

## Golden Jubilee Celebration of Indian Economic Service

By Usha Thorat<sup>1</sup>

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Hon'ble Speaker, Mr.Gopalan, Mr.Sumit Bose, Professor Desai and Dr Kaushik Basu  
and Members of the IES

It gives me great pleasure to be here at this function to celebrate the golden jubilee of the Indian Economic Service. I thank Professor Kaushik Basu for inviting me to speak to you on what is truly a milestone event in the history of the Indian Economic Service. I feel privileged to have been invited to share this event with you. Reading the history of the Service from your site, it appears that it was originally conceived in the 50s by Pandit Jawaharlal Lal Nehru to create a separate cadre of economists for steering the economic development of the nation. As I read, the IES was formally constituted in 1961 and operationalised in 1964. The role of the service is to provide the Government with professional economic advice and engage in economic administration and implementation. In the reform period the IES officers are expected to be involved in the economic reform process in every ministry or department to which they are affiliated on all matters having a bearing on internal and external economic management and reform.

It is common to consider the recent economic history of India as pre reform and post reform period. It is also quite common in economic history to find that most reforms take place in the aftermath of a crisis. Take the New Deal for example which came in after the severe depression in the 1930s. Similarly in India the BOP crisis of 1991 jolted us into the reform path. For those of us who were in University in the late 60s and early 70s- I was in DSE in 1969-71- the received wisdom was mixed economy, planning and

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democratic socialism. A few favoured the extreme left, while those who wholeheartedly agreed with the underlying message of the then famous Bhagwati and Desai book 'Planning for industrialization' advocated total decontrol and dismantling of the license raj. This was also the time of the famous differences between the Bombay school and the Delhi School. However the eighties saw the thinking of policy makers and advisers veering around more closely to the freeing of trade and investment controls and a more liberal industrial policy. But it was not till 1991 when we had a BOP crisis and pledged our gold that full-fledged reforms could actually take place. In a way, today, with the global financial crisis moving into a debt crisis especially in Europe, one senses a need for major reform in the economic and financial administration of the world. While some reforms in the financial sector regulation have taken place one is not sure whether these are enough and whether there is not a more fundamental need to re-examine the underlying philosophy of the market economy and the kind of havoc that can be caused by excesses in the financial sector and markets. Occupy Wall street and such movements reflect this. While businesses and finance have got globalised, macro economic policy and financial regulation is still national, making the task of reform a difficult one especially when there is no clear emergence of a global financial architecture. Also in many countries where there is a debt crisis, reform of the social security system at a time when global unemployment is at unprecedented levels implies social stresses and vulnerabilities.

An aspect of economic policy with which you all may not be that familiar is financial sector regulation and thought I could take you through the deliberations of an international conference CAFRAL held jointly with the Bank for International Settlements in November 2011 on the implications of financial sector regulation for growth equity and regulation in a post crisis world and how these are closely linked to the relationship between the macro, the fiscal, the financial sector and the external account.

To understand the context of the changes in the global financial sector regulation it is necessary to go back to the early 80s. The more insular environment of the early 80s for global finance was followed by an era of liberalization and deregulation facilitated by the revolution in communication and computing, which transformed the global financial

system. The funding requirements of global trade, investment and output were met, in no small measure, by the financial system contributing to the steady growth and prosperity in the world. Regulation on its part evolved and responded to the innovations and the developments in the financial sector. The philosophy underlying it increasingly moved towards deregulation, rather towards encouraging financial innovation. The overarching view was that that the markets knew best. But as innovation overtook itself and financial sector growth became an end in itself, the excesses morphed into a global crisis leading to a host of challenges for regulation. In responding to these challenges thrown up by the crisis, regulation has had to evaluate and take a new path, in particular, by looking at systemic risk and systemic stability. This is what has been attempted over the last three years and the end is still not in sight. In the process, stability, rightfully so, has taken centre stage, for without stability, the other objectives of the society - growth and equity- cannot achieve full fruition. At the same time unless there is growth , it will not be possible at all to get out of the debt crisis, attain sustainability and ensure equity through employment generating growth that is so important for social stability.

While the crisis has been largely a Trans Atlantic scenario, the issues for the EME have been different. The EMEs did not contribute to the crisis but had to bear its consequences. For EMEs, the imperatives of equitable growth continue to be real and strong. Consequently, regulation seeks to blend in their context the concerns of growth and equity with those of stability.

To what extent does the framework of financial sector regulation adopted globally in the post crisis period impinge on the growth objective, especially for the EMEs? What are the implications for SME and infrastructure financing? Should and can equity be a specific objective for financial sector regulation? What are the implications of macro economic policies for financial stability? How does the global financial architecture impinge on national policies?

## **Regulation and growth**

The issues relating to regulation and growth can be seen from a global perspective and from an EME perspective. From a global perspective, three issues emerge as relevant in the context of the discussion on the implications of regulation for growth. The first is whether there is a tradeoff between growth and stability; the second, whether there is any “optimal” size or composition of the financial sector; the third, whether regulation can directly target growth and equity or whether through targeting stability it provides a necessary, but not sufficient condition for ensuring growth and equity.

