21st Dec. 2017 Revised Draft used for Delivery

INDIAN INSTITUTE OF MANAGEMENT,
BANGALORE

7th India Finance Conference 2017
(IFC 2017)
20th December 2017

MONEY & FINANCE
Asking Different Questions
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Professor R. Vaidyanathan, distinguished scholars, and friends,

I am thankful to the organisers, in particular, to Professor Sankarshan Basu, for giving me an opportunity to address the 7th India Finance Conference 2017.

A Conference of Finance professionals organised jointly by IIMs Bangalore, Kolkatta and Ahmedabad, cannot but command respect. Being invited to address such a Conference is an honour that cannot be easily refused.

After considerable deliberation and consultations, I decided to speak on a subject with which I am familiar and in which you might be interested: "Money and Finance: Asking Different Questions". If one asks the same questions as in the past, one often gets the same answers or same set of answers as in the past. So, it is good to think of asking questions different from the ones generally debated. I intend posing some questions which may be different from the usual ones. I will ask some questions which may not be different, but for which the answers could be different from those in the past. For some questions, there may be no ready answers and yet they should be asked.

In the presentation today, I will share the questions and some possible answers in seven areas relating to money and finance. I hope you will provide answers in your interactions.

These are: Global Money and Finance; Central Banking; Commercial Banking; Financial Regulation; Financial Markets; Financial Institutions; and Finance for Inclusive Growth.

1. **Global Money and Finance**

How much of competition, the key to efficient markets, prevails in global finance? Foremost is the issue of currency. Gold is generally accepted globally, and is, in fact, a form in which a part of the reserves of central banks themselves are kept, and is by implication, a global currency acceptable to all the central banks.

Often the signals about confidence of central banks in the future of monetary system are available from their purchases and sales of gold in their forex reserve management. Closest to gold as a global currency is the U.S. Dollar. (SDR is only an accounting unit). The supply of U.S. Dollar is essentially determined by the Federal Reserve of U.S.A. The Federal Reserve is required by law to serve the interests of U.S.A. It may take into account the role of U.S. Dollar in global economy, but that is incidental and not integral to the monetary management. Hence the famous saying of an U.S. policy maker: "My currency, your problem". The supply of global liquidity is primarily oriented to serve U.S. interests and not necessarily to meet the needs of the global economy. In a way, the global finance is operating in a monetary non-system.

The currencies other than U.S. Dollar can be divided into reserve currencies which are few and others. Among the others, there are some governments which can raise resources from outside the jurisdiction, but designated in their own currency. There are others who cannot. In brief, the global finance is operating with several currencies, but with unequal status in the system.

The search for an alternative to US Dollar has proved elusive so far. (Euro was briefly competing. Now, bit coin seems to be on the wings, but, nowhere near a threat to Dollar.

Who fosters competition in global finance?

What is the status of global financial architecture consisting of IMF, World Bank, WTO, perhaps, G20?

The global financial system appears to be somewhat oligopolistic. Two rating agencies dominate the global rating. Four audit firms are the giants. There are two business news agencies that are generally dominant. The dispute resolution mechanisms are concentrated in a few centres (London, New York, Frankfurt) governed by their respective national laws.

Above all, how much of geopolitics is relevant in global finance and to national policies? Should our policy makers assess these in calculating the affordable risks that public policy can take?

Is it possible for countries to bypass the global financial system and interact with other countries? This was possible, to some extent, when the world was bi-polar, one led by USSR and other by the West. That is no longer true since the global economy is far more integrated than ever before; and large economies, U.S.A. and China included, are closely inter-related. China, however, has entered into a series of bilateral agreements in particular for infrastructure. In a way, these investments and trade agreements bypass the global financial system.

What are the implications of such by passing for countries like India, which are not yet keen to be seriously involved in the bypassing?

Will this by passing of global finance by China pose a challenge to our understanding of global finance in future?

2. **Central Banking**:

How critical is independence of a central bank?

A study of history of central banking shows that independence of a central bank vis-a-vis the government is a recent and contextual position. It is not fundamental to central banking.

