Further Reflections from a Reforming Indian Central Banker*

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Yaga Venugopal Reddy, Governor of the Reserve Bank of India (RBI) during the critical period, 2003-2008, is widely given credit not only for the RBI's skilful management of India's external payments during this period but also for presiding over the introduction of reforms of the country's financial regulation of which some actually anticipated parts of the international financial reform agenda subsequently promoted by the Financial Stability Board in response to the current financial crisis.

His third book since 2009[i] like its predecessors, consists of talks and lectures given to official and academic audiences in India and abroad, and covers the global financial and monetary system as well as various specifically Indian policy issues – in both cases subjects where he was actively involved in the process of policy design while he was still Governor. The article which follows is largely limited to Reddy's commentary on issues related to global governance, and his discussion of the Indian financial system is included only when relevant to his global commentary. Although the article consists primarily of explication of Reddy's commentary, it also suggests ways in which some topics raised but not discussed by him at length could have been further developed.

PURPOSE OF FINANCIAL SERVICES AND FINANCIALISATION

Reddy's commentary on issues of financial and monetary policy is rooted in his views as to the roles which financial services should fulfil and as to who should be targeted as the main recipients of these services. As he puts it, "The social value of the financial sector can be assessed in terms of its direct relevance as a service to the average person in providing financial services and its indirect relevance through its resource mobilisation and allocation, including managing risks and rewards."

Reddy's concern with not only "average persons" but also with the poor helps to explain the space he accords the issue of financial inclusion, i.e. the extension of banking services to the poor (in India especially the rural poor)as well as the constructive role which he believes public-sector banks (despite the mixed historical record of their governance) can play in extending such inclusion, in implementing priorities in public policy, and in providing access to financial services to the underprivileged. Occasional tart phrases in the book highlight the central role of "average persons" in Reddy's thinking. For example, he cites with approval a view held in the RBI that socially "an ATM was...a great level maker in the sense that all the customers have to stand in the same queue, unlike in the banks where the privileged customers could get faster service".

Unsurprisingly Reddy thus draws special attention to the public-utility dimension of financial services and the relation of this dimension to their regulation. He notes the heterogeneous experience revealed by empirical evidence concerning the performance of the financial sector in different countries. Nevertheless, his conclusion is that "there is an optimal level and quality of financial sector intermediation and sophistication that seems to enable growth with stability while anything above that has not added fundamentally to the society".

Also unsurprisingly Reddy is highly critical of the excessive financialisation of the financial sector which he believes is now characteristic of major advanced economies but not of emerging-market and other developing economies. Features of such excessive financialisation identified by Reddy are incentives in the form of commissions related to transactions leading to multiple layers of transactions, innovations functioning like mirrors of reality whose multiplication has increased the distortions of the original purposes of the underlying operations, and complexity injected to circumvent regulations on transparency and capital or to mislead an institution's counterparties.

The consequences of excessive financialisation are visible in "the growth of the financial sector as a percentage of GDP, the growth of profits of the financial institutions as a percentage of the profits of all the corporates engaged in the economic activity, the remuneration of managers in the financial sector relative to others and the share of shadow banking [the carrying out of financial intermediation involving both credit and maturity transformation through entities which are subject to lighter regulation than traditional banks and lack a financial backstop from the government] as well as derivatives in the total activity of the financial sector". Excessive financialisation has now extended to the commodity markets, resulting in an enormous increase in the relative scale of speculative as opposed to hedging positions and in the susceptibility of these markets to periods of high volatility. At the systemic level excessive financialisation was inextricably linked to the excessive leverage of both firms and households which was exposed by and contributed to the financial crisis.

MAJOR ITEMS OF THE REFORM AGENDA

The post-crisis reform agenda targets both cross-border and domestic regulation as well as other policies directed at the financial sector. Some items on this agenda are self-evidently cross-border. Others are concerned in the first instance with countries' domestic financial sectors but usually also have a partly cross-border rationale as well as cross-border implications.

Capital controls

Since the outbreak of the crisis the appropriateness of capital controls as a policy instrument is being reconsidered even in policy-making circles in advanced economies and in the international financial institutions which are under the sway of these countries. Reddy has long had a pragmatic position on capital controls, viewing them as the best policy in several situations. His new book contains perhaps the most systematic and canonical statement of his views on the subject.