The relationship between growth and finance is usually seen as positive but there have been different views. Recent events have shown that excessive growth in the financial sector can become a source of instability and can become a drag on the growth of the real sector. All recent studies on the implication of the new capital and liquidity requirements on growth point out that there could be some near term adverse impact on growth due to higher capital and liquidity requirements proposed. However, the sacrifice in growth is negligible – even after taking into account the varying results of different studies. On the other hand, excessive growth in the financial sector resulted in sharp drop/slowing down in world trade, output and investment in the aftermath of the crisis with its concomitant impact on equity. Hence trade off, if any, in growth, equity and stability is only in the short run.

On the question of the optimal size of the financial sector, it is observed that over the last 50 years, the share of the financial sector in profits more than doubled from 17 per cent to 35 per cent. Does this mean a mis-alignment of the real and financial sectors? But, how does one judge the optimal share of, for that matter, the optimal scope or composition of the financial sector? In answering this question it may be useful to attempt an empirical cross country assessment of the appropriate size of the financial sector conducive to sustained and stable growth. Similarly, jurisdictions need to take a view on the optimal structure of the banking system. This involves issues such as the share of the public sector financial institutions and foreign banks; and in both cases an important factor is to what extent the regulator can have sufficient oversight. There are also issues whether banks should be allowed to do investment banking and prop trading. The cross country experience shows that while global finance contributed to

growth in world trade investment and output, some countries have achieved high and consistent growth rates without too much innovative banking or even too much growth in the investment banking. However, some have argued that the growth of financial markets and derivatives since the early 80's have contributed to efficiency in the allocation of both debt and equity capital and the excesses have been a phenomenon only in the recent period.

What are the implications of the new regulations for SME, infrastructure and trade credit? Some tweaking has already been done by the Basel Committee to address concerns on trade credit. In the context of EMEs, there is a view that national regulators would need to use national discretion in considering the implications of the regulations on credit flow for trade, SME and infrastructure, and take appropriate measures for promoting growth without jeopardizing prudential concerns.

## **Regulation and equity**

While financial inclusion and access to finance is perceived as high priority for achieving inclusive growth at the micro level, finance by itself does not have a pro-equity bias – indeed the seeking out of collaterals to mitigate risk can be said to have an anti equity bias. Similarly economies of scale dictate serving the large and valuable rather than the numerous small. Hence, mainstream finance does have a pro- big and pro –rich bias. This raises three important questions.

Should equity be a specific objective of regulation?

If so, will this run counter to the objective of securing stability?

How do regulators balance the objectives of equity and stability?

Today, it is increasingly realized that equity should be an explicit objective of regulation to achieve growth and stability in the long run. G20 has adopted this in their agenda. The important caveat is that financial instruments for pro-poor growth, to be effective on a sustainable basis, need to be supported by broader policy and institutional framework with simplified regulation---reliance on credit alone could be dangerous. This was obvious from our own experience in micro finance. Requiring the financial sector to adopt specific pro

poor policies can be justified as there are implicit subsidies involved in granting the banking franchise such as deposit insurance and bailouts due to public utility and systemic importance. There is a view that some prescriptions with regards to allocation of credit and pricing of transactions to achieve the equity objective can receive better acceptance today than during the pre crisis period. This is not to advocate regulatory forbearance or relaxation of prudential norms, but to support the use of regulatory prescriptions to encourage financing of directly productive activities which support self employment and small businesses in the real sector. Similarly, there is merit in incorporating incentives for financial inclusion in the regulatory regimes of developing countries.

The impact of regulation on equity can also be viewed from the macro perspective. Over the last 30 years, the growth in wage rate and the deposit rate have been lower than the real growth rate, leading to wage and financial repression that have contributed to savers subsidizing the borrowers and the workers subsidizing the asset owners. Provision of safety nets could indeed be one form of protection for the poor. As financial crises of different dimensions seem to recur periodically, regulation needs to ensure that the engagement of poor with the formal financial system is within a framework which supports their survival during downturns. There should be sufficient space for them to cut losses, so to say, beyond a point. This could be achieved through some form of insurance/credit guarantees. Similarly ring fencing of trade credit in future crises could be area for an important area for regulatory reform which could be part of the living wills of financial institutions. There could also be a case to expand time horizons for engagement of the financial sector with the poor as the current accounting standards, regulatory guidelines and institutional behavior focus on the short term. The small stakeholders suffer the worst since their engagement is seen as a charge on current profits, irrespective of long-term gains. It is here that the role of alternate non-bank channels becomes important. Perhaps entities not governed purely by market forces and hence can afford to take a longer term view – such as social enterprises -can be given appropriate policy regulatory and fiscal support to innovate within certain thresholds. Full advantage would need to be taken of ICT solutions to achieve greater outreach, reduce transaction costs while ensuring

sufficient safeguards. In regard to 'creditworthiness' of small clients, banks need to think innovatively beyond credit bureaus and evolve a mechanism based on transparency of transactions - much as e-bay does for its sellers. Transaction history, based on cash flows, could be a strong indicator of creditworthiness. This could overcome the problem of collateral for small borrowers.