Broadly speaking, the central banking historically had four objectives: 1) Price stability; 2) Financial sector development and stability; 3) Output and employment; and 4) Supporting the borrowing program of the government when required, and restraining excessive recourse of the government to borrowing so that the value of the currency and the trust in the financial system are maintained. Historically, the relative emphasis among the four depended on the circumstances.

High priority for price stability to the point of adoption of inflation targetting came about only in 1980s. This was a result of combination of several factors, namely, breaking down of the Brettenwood system, the oil crisis, emergence of

Euro-dollar market and high inflation in many countries. Inflation expectations went out of control at that time. Paul Volcker in U.S.A. demonstrated the effectiveness of central bank in achieving price stability and anchoring inflation expectations. This made price stability and inflation targetting the "science" of monetary policy. The idea of independent central bank coupled with price stability as a primary objective was adopted by Bank of England in 1997. Regulatory functions of the financial sector were carved out into a separate authority, separate from the functioning of the central bank.

There was a clamour for similar separation in India also. When I was asked my opinion, I said, as Governor I welcomed it, and as a citizen of India, I am scared of the prospects. Anyway, after the global crisis, the position was partly reversed in U.K.

Global financial crisis, also described by some as Anglo-Saxon financial crisis that affected the global economy provoked a rethink on the independence of central banks and inflation targetting. The rule based approach to monetary policy has not been abandoned but questioned. From 2007, we are at a stage of what Professor Goodhart described as "confused interregnum" on priorities for central banking, before a new approach is firmly put in place.

Is inflation targetting untouched by global financial crisis?

inflation targetting which became the dominant theme in many countries prior to the global financial crisis has been moderated by emphasis on flexibility in the inflation targetting.

It is interesting to ask the question as to why India had adopted legally binding inflation targetting at a time when other countries were dilluting? This question is of particular relevance because hyper inflation or very high inflation has not been the primary problem for Indian economy. The Government due to democratic pressures had always been very keen to maintain price stability all through the years and RBI had impeccable record in this regard, relative to most developing countries, despite high fiscal deficits.

Is there a danger that the reputation of RBI is at risk since the capacity of central bank to influence price levels in India is constrained by the role of fisc in determining the price of energy and food?

Are policy statements, policy actions and policy outcomes enough to influence inflation expectations?

Are we trying to fix something which was not broken, namely, inflation, and ignoring the area that constrained our policy space for decades, namely, external sector?

With mandated inflation targetting, is the management of financial stability left to the Government? Is the external sector balance left to the government? In any case, it appears that in case of conflict between price stability and external sector balance, priority is required to be given to price stability under the new arrangement.

3. **<u>Commercial Banking</u>**:

Who owns our banking system?

The foreign banks account for relatively small part of the banking business in India. From regulators point of view, large presence of foreign banks, either as subsidiaries or as branches, poses problems of effectiveness. This is not an issue in India now.

What is the extent of foreign share-holding in Indian banking system? The foreign share-holding in the largest private sector banks is over 70 per cent. In regard to public sector banks, the government and the LIC which is part of the public sector account for bulk of the ownership of the shareholding, and a major part of the rest is with foreigners. Thus, a major part of the private sector share-holding is held by the foreigners. In brief, our banking system is predominantly owned by public sector and a major part of the rest by foreign investors. There may be no issue here for the regulator, but in general, unlike in other activities, the ownership of pattern of banks is relevant to the regulators.

Is there a banking crisis in India, or is it merely a stress?

Banking crisis is generally associated with macro economic instability especially in the external sector or financial sector. In India, there are no signs of any such instability. Banking crisis is also associated with lack of trust in the banking system. Barring the recent draft bill on resolution, to which I will revert later, there is no evidence of lack of trust in banking or a tendency to withdraw deposits. Finally, the problem of inadequate capital (or capital inadequacy) is confined to the public sector banks and not private sector banks. The fact that private sector banks have adequate capital shows that RBI's regulation cannot be fully faulted for the current problems.

The issue essentially boils down to providing adequate capital to the public sector banks to enable the normal lending operations as per the stipulation of RBI, the regulator. Capital adequacy is a normal stipulation.