Reddy addresses both what he considers to be the primarily conceptual issues and what he considers to be the primarily empirical issues associated with capital controls. Key issues which he raises under the first heading are as follows:

- Outflows and inflows are typically closely related and should thus be considered together.
- The role of source as well as recipient countries should not be lost from view.
- Proper account should be taken of the difficulty of relying – as still recommended by major multilateral financial institutions – on fiscal and other macroeconomic policies as an alternative to capital controls.
- Account should be taken of the distribution of gains and losses within the economy from capital movements and from policy responses to them.
- The volatility associated with international capital movements may involve not only financial flows but also the value of external assets and liabilities – and thus balance sheets throughout an economy.
- Means of circumventing capital controls always need to be born in mind.
- Effective capital controls may often need to discriminate between both countries and currencies. (This is a matter to which we shall return under international trade in banking services and the General Agreement on Trade in Services).

The issues which Reddy classified as empirical – concerning which his remarks clearly draw on his first-hand experience of Indian balance-of-payments management – are the following:

- There is a need to distinguish between capital movements driven primarily by domestic developments and those driven primarily by global developments. Amongst the latter Reddy draws special attention to changes in global liquidity conditions.
- There is a lack of evidence concerning the long-term costs of capital controls (in terms of a less efficient allocation of savings and a lower growth trajectory).

- Capital controls need to assessed not in the abstract but in terms of the policy objectives of the government imposing them. As Reddy puts it, “The policy makers have to contend with not only the consequences of managing capital account, but also the consequences of not managing it under stressful conditions”.

- Policy design needs to take account of a hierarchy of types of capital flow in terms of their instability. For example, “there is inadequate appreciation of the fact that the instability of the capital account transactions is high with regard to the activities of the financial sector, lower with regard to the activities of the corporates, and least with regard to households”.

- Both liberalisation and control must take account of linkages between transactions on capital account and those on current account. The latter must be monitored as to the extent to which they are used to conceal transactions on capital account. India’s solution to this problem includes requirements for the repatriation and surrender of foreign exchange-earnings except in the case of categories specifically exempted.

Reddy also makes some general points concerning capital controls which do not fit easily into his binary classification of conceptual and empirical issues. For example, capital controls should be part of the authorities’ policy armoury at all times. In other words they should not require piecemeal legislative permission. Availability at all times will provide the policy flexibility required for dealing with international capital movements. Moreover, the level and stability of the exchange rate have important implications for the stability of the financial sector. Capital controls and prudential regulation are thus closely linked – a point now acknowledged as part of the agenda of macroprudential regulation.

Financial regulation

The global agenda of regulatory reform (enunciated principally by the Financial Stability Board and the Basel Committee on Banking Supervision) covers the major components of the financial system, namely markets, intermediaries, instruments and infrastructure.

The principal headings of this reform are included in Reddy’s overview: the capital standards of Basel II and Basel III designed to ensure that banks have adequate capital for their exposures to credit and market risks as well as improved internal management of these risks; the liquidity rules of Basel III designed to ensure that banks have the liquid resources to meet short-term outflows of funding and adequate stable sources of funding in relation to the liquidity profiles of their assets; the size and complexity of today’s large financial institutions- the Too Big To Fail institutions; shadow banking; systemic stability and macroprudential regulation; new financial instruments, in particular OTC derivatives; incentives and bankers’ remuneration; deposit insurance and taxation; credit rating agencies and accounting; cross-border issues such as how to resolve failed banks with entities in several jurisdictions and how to control regulatory and tax arbitrage; and the implications of the shift in regulatory philosophy since the crisis away from self-regulation and soft-touch regulation towards whatever framework is required for financial stability.

Reddy has observations on several of the principal subjects covered by the global reform agenda which are generally highly pertinent but also in some cases – sometimes tantalisingly – open up or point to further questions not treated by him.

TBTF banks are attracting increasing attention as part of the design not only of the global agenda of regulatory reform but also of national reform agendas which often go beyond the globally enunciated rules either because national authorities believe that the global proposals are insufficiently stringent or because important issues are not considered suitable subjects for, and are thus not included in, the global agenda. Reddy wishes to add to TBTF that institutions – often the same ones - can also be too powerful to regulate. I think he might have added that the same set of institutions have also often become too complex to manage properly –as graphically described by Richard Bookstaber, whose career has spanned risk management at Morgan Stanley, Salomon Brothers and Citibank, in his aptly entitled 2007 book, *A Demon of Our Own Design*.

