The Real/Financial Nexus Information and Liquidity Challenges

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The Real/Financial Nexus

- Contextual Relevance
  - The topic assumes importance in transitional and other developing economies on account of the specific role the financial sector play in the growth of real sector and to economic growth.
  - There has been regulatory concerns on the segments of the real sectors to be promoted to attain economic growth and the role of financial sector in it.
  - Though near complete information symmetry may take time to achieve, improving information base for rational decision making and to provide ample liquidity for the growth of real sector is critical.

Global Economic Scenario

- Of late there has been disturbing developments at the global level creating global imbalances and challenging global sustainabilities.
- Supply side: Chinese producers
- Demand side: American consumer
- In terms of global trade the Chinese share has been increasing and contributing to imbalances in global trade.
- Imbalances and vulnerability

World Growth at a Glance

GDP	2002	2003	2004(E)	2005(E)
Global	3.0%	3.4%	4.7%	3.8%
US	2.4	3.0	4.4	3.8
Europe	1.0	0.8	2.1	2.1
Emerging Europe	4.1	5.1	5.9	5.3
Japan	-0.4	2.4	4.6	1.3
Asia ex-Japan	6.1	6.3	7.0	5.8
China	8.3	9.1	9.0	7.5
India	4.7	7.0	6.3	6.2
Latin America	-0.2	1.3	4.8	3.3
Source: Morgan Stanley Research				

Global Property Bubble

	Bubbles	Bubble Watch	No Bubble
	Australia UK China Korea Spain Netherlands South Africa	US Canada France Sweden Italy Hong Kong Thailand Russia Argentina	Japan Germany ASEAN India Latin America
Share of world GDP	**25%**	**40%**	**35%**
Morgan Stanley Research			

Changing global financial system

- The end of the 20th Century witnessed sweeping financial liberalisation across the globe.
- Trade liberalisation coupled with opening up of the capital account has made it easier for the flow of capital in the real sector across the border
- Practically the capital has no boundaries resulting into “vulture capitalism”.
- Globalisation of financial and banking institutions catalised the emerging globalisation of financial markets
- Globalisation of financial services along with advancements in technology has resulted into emergence of a variety of risks which are contagious.

Economics of Real Sector

- The economic growth and the real sector supports each other
- The real sector, by nature have higher gestation period for effecting into economic growth.
- With the internationalisation in all spheres of economic activities, the real sector have also implications for the global changes.
- The capital surplus economies have been investing heavily in real sector in emerging market economies and this has enhanced the financial vulnerability.
- The real sector has tremendous potential for direct and indirect employment generation, which is critical for the emerging market economies.

Financial and Real Sector Nexus

- **Of late there has been a southward movement in nominal interest rate all across the globe.**
- **This has led to movement of capital particularly from the capital surplus countries to real sector in emerging market economies for higher returns.**
- **Some of the real sector booms were led by such investments particularly in a number of South East Asian and latin American countries.**
- **In order to achieve higher growth a few developing economies resorted to heavy foreign borrowings to finance their infrastructure**
- **These economies could not assess the fragility of their financial system.**
- **A number of emerging market economies have the system of directed lending including the real sector which has further deepened the vulnerability of financial system in these economies.**

Information asymmetry and imperfect markets

- While there has been globalisation of real and financial sectors, the information asymmetry still persists.
- For Example:
  - Among different Governments
  - Between FIIs, other investors and the debtor countries.
  - Perception on short term liquidity of the banking system in transitional economies.
  - Assessment of the maturity profiles of the public debts
- Information asymmetry led to faulty risk assessment, expectation mismatch leading to over investment in certain sectors.

Assessment of global financial challenges

- **Improved financial system leading to solid economic growth and stability**
- **Improvements in performance of Corporates and financial sector globally**
- **Financial institutions have improved profitability and strengthened capital base leading to reduction in liquidity challenges**
- **The global economy is likely to enjoy solid growth in the foreseeable future with controlled inflation.**
- **Coupled with the above, there has been certain disturbing pointers as well, which may hamper the growth and future expectations**

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Risk in the Period Ahead

- Lack of prudent risk management mechanism in certain economies particularly in the economies under transition
- Risk of currency adjustment
- Burgeoning current account and fiscal deficit in U.S economy
- Continuing upward pressure on oil prices feeding through to inflation larger than expected rise in interest rates may lead to negative surprises for corporate profits and credit quality

Indian Experiences

- **Indian Financial System has proved its tenacity and strength and perhaps was the only country insulated from the South East Asian crisis.**
- **Financial Sector liberalisation introduced since 1991**
- **Financial markets were de-regulated on a phased manner has helped the economy to gain the advantages of the financial sector globalisation by insulating from external shocks.**
- **Sectors to be opened for foreign capital flows were identified after careful analysis of the specific role such as expansions may contribute to the economic growth.**
- **Higher risk weights have been assigned to the investments flowing to the housing and other real sectors to contain the excessive investment and as a prudent measure to ward against fluctuations.**

Indian Experiences

- **In order to maintain appropriate liquidity in the system a well developed liquidity management system such as liquidity adjustment facility(LAF), Repo and Reverse Repo, etc are in place.**

- **Credit Risk:**
  - **Detailed financial information disclosures were made on asset quality, capital adequacy and liquidity; detailed analysis of borrowers including risk hedging capacities**

- **Liquidity Risk:**
  - **Contain maturity mismatch and maintain minimum level of liquid assets, restrictions on exposures and concentration, promote liquid market for foreign exchange transactions by fostering efficient and transparent trading and market arrangements, etc.**

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Indian Experience

- **Interest rate Risk :**
  - **Tightened prudential requirements for risk management of portfolios**
  - **Achieve an adequate degree of transparency in large positions, trading data..**
- **Exchange rate risk :**
  - **Establishing internal limits and monitoring mechanisms for foreign exchange exposure, including off balance sheet items.**
  - **Establish net open position limits**
  - **Set capital requirements against exchange rate risk**
  - **Develop instruments for hedging exchange rate risk.**

Thank You