Does absence of a crisis mean that there is no serious problem with the banking system in India?

The cost of intermediation through the banking system in India is by all accounts higher than in other countries. However, it can be argued that the resources available for the banks are constrained by the stipulations of statutory liquidity ratio, CRR, priority sector lending stipulations and other social objectives from time to time. In other words, the major problem faced by the banking system is exogenous and lies in large pre-emption of resources and non-commercial operations. What has been the progress to remove these externally imposed constraints on the banking system? Not much, after the first decade of reform?

In the meantime, government has been keen to develop non-bank financial intermediation such as mutual funds, which is consistent with reforms as a goal. The question is: are the bank-depositors asked to bear the social objectives and also pay taxes? In fact, are the banks, 'special' in a positive sense or negative sense or not special at all?

What is the biggest uncertainty for the future of banking industry in India? By all accounts, it is the future of the public sector banks which is not very clear where it is headed. The current proposals seem to indicate that there would be consolidation in order to make them efficient, in which case the public sector banks may replicate HDFC or ICICI. The question would then arise as to the justification for having government ownership and tax payer's money locked up, if they perform purely commercial functions.

In brief, if there is no crisis in banking is there (a) stress on public sector banking and (b) confusion about way forward for them? More important, are we 'clear about the future of public sector banking, and the possible costs and benefits to the society?

Are bank deposits fully protected or perceived to be fully protected?

As mentioned, banking crisis arises when the trust of the people in the banking system as a whole is eroded. That has not happened in India so far. But a recent legislative proposal for bail-in has created widespread concerns. It is useful to appreciate the background.

Modern finance or Anglo-Saxon finance is built on two assumptions if not theologies. First, banks are not special and they are like any other financial intermediaries, and non-bank financial intermediaries should be encouraged in order to diversify the risks in the system. Second, the consumer is responsible for the decisions that he or she takes – the principle of Caveat Emptor. After the recent global financial crisis in which there was bail-out of large conglomerates at a huge cost, the G-20 recommended or agreed to provide a legal framework for bail-in. This is primarily in the context of large inter-connected 'too big to fail' conglomerates with globally inter-connected operations across countries.

Is this good or relevant or necessary?

In India, banks have a special place. There are large number of savers who put their money out of total trust in the banking system. The RBI has been practicing what may be called "constructive ambiguity" in assuring a sense of safety of all depositors – including those that are not covered, though there has been no legal or formal commitment by Government or RBI to do so. The RBI does not assure a bail-out, or legally guarantee safety of all deposits but somehow manages the situation on a case by case basis, giving full comfort to the community of depositors that their deposits are generally safe under the watch and authority of RBI.

Two examples will suffice. In 2002, there was a beginning of a run on the bank and a Press Release from RBI stopped it. In regard to Global Trust Bank, RBI assured the markets about its balance sheet, but acted on it at the time of its own choosing to protect the depositors' interest as authorised Banking Regulation Act.

I believe that the depositors in banks are essentially those who have no inclination to apply their mind or who have no capacity to apply their mind for choosing among different financial instruments. They prefer, above all, safety of their savings. It is the responsibility of the Government and the central bank to ensure that there is a place where such people can keep their money safely in India, that is, bank deposit.

Despite assurances to the contrary, the current proposal for bail-in may really be a "bail-out" for other stakeholders relative to depositors who had a pride of place in the current dispensation under BR Act. Under the proposals, bank depositors are in the queue along with many others and subject to decisions by authorities dealing with many other institutions and claimants. This proposal has not stood test of time in other countries. In fact, half of G20 countries have not even adopted this approach so far.

The proposal for applying bail-in provisions for bank depositors on par with other market participants in finance removes the sense of comfort that prevails. The current proposal is, therefore, trying to find a solution where no problem existed and in the process, problem of trust in banking has been created.

4. **Financial Regulation**:

What is unique about regulation of financial sector?