The approach adopted so far as part of the global reform agenda has been to impose additional capital requirements on TBTF banks, thus increasing the costs of size and, it is hoped, providing an incentive to scale down. While not disowning this approach, Reddy would also like to see greater recourse to public ownership in this context. An appropriate mix of private and public-sector banks is, as already mentioned, part of Reddy's agenda for the typical emerging-market or other developing economy. But he also believes that the state should consider continuing public ownership of at least some of the banks taken over in bail-outs since the beginning of the financial crisis. Moreover public-sector banks, Reddy maintains on the basis of his Indian experience, provide regulators with better access to information relevant to their task on several issues than private banks, thus facilitating an enhanced quality of regulation.

Reddy acknowledges the increased importance since the beginning of the financial crisis accorded to systemic instability and macroprudential regulation. He also notes that the measures proposed under this heading and the problems which must be confronted draw heavily on the experience of advanced economies such as the lack of synchronisation of financial and business cycles. Importantly, owing to the structural transformation which is part and parcel of economic development, cycles in the sense in which the term is used for advanced economies are more difficult to identify in developing countries.

However, this difficulty regarding the way in which the concept has so far been developed in no wise means that macroprudential regulation is not of great importance for developing countries.

Indeed, as Reddy puts it, the "regulatory framework must be an instrument for stability and, therefore, it can be an instrument for promoting development". But, somewhat tantalisingly, Reddy takes this point no further.

In the context of development policy it can be difficult to distinguish between components of microprudential regulation (directed at the stability of individual banks) and macroprudential regulation (directed at systemic stability). But one can easily think of subjects where appropriate regulation, arguably serving both macroprudential and microprudential purposes, may differ for advanced economies, on the one hand, and emerging-market and other developing economies, on the other: rules on the permissible degree of concentration in the loans in a bank's portfolio; rules concerning the qualifying liquid financial instruments under the headings of collateral and of the liquidity standard of Basel III (a subject which the Basel Committee on Banking Supervision does now appear to be addressing); and rules concerning the appropriate liability structures and capital for alternative financial institutions (such as cooperatives) as well as for public sector banks in view of their deployment of the latter as instruments for the promotion of the government's development policy.

Reddy acknowledges the way in which management's remuneration in banks, owing to its connection to short-term profits, has tilted decisions in favour of excessive risk taking and thus contributed to the financial crisis. Moreover he notes the "massive and intense unhappiness" amongst the public over the huge bonuses associated with this risk taking. However, on controlling this state of affairs he appears to believe that the lobbying of the banks has prevented much progress. But it would have been interesting to have had Reddy's views on the form which such control might take.

International initiatives have largely concentrated on rules ensuring that the payment of bonuses is phased over several years (with provisions for claw-back). It is possible to visualise measures which would target more directly the connection between excessive remuneration and risk taking. For example, investment banking activities (where most of those receiving huge bonuses work) could be legally separated from more traditional commercial banking activities in entities which would not be permitted to enjoy limited liability. Reddy does mention (in his chapter on trust in finance) limited liability as an institutional innovation which has historically contributed to the efficiency of the economic system. However he does not mention what seems to me to be the important downside of limited liability as opposed to the partnership form in investment banking regarding the question of acceptance by management of the consequences of decisions involving risk and management's meeting of the cost associated with its decisions.

Implications for the GATS

There has been a sea change in prevailing views concerning both financial liberalisation and financial regulation since the negotiation in the 1990s of rules and commitments for international trade in banking services as part of WTO General Agreement on Trade in Services (GATS). In this book Reddy does not explicitly address the shortcomings of the GATS with regard to banking services. However, some of his reflections and recommendations none the less bear on GATS rules.

As mentioned earlier, Reddy believes that capital controls may need to discriminate by the residence and currency, discrimination which would be in contradiction with the provision concerning non-discrimination of Article XII of the GATS (the article covering restrictions to safeguard the balance of payments). Other potential contradictions between Reddy's views on capital controls and GATS rules might follow from his emphasis on the authorities' need for flexibility regarding capital controls and from his position that in the design of policy towards foreign banks a distinction is necessary between "multinational banks", on the one hand, and "international banks", on the other.