## **Regulation and Stability**

What is the role of regulation in ensuring financial stability?

The sources of systemic risk in EMEs are several and some of them go beyond the scope of national financial sector regulator/s. Even if the EMEs have perfectly flexible exchange rates (and in most cases they do not), the monetary and fiscal policies of significant reserve currency countries have impact of systemic nature on EMEs especially through volatile and undependable capital flows. Hence capital account management becomes very much part of the tool kit to ensure macro economic and financial stability in the EMEs. Other macro economic factors are the nature and extent of cross border lending, inadequacy of resolution mechanisms for cross border financial institutions and the perimeter of regulation. The extent of sovereign paper holdings in the financial sector and erosion of confidence in what is otherwise considered a risk free paper could also threaten financial stability as we are witnessing and this is an important lesson for the EMEs. The micro economic aspects of systemic risk relate to externalities- interconnectedness, procyclicality and contagion. Equally important is the quality and effectiveness of supervision.

In the case of the EMEs, data on system wide currency and maturity mismatches as also on the highly levered counterparties in the more innovative segments of domestic capital markets need to be collected and monitored at regular intervals. In view of the interconnectedness between the financial sector, macro economy, businesses, households and sovereigns, there could be a problem of choosing the right indicators to measure systemic risk. Each jurisdiction will need to build up an integrated indicator which reflects the global build up of risk; comparable parameters locally, as also local risk build up including exposures and leverage of local financial institutions. Even if such a metric is built up, a judgment call would need to be exercised on when to invoke the

instruments or tools as there is a risk of too early or too late an intervention. Furthermore, there is no perfect indicator – hence a judgment call is unavoidable. There is also a need for coordination between monetary and macro prudential policy, and adequate preparation of the market through appropriate communication of the authorities' intention to bring in macro prudential measures unless the risks subside. Usually, the desired change in monetary policy and macro prudential policy would be in the same direction. But circumstances may arise when macroeconomic and macro prudential policies will need to move in opposite directions. It may be difficult to have clear demarcations and in practice the two may have to be framed jointly although there could be a hierarchy in the decision making process. The choice of policy tools is largely a country-specific issue and use of greater number of instruments in a modest way would generally be less distortionary (and therefore more effective) than heavy reliance on just a few instruments. As regards institutional arrangements for macro-prudential policies, there is a dominant opinion in favour of the levers being in the central bank in view of the close link between monetary policy and macro-prudential policy, expertise within central banks due to active participation in financial markets and central banks being lenders of last resort. The focus on macro prudential regulation has brought in a new equilibrium between central banks and supervisory authorities which may have interesting connotations even where both the activities reside within the same entity and there are concerns that the monetary authority may lose some independence in the process. Whatever be the model, there would be a need to shield the body responsible for these policies from both political and commercial interests of the financial industry. Central banks, being independent of the political cycle as well as of the industry, are the only authorities which can take away the punch bowl.

### **Macroeconomic policy and financial regulation**

An important aspect is the implications of the linkage between the financial sector and the sovereign for financial stability. Financial stability depends not only on the link between the banks and the corporate and household sectors, but also on their links with the sovereign. Just as macro prudential policies emphasise the building up of buffers in good times to be drawn down in bad times, there is need to build headroom in

the fisc in good times to be able to have headroom to stimulate the economy in a downturn; otherwise the fisc itself could become a source of instability. Sovereign solvency is a precondition for the central bank's success in dealing with threats to monetary and financial stability. The persisting global imbalances imply continuance of the paradox of uphill flow of capital from the EMEs to developed countries and this is not expected to change for a while. This is because of three reasons. First, public debt is growing faster than GDP in advanced countries, second, demographic factors will put further pressure on the fisc, and third, there is limited scope for increase in savings in advanced countries. Hence there does not seem to be likelihood of net capital flows to developed countries reversing in the near future.

On the global financial architecture, it is clear there is no credible lender of last resort. The dollar is the dominant reserve currency and as long as the rest of the world is willing to hold dollars, US can finance its deficits easily with implications for continuing global imbalances. Multiple reserve currencies or fully floating exchange rates cannot be seen as feasible solutions. Global finance and presence of large international banks also brings into issue, the autonomy and effectiveness of the national financial regulator. To quote Dr Reddy "globalization of finance in the context of serious market imperfections and absence of globally enforceable rules could, by virtue of close linkage of finance with other macro policies at national level, restrict the space available for national authorities to conduct macro-policies".

To conclude, the focus on improving the soundness and resilience of the financial stability and on sovereigns to get back their risk free status is seen as imperative in getting the confidence back in the global financial system and getting it to play its rightful role in meeting the needs of the real sector. This might involve sacrifice in growth in the near term not only in the developed countries but also in the developing economies which cannot be decoupled from the former. Financial regulation by focusing on stability creates conducive conditions for growth and equity, which need to be fostered through both macroeconomic policies as also conducive regulatory policies that do not compromise on prudence.