When people go to buy vegetables for Rs.200/-, they ensure that it is weighed carefully, look at quality, feel their texture with palms, etc. There is lot of bargaining. Why is it that people do not spend as much time when they are putting thousands of rupees while depositing in a bank or while buying insurance? The distinguishing feature of financial sector is the special relationship between trust and the financial sector. Trust is a universal value, but trust is critical in finance. In finance, there is no exchange of goods and services which one can feel instantly. One is only exchanging money which will give the claim for goods and services in future. If one buys insurance now, and under some conditions, she will get money in future. If one puts a bank deposit now, he gets back the money with interest sometime in future. Exchange of money and financial instruments involves movement of claims over space also.

Whenever we, as common persons, deal with a financial institution like a bank or an insurance company, we give lot of information about ourselves. In the process, the banker or the insurance company knows a lot about us, but we have very little information about the institutions. When we buy health insurance, the insurance company knows a lot about my health condition, but I know very little about the financial health of the insurance company!

Most of the financial intermediaries are limited liability entities. The liability of owners or share holders is limited to their capital put in. Therefore, there is always a temptation on the part of the owners or the managers to leverage excessively and take excessive risks. They gain when there is profit, but when they lose, they can declare insolvency.

Experience has shown that some of the characteristics of modern financial sector attract many intelligent people to this sector. That is mainly due to the potential for making money within a short period by dealing in other people's savings. It also means that financial sector will be especially attractive to those who are both intelligent and crooked.

In brief, therefore, financial sector is special and it requires appropriate regulation. However, it is also important that the customers are on their guard and take informed risks and informed decisions when they are active in financial markets.

Financial sector regulation should take care of both individuals and of systemic stability, in addition to facilitating or not inhibiting financial innovation. There are trade-offs in these competing objectives. Less regulation facilitates more innovation, and perhaps, results in less consumer protection. Further, when the markets correct over a period for excesses, the losers may be different from the gainers. The concept of affordable risk is relevant to the society or economy as a whole, and not only individuals. The question is, how important are the country specific considerations in these trade-offs?

Is RBI a financial regulator?

RBI is one of the regulators because it regulates a bank which is an important component of the financial system in India, but it is much more than that. RBI is the central bank with responsibility for monetary policy and banking regulation is one of the tasks assigned to it through a separate legislation. In a way, regulation of banks is an additional subject and not the core of RBI unlike other regulators that have been created for specific purpose of regulation.

A regulator is essentially an umpire and ensures the evolution and observance of rules of the game that make if fair and improve the quality of the game. A monetary authority is responsible for some of the macro conditions in which the game is played. In some senses central bank performs sovereign function in relation to money. Further, many operations of the monetary authority have quasi-fiscal implications.

The RBI as a monetary authority deals with liquidity in the financial system and is invariably the first line of defence in times of crisis. It has a special place and a leadership role in crisis management, particular when there is a potential for political uncertainty. It is possible to argue that the government as a sovereign should have the responsibility for crisis management which is true, but the first line of defence is admittedly the central bank.

The issue is whether the central bank should have the primary responsibility for financial stability which, in any case, involves close coordination with the fiscal authorities, or whether the fiscal authority, namely, the Minister should directly take the responsibility of coordinating directly with all regulators and the central bank, instead of overseeing these functions being performed by RBI.

5. **Financial Markets**

Why Bond Markets did not develop and fund infrastructure in India?

Is the belief that infrastructure should be funded by development of bond markets, justified?

It will be interesting to analyse how infrastructure was funded in different countries. Of course, in USA, it was significantly bond financing and, to some extent, in UK. In Europe and Asia, infrastructure was not funded significantly by bond markets. In Europe bond market development picked up after significant infrastructure was built. More recently, East Asian countries and China developed infrastructure in a significant manner, and the bond markets are yet to be developed in these countries.

Is it possible that bond market development follows rather than leads infrastructure development?

The most important part of the bond market is the government securities market. The global experience seems to show that development of government securities market precedes the development of corporate bond market.