In Reddy's terminology multinational banks operate in different countries operate through branches or subsidiaries financed largely locally in local currency. International banks operate across borders and are active in cross-border capital movements. In Reddy's view, the main focus of global coordination in regulation should be international banks, especially large conglomerates. This is an interesting distinction, no doubt based on Reddy's Indian experience of central banking and of financial regulation, which probably would have implications for the GATS. Unfortunately Reddy does not elaborate on how the distinction might be embodied in financial regulation.

Elsewhere Reddy has expressed his scepticism concerning the appropriateness of the GATS rules on banking services in the light of the lessons of the financial crisis. However, he has not addressed the difficulty of reforming these rules, which were the result of lengthy and contentious negotiations, in an institution (the WTO) which operates by consensus. Uncertainty concerning the scope and limitations in practice of the GATS rules dealing with governments' freedom of action regarding prudential measures and capital controls appears now to be widely acknowledged among the member countries of the WTO. But precisely because the application of these rules in dispute settlement is largely *terra incognita,* the generally prevailing line at present within the WTO seems to be mutual forbearance in the form of avoidance of testing the rules through cases directed at other member countries' measures.

LOBBYING, REGULATORY CAPTURE AND THE INTELLECTUAL HIGH GROUND

Reddy discusses at length the way in which comprehensive regulatory capture and lobbying by the financial sector set the stage for the financial crisis. Regulators in the years preceding the crisis (and to a still major extent even now) have depended heavily on consultation with the financial firms regulated by them concerning both the design of regulation and the practice of supervision. Indeed, deregulation was to a significant extent the result of the confluence of the all too frequently cosy relationship between regulated and regulators and a climate of opinion increasingly persuaded that modern financial systems were contributing to the public good.

Incentives also played an important role here. In many countries the financial sector has offered prospects of eventual highly paid jobs for those who have been employed in regulatory agencies and ministries of finance. Moreover a large part of the academic research on the functioning and regulation of finance is funded by the financial sector.

Under the heading of regulatory capture Reddy seems to me not to give sufficient emphasis to an insidious long-term consequence of the close relations between the financial sector and the upper reaches of academe in major advanced economies. The consultancy fees for position papers on policy issues and the speech payments for big-name financial - and to a lesser extent macroeconomic – academic experts can be large (USD 40,000 and upwards), as are the emoluments of academic economists who are members of the boards of directors of financial institutions. Eligibility here is mostly available only for economists who either support positions favoured by the financial sector or avoid subjects which the sector is likely to find contentious or to regard as having potentially unfavourable implications for the industry. The same big-name economists also usually have a major influence on peer reviewing for the major professional journals which play an important role in academic appointments and promotions. As a result connections between the financial firms and academia eventually influence not only the contents of work commissioned by the firms but also the parameters of the research agenda on finance – what is considered “scientific” and what is considered unscholarly or “journalistic”. This has contributed to the technically accomplished but politically safe and conventional character of much, if not most, academic research on finance in recent decades.

So what does Reddy suggest to counterbalance these influences? He is understandably somewhat sceptical as to the likely effectiveness of proposed codes of fair practice for financial professionals, regulators and academics. Rightly – but not simplistically – he suggests the need for trustworthy institutional structures to reassure the public that the scope for regulatory capture – and the excesses that go with it – are being minimised. Such structures, it seems to me, will have to be rooted in national cultures, which may differ in significant ways. But the result which one may hope for is the restoration of the fundamental concept of banking as “a people business” (as an

Irish friend and former regulator once described it to me) in place of the overriding emphasis increasingly given in financial institutions to quantitative methods and numerical targets, which has spread outwards from the main Anglo-American financial centres.

TRUST

Trust is an issue of ethics but also of the proper functioning of an economy. Indeed, without the confidence in others, engendered by trust – a frequently overlooked economic overhead - , society is incapable of realising its needs and wants. In a separate chapter on trust in relation to the financial sector Reddy draws special attention to trust's relation to the proper functioning of an economy, emphasising the essential role of trust in exchanges involving movement of claims over time, space and different risk profiles. Moreover many banking services are – or should be – of a long-term character and thus require trust between the parties involved.

As Reddy notes, the erosion of trust during the financial crisis has been principally directed at the financial sector in advanced economies. The erosion has been due to the widespread adverse impact of the crisis in terms of losses of income and asset values and of increases in unemployment due to dysfunctions of institutions previously widely lauded for their performance and their positive contribution to the general good. The erosion has also been the consequence of the way in which the costs of the dysfunctions were often met more by taxpayers than by the bankers and banks responsible for mismanagement.

