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FINANCIAL GLOBALISATION: THE INDIAN APPROACH AND ITS IMPACT ON INDIAN BANKING SECTOR : SOME ISSUES

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Introduction

The crisis in the international financial markets of advanced economies, that started around mid-2007, has exacerbated substantially since August 2008. The financial market crisis has led to the collapse of major financial institutions and is now beginning to impact the real economy in the advanced economies. As this crisis is unfolding, credit markets appear to be drying up in the developed world. With the substantive increase in financial globalisation, how much will these developments affect India and other Asian emerging market economies (EMEs)? India, like most other emerging market economies, has so far, not been seriously affected by the recent financial turmoil in developed economies. Hence an attempt was made to analyse the Indian approach of financial globalisation and its impact on banking sector.

Financial Globalisation: The Indian Approach

The Indian economy is now a relatively open economy, despite the capital account not being fully open. The current account, as measured by the sum of current receipts and current payments, amounted to about 53 per cent of GDP in 2007-08, up from about 19 per cent of GDP in 1991. Similarly, on the capital account, the sum of gross capital inflows and outflows increased from 12 per cent of GDP in 1990-91 to around 64 per cent in 2007-08. With this degree of openness, developments in international markets are bound to affect the Indian economy and policy makers have to be vigilant in order to minimize the impact of adverse international developments on the domestic economy. The relatively limited impact of the ongoing turmoil in financial markets of the advanced economies in the Indian financial markets, and more generally the Indian economy, needs to be assessed in this context. Whereas the Indian current account has been opened fully, though gradually, over the 1990s, a more calibrated approach has been followed to the opening of the capital account and to opening up of the financial sector. This approach is consistent with the weight of the available empirical evidence with regard to the benefits that may be gained from capital account liberalization for acceleration of economic growth, particularly in emerging market economies. The evidence suggests that the greatest gains are obtained from the opening to foreign direct investment, followed by portfolio equity investment. The benefits emanating from external debt flows have been found to be more questionable until greater domestic financial market development has taken place (Henry, 2007; Prasad, Rajan and Subramanian, 2007). Accordingly, in India, while encouraging foreign investment flows, especially direct investment inflows, a more cautious, nuanced approach has been adopted in regard to debt flows. Debt flows in the form of external commercial borrowings are subject to ceilings and some end-use restrictions, which are modulated from time to time taking into account prevailing macroeconomic and monetary conditions. Similarly, portfolio investment in government securities and corporate bonds are also subject to macro ceilings, which are also modulated from time to time. Thus, prudential policies have attempted to prevent excessive recourse to foreign borrowings and dollarisation of the economy. In regard to capital outflows, the policy framework has been progressively liberalised to enable the non-financial corporate sector to invest abroad and to acquire companies in the overseas market. Resident individuals are also permitted outflows subject to reasonable limits. The financial sector, especially banks, is subject to prudential regulations, both in

suffer during the phase of rapid expansion. Hence, as a counter cyclical measure, the Reserve Bank increased the risk weight for consumer credit and capital market exposures from 100 per cent to 125 per cent. An additional feature of recent prudential actions by the Reserve Bank relate to the tightening of regulation and supervision of Non-banking Financial Companies (NBFCs), so that regulatory arbitrage between these companies and the banking system is minimized. The overarching principle is that banks should not use an NBFC as a delivery vehicle for seeking regulatory arbitrage opportunities or to circumvent bank regulation(s) and that the activities of NBFCs do not undermine banking regulations. Thus, capital adequacy ratios and prudential limits to single/group exposures in the case of NBFCs have been progressively brought nearer to those applicable to banks. The regulatory interventions are graded: higher in deposit-taking NBFCs and lower in non-deposit-taking NBFCs. Thus, excessive leverage in this sector has been contained. Various segments of the domestic financial market have been developed over a period of time to facilitate efficient channeling of resources from savers to investors and enable the continuation of domestic growth momentum (Mohan, 2007a). Investment has been predominantly financed domestically in India – the current account deficit has averaged between one and two per cent of GDP since the early 1990s. The Government's fiscal deficit has been high by international standards but is also largely internally financed through a vibrant and well developed government securities market, and thus, despite large fiscal deficits, macroeconomic and financial stability has been maintained. Derivative instruments have been introduced cautiously in a phased manner, both for product diversity and, more importantly, as a risk management tool. All these developments have facilitated the process of price discovery in various financial market segments. The rate of increase in foreign exchange market turnover in India between April 2004 and April 2007 was the highest amongst the 54 countries covered in the latest Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity conducted by the Bank for International Settlements (BIS). According to the survey, daily average turnover in India jumped almost 5-fold from US \$ 7 billion in April 2004 to US \$ 34 billion in April 2007; the share of India in global foreign exchange market turnover trebled from 0.3 per cent in April 2004 to 0.9 per cent in April 2007. There has been consistent development of well-functioning, relatively deep and liquid markets for government securities, currency and derivatives in India, though much further development needs to be done. However, as large segments of economic agents in India may not have adequate resilience to withstand volatility in currency and money markets, our approach has been to be increasingly vigilant and proactive to any incipient signs of volatility in financial markets. In brief, the Indian approach has focused on gradual, phased and calibrated opening of the domestic financial and external sectors, taking into cognizance reforms in the other sectors of the economy. Financial markets are contributing to efficient channelling of domestic savings into productive uses and, by financing the overwhelming part of domestic investment, are supporting domestic growth. These characteristics of India's external and financial sector management coupled with ample foreign exchange reserves coverage and the growing underlying strength of the Indian economy reduce the susceptibility of the Indian economy to global turbulence.

Impact on the Indian Banking System

One of the key features of the current financial turmoil has been the lack of perceived contagion being felt by banking systems in EMEs, particularly in Asia. The Indian banking system also has not experienced any contagion, similar to its peers in the rest of Asia. A detailed study undertaken by the RBI in September 2007 on the impact of the subprime episode on the Indian banks had revealed that none of the Indian banks or the foreign banks, with whom the discussions had been held, had any direct exposure to the sub-prime markets in the USA or other markets. However, a few Indian banks had invested in the collateralised debt obligations (CDOs) / bonds which had a few