Transcript of the Inaugural Speech of Finance Minister at the CAFRAL Conference

Ms. Usha Thorat, Director, CAFRAL, Prof Joseph Stiglitz, Prof Stephany Griffith Jones, former Governors of the Reserve Bank of India, distinguished participants in this conference on Capital Account Management and Macro Prudential regulation, especially our guests from abroad, friends, ladies and gentlemen.

Let me compliment and thank CAFRAL and Colombia University for jointly organizing this conference on Capital Account Management and Macro Prudential Regulation for Financial Stability and Growth. In India we have experienced many systemic crises in finance. These included problems such as the stock market scandal of 1992. It extended to the bond market as well. That experience motivated us to strengthen the framework for financial regulation in India and the construction of well governed infrastructure institutions such as the National Stock Exchange, the NSDL, the depository and the CCIL, the clearing corporation. Since 1992, we have also weathered the global crisis of 2008. In the period immediately after the bankruptcy of Lehman Brothers, India was one of the most affected emerging markets. The money market experienced great turmoil and the short-term rate went beyond the band between the repo rate and the reverse repo rate. Money Market Mutual Funds were forced to do fire sales. Corporate treasuries pulled out their money. The bond market collapsed under the burden of the fire sales and became illiquid. The Reserve Bank of India had to set up an emergency mechanism to give liquidity to mutual funds.

Over 5 years later, the dust has settled and it all seems easy, what we did in 2008. But it was not easy. For those of us who lived through that period, we know that we were really tested. I wish to congratulate all the people who worked on understanding and addressing that crisis with rapid thinking and responses, day after day, and some times through the night, through that difficult period. Contrary to popular perception, the government and the RBI worked together closely at that time. These experiences have motivated much soul searching on the subject of systemic risk and I would like to take this opportunity to summarize our thinking on four points.

First, some systemic crises are born out of blunders in the fundamentals of financial regulation. Financial regulation is about three problems: consumer protection, micro-prudential regulation, and resolution. The institutional framework governing the financial sector in India has been built up over a century. The Financial Sector Legislation Reforms Commission reviewed the scene and it concluded and I **quote**: “There are over 60 Acts and multiple rules and regulations that govern the financial sector. Many of the

financial sector laws date back several decades when the financial landscape was very different from that seen today. For example, the Reserve Bank of India (RBI) Act and the Insurance Act are of 1934 and 1938 vintage respectively. Financial economic governance has been modified in a piecemeal fashion from time to time without substantial changes to the underlying foundations. Over the years, as the economy and the financial system have grown in size and sophistication, an increasing gap has come about between the requirements of the country and the present legal and regulatory arrangements." **Unquote**

Given that legal framework, many but not all systemic crises were born of blunders on those foundations. As an example, better micro prudential regulation may have stopped the stock market scandal of 1992 in its tracks. Our first port of call is therefore to strengthen our foundations. The Draft Indian Financial Code presented by the Commission, envisages a lot of new work on all three fronts including the construction of a brand new resolution corporation.

Second, deep and liquid markets are shock absorbers. When MFs faced large redemptions on money market mutual funds they ran into trouble because we failed to build a deep and liquid bond market. The currency market would have experienced less trouble after Lehman collapsed if we had a deep and liquid currency market. We should never lose sight of the importance of deep and liquid markets as shock absorbers. We have done a decent job with the equity market, but there is a big unfinished agenda with the Bond-Currency-Derivative nexus.

Three, systemic risk is all about the woods and not the trees. Nobody that thinks a lot about any one sector can understand systemic risk, which involves complicated interactions of all sectors. Persons, who are experts on any one sector, say for example Mutual Funds, may not understand the interconnection between Indian multinationals and the Lehman shock and the treasury balances held by Indian firms with Mutual Funds and the fire sales on the bond market. This requires a new kind of thinking, what we call a financial system thinking which will be elusive to people who think about one sector at a time or one firm at a time.

Four, in order improve policy co-ordination and to undertake system-wide actions, we responded to these experiences by constructing a Council of Regulators: the Financial Stability and Development Council, FSDC for short. This is a mechanism for all financial regulators to meet, exchange information and co-ordinate strategies. The Ministry of Finance is part of the FSDC and the FSDC is intended to ensure co-ordination of the use of fiscal resources if such a moment should arise. FSDC, since it was set up, has already improved communication between all regulators. It is our sincere hope that it will

increasingly play this co-ordination role, better and with sharper focus. We are working to strengthen databases and technical capabilities at FSDC so far as to make it a full-blown systemic risk agency. Towards this, we intend to construct the financial data management center envisaged by the Commission. In the future, if you face a situation like 2008 again, FSDC will be the war room.

I would like to end with a note of caution and before that I would like to identify the fault lines that we have discovered in the last few years. These fault lines, once more or less hidden, are now evidently open in the form of, as FSLRC says, lack of legal clarity on responsibility and powers of regulators, inter regulatory disputes, regulator-regulated court battles, adventurism of market participants, and the growing shadow banking and shallow financial sector. Given these fault lines, in the aftermath of the global crisis, we find that legislatures world wide have rushed to create new agencies and confer them with additional powers to ensure that that no systemic crisis takes place. Is that the way to go forward? Our foundations of knowledge in this field are only emerging. For a comparison, central banks that printed paper money experienced all sorts of problems until the late 1970s or early 1980s, by which time the body of knowledge on monetary policy was strong enough to support the smooth working of monetary policy. In the same way, should we not be careful about creating new agencies or giving them new powers and using them without adequate evidence in the field of systemic risk? There is profound need for more scientific knowledge and more experience. We should make the most of our limited data on systemic risk and we should be constantly skeptical and questioning about the evidentiary base based on such a short time. I think we should apply a Hippocratic oath “Above all, do no harm”. We should be mindful when we use the new powers in the field of systemic risk. I look forward to the deliberations of your conference. I wish the conference success. Thank you.