In our country, the government securities market has expanded significantly, but in the background of high level of statutory pre-emptions. Banks are required to invest at least a fifth of their depositors' money in government securities. In other words, due to financial repression, the government securities market itself is not genuinely market driven. Is it possible to argue that in terms of sequencing, the financial repression should be removed to develop government securities market and, development of bond market takes place after realistic bench marks are set by government securities markets and money markets?

What are the unique characteristics of the corporate bond markets in India? Private placement prevails. While the listing is fairly impressive, the actual trade and, more important, settlement, is a small proportion of stock. What does that signify?

We should have a strong corporate bond market, to assure long term savings to match demand for long term investments. To develop a strong vibrant corporate bond market that inspires investor confidence, actions are required in macro-economic and governance aspects.

6. **Financial Institutions**:

What are the unique features of mutual funds in India?

Firstly, most of the funds have been promoted either by corporates or by financial conglomerates or banks. There is potential for conflicts of interests.

Secondly, the access to investments in mutual funds is not restricted to individuals but extends to banks and corporates. The whole-sale deposits often account for a major part of the resources of the mutual fund. Thirdly, the mutual funds original purpose of serving the individuals who may have neither capacity nor inclination to assess the financial markets is not served in the absence of exclusive attention to their interests.

The return obtained by investments in mutual funds is significantly higher than the interest earned on bank deposits. The mutual funds have advantage over banks in terms of tax treatment. The mutual funds do not have obligations with regard to investments in government securities or priority sector lending. Yet, bank deposits have been popular till recently.

Is there a trust deficit in mutual funds? Are there concerns about accounting practices or governance standards?

Is it possible that recent high growth in assets under management was in the nature of making up for shortfall in bank credit due to capital adequacy issues? If so, is the quality of assets impaired? Is too rapid a growth in their assets in recent times a cause for concern?

7. **Finance for Inclusive Growth**:

What should be the relative roles of foreign savings and domestic savings in financing our development?

The experience of some countries, including China, in recent years shows that on a net basis, foreign savings is not a major contribution for financing economic growth. In other words, countries may generate current account surplus even while they are developing. In any case, the financial markets may not be willing to finance recurring large current account deficits. Hence, the sustainable current account deficits could be considered as the limit for dependence on foreign savings. Since the reform, we have been aiming at a current account deficit of not more than 2 – 2.5 per cent deficit. Obviously, we need to attract foreign investments for different purposes, but all that will still have to be accommodated within this limit of aggregate foreign savings to finance development. Experience so far shows that the foreign savings constitute less than 10 per cent of the total investments.

Is our policy framework focusing on the over 90 per cent, namely, domestic savings, or focusing more on the 10 per cent?

In the discussions on policy interest rates, there is invariably an emphasis on investments and importance of credit. However, in our country, the number of savers particularly in the banking system is a multiple of the number of borrowers or the loan accounts. However, the savers are dispersed and they do not have many choices. The borrowers have many choices. In the Indian conditions, the savers are more or less trapped into the banking system. The banks are burdened with financing the government borrowing program and financing the priority sector programs. Yet, the interest income from deposits is taxed unlike from mutual funds. In brief, the savers who put their money in the banks have to pay more tax than those who invest in non-banks. In a way, is the financial intermediation favouring the borrowers more than the savers?

In regard to the rural urban dynamics, there is an impression that the rural areas are subsidized by the banking system. However, the data shows that the credit deposit ratio is poor in rural areas related to urban areas. In other words, the savings of the rural areas which are already impoverished are actually transferred to the urban areas for investments through the banking system. Are the savers in rural areas financing growth of urban areas?

The write-off of the farmers' loan attracts considerable attention. However, the implicit write-off in the corporate restructuring benefitting a few business houses is relatively large, may be larger, over the years.

In brief, the issue is whether the financial intermediation as it exists is consistent with the popular impression? Indeed, what is the popular impression? And what is the perception of Finance experts? Do they diverge?

CONCLUSION

Amartya Sen famously popularised the word 'Argumentative Indian'. Today, I have been a questioning Indian, if not an argumentative one. Let me conclude with one question.

Financial sector reforms in India were smooth and successful till about ten years ago; and have become contentious since then. Why?

I wish the Conference all success and great future.

Thank you.