In Reddy's view, while the post-crisis restoration of trust in the financial sector is primarily a task for policy makers, regulators and regulated institutions in major advanced economies, the continuing promotion of such trust should also be a continuing objective in developing countries. This has the important implication that whereas the restoration of trust in advanced economies will entail reregulation in the interests of stability and the protection of the interests of the general public, in many developing economies promotion of trust may actually entail deregulation in the interest of increased efficiency (though Reddy stresses that this should not compromise regulators' and fiscal authorities' difficult task of controlling the cross-border operations of financial conglomerates).

Owing to Reddy's conviction that trust is closely connected to "ethics, morals, values, sense of fairness, etc., which are often country- specific and culture-specific", he largely limits his specific suggested steps for the restoration and promotion of trust to its interface with regulatory and tax reform. He stresses the need to ensure that the distribution of the burden of this reform is generally perceived to be fair.

Here he draws special attention to the strengthening of consumer protection in banking transactions, to making derivatives trading more transparent – and thus presumably easier to understand by a wider public -, to the ring-fencing of retail and traditional banking from investment banking, and to the desirability of increased taxation of banking activities – through, for example, the taxation of financial transactions – as a contribution to meeting the cost of the current and possible future crises and as a disincentive to excessive financialisation. Reddy might also naturally have linked his discussion of the restoration and promotion of trust to his discussion of lobbying and of the conduct of financial practitioners and experts which have also been in the forefront of public's perception of the financial sector's shortcomings since the start of the crisis.

GLOBAL GOVERNANCE

Reddy clearly believes that, even after recent changes, the current structures of global governance take inadequate account of the specific concerns of emerging market and other developing countries. He notes that the larger developing economies cooperated with the advanced economies regarding measures designed to mitigate the impact of the global crisis, though they were uncomfortable with the deficiencies in the governance of the institutions through which the decisions were taken.

Reddy has specific reservations concerning the way in which standards for regulation and regulatory coordination are being harmonised within the Bank for International Settlements and the Financial Stability Board. As he puts it, "there are some financial system issues that are unique to the emerging and developing economies, and so far these do not find a prominent place in the agenda of the international standard setting bodies".

On these matters Reddy's views are no doubt widely shared by policy makers and regulators in developing countries. But he also puts forward another argument about global governance – in this book and his other writings – regarding which his views may be more controversial (though I strongly agree with him). This argument concerns the appropriate balance between harmonisation, on the one hand, and acceptance of diversity at national level, on the other, in international standard setting.

On one side of the argument the authorities in several advanced economies and important parts of the international banking lobby such as the Institute for International Finance are pushing for a high degree of harmonisation. Harmonised global standards, in their view, are a prerequisite for the freer cross-border movement of capital and of banks. Reddy raises the opposite point of view with a question, "A simple principle of any management, and in particular financial management, is diversity. To what extent is the principle of diversity, which is required for survival, undermined by insisting on global coordination in the financial sector?" While Reddy accepts that signing up to minimum internationally enunciated standards – but not necessarily to substantially increased cross-border movement of capital and banks - will contribute to global financial stability, he clearly also believes that beyond these minimum standards national authorities should have the latitude to decide on the gold plating of the standards required and on important aspects of the embodiment of global standards in national supervisory rules.

Reddy's dissatisfaction is understandable over the slowness of the process through which developing economies – despite the now widespread acknowledgement of their greatly increased weight in the global economy – are achieving a greater say in global economic governance. The obstacles here involve not only such matters as voting shares in institutions but also ways of thinking. Arguably acceptance of openness to alternative ways of thinking is proving the more difficult of the two obstacles despite the all too evident shortcomings of advanced economies' handling of the antecedents of the current financial crisis as well as of their eventual policy response to it. Reddy's new book, like the others since 2009, has an honourable place in the explication of the alternative ways of thinking coming from developing economies which are now at last getting a more serious hearing and eventually, one may hope, will help to reshape global financial governance.

*** A version of this review has been originally published in SUNS – South-North Development Monitor**

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[i] *Economic Policies and India's Reform Agenda New Thinking,* Hyderabad, Orient BlackSwan, 2013. The previous books by Reddy were *India and the Global Financial Crisis Managing Money and Finance* (2009) and *Global Crisis Recession and Recovery* (2011), both from the same publisher.