowering them to decide the course of their personal lives and the right of self-determination. I am glad that the V.V. Vanniaperumal College is playing a transformational role by churning out a knowledgeable and empowered lot of women year after year, who can claim their rightful place under the sun.

10. Lack of education and empowerment of women is also reflected in the extent of disparity between the proportion of financially excluded men and women. That women in India are much more financially excluded than the men is evident from the fact that as of March 2011, only 21 per cent of total bank deposit accounts were held by women and these accounted for just about 12 per cent of the total volume of deposits. Similarly, women availed only 18 per cent of the total small credit from banks in 2011. Therefore, initiatives to empower women should, necessarily, include strategies to link them to the formal financial system by providing them access to deposit and credit accounts.

11. However, considering the centrality of banks to the nation's economic order, their role in women empowerment cannot be restricted merely to linking them to the formal financial system. The banking and finance sector in India has emerged as a significant employer of women, though related data suggests that there is still tremendous scope for improving their presence in this sector. The financial sector, in specific, requires its employees to possess traits of passion, conviction and compassion that the women display in abundance. The sense of empathy and understanding that the women possess enables them to earn respect and acceptability of their co-workers. Expert studies highlight that women are more adapt in dealing with concerns of employees, shareholders and customers. They are not only good at collating and combining information, their better intuitive abilities also helps them to make informed decisions. As leaders, the women bring in an environment of strength, confidence, inclusiveness and trust. It is no wonder then that women have risen remarkably to the top in the banking sector in both – the public and private sector in India. I urge this bunch of young women

graduates today to choose finance and banking as their career option where they can really excel and serve the customers and society with distinction.

12. As you must be aware, the Hon'ble Union Finance Minister Shri P. Chidambaram has proposed in this year's Union Budget that an all-women public sector bank will soon be set up, which will predominantly employ and lend to women. This is, indeed, a very welcome step and will also, in a sense; help take forward the Reserve Bank's financial inclusion and financial literacy efforts, which also strongly focus on women's awareness about and access to financial services.

13. The world of banking has, in fact, been a mirror of history at large. 'Money makes the world go around', the saying goes. Banking activities resemble a wheel turning continually. Banking in India too has gone through many phases. While historians can slice the past into countless slivers, in terms of transformational change, there have been only a few inflexion points in post-independence banking in India.

14. The first was the enactment of the Banking Regulation Act, 1949 which brought in a comprehensive and formal structure of bank regulation and supervision in India. The nationalization of banks in our country in 1969 marked the second such point. It generated forces that took banking beyond the elite class to the masses. It led to the establishment of a very substantial infrastructure across the geographical expanse of the country and was, thus, a critical trigger for financial outreach of institutions and empowerment of the common man. The third inflexion point in banking was the financial sector reforms initiative that was launched in the early 1990s.

15. These reform measures were initiated and sequenced to create an enabling environment for banks to overcome the external constraints – these were related to administered structure of interest rates, high levels of pre-emption in the form of reserve requirements, and credit allocation to certain sectors. One of the major objectives of banking sector reforms has been to enhance efficiency and productivity through competition. As you know, the Reserve Bank is currently considering issuing licenses for establishment of new banks in the private sector.

16. This changed environment and the internal compulsions arising from greater competition and the need to improve market shares and/or profitability is resulting in the banks' quest for greater efficiency and an effort to reposition themselves, given the realities of the environment and their internal strengths and weaknesses. This also generates more possibilities and greater opportunities for young graduates and post-graduates like you. The Reserve Bank too now recruits a certain number of people every year. It is a wonderful opportunity that aspirants like you can look forward to, and prepare for, every year.

17. We live in an age of unprecedented opportunities. But, with opportunity comes responsibility. It is for tomorrow's managers to carve out their own place, to know when to change course and how to keep themselves engaged and productive throughout. To do things well, one needs to cultivate a deep understanding of oneself – not only the strengths and weaknesses but also how one learns, how one works with others, what his or her values are and where he or she can make the greatest contribution. Because only when one operates from strength, can true excellence be achieved! It is, therefore, for all of