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**Comments by Dr. Y V Reddy on**
**Professor Alan M. Taylor's presentation**

# THE GREAT LEVERAGING
## Five Facts and Five Lessons for Policymakers

Governor Alexandre Tombini, Professor Alan Taylor, Professor Eichengreen and distinguished participants,

I am thankful to the BIS, in particular, my friend Claudio, for the opportunity given to me to participate in this Conference. It is great to be with many friends again, and have the benefit of intellectual stimulation as a bonus. Professor Taylor's presentation is very scholarly and very perceptive. It gives an excellent big picture. It is, indeed, a valuable supplement to the preceding session in the Conference. The criticality of credit and, in particular leverage in the context of all the financial crises has been convincingly brought out. The five lessons for policymakers are of particular interest to Emerging Market Economies (EMEs) which generally pursue policies for financial deepening.

I will confine myself to presenting the perspective of a sort of practical economist – someone who was involved in the financial sector policies in an Emerging Market Economy, viz., India.

I will start with a semi-personal account on the major theme of relationship between excess credit and financial crisis. On the run-up, the global financial crisis, my instincts led me to agree with Bill White and Claudio that credit is the most critical element of financial sector. I mentioned this to Bill, but I also shared with him the difficulties of designing and implementing policies for restraining excess credit growth.

In 2001-02, the problem in India was actually one of slow growth in credit. We described it as lazy banking and tried to encourage the banks to improve the credit growth by considerable regulatory and monetary policy initiatives. Soon, the lazy bankers became crazy bankers. Excess credit seems to have been preceded by slow growth in credit. The problem is to identify the point at which credit growth becomes excessive or too rapid. Most often, there is resistance from the financial markets as well as political leadership for measures that try to contain rapid growth in credit. In India, 2005 was, perhaps, the turning point when explosion of credit started due to mutually reinforcing global liquidity and domestic "animal spirits".

For policy purposes, it may be useful to make a distinction between the level of credit and the rate of growth of credit. For India, the credit GDP ratios and all other indicators of financialisation show the compelling need to increasing the credit in relation to GDP, over the medium to long term since the usual arguments in favour of financial deepening apply to

India at this stage of development. However, the increase in growth of credit in relation to GDP does not happen in a linear fashion, and there are cyclical elements. The challenge for the policymakers is to simultaneously encourage structural growth in credit to enable appropriate role for finance to facilitate growth and also to contain the cyclical upward and downward movements in the desired secular growth in credit.

For EMEs, not only the growth in volume of credit but also the sectoral composition of the growth in credit is important. Credit growth may be very rapid in some sectors, and not so rapid in other sectors. For example, during the credit boom in India, infrastructure could not get adequate credit, but the real estate became a source of speculation with increasing leverage. In regard to housing, it was essential to increase the credit penetration due to reasons of demography (booming youth) and accelerated growth in GDP at 9 per cent per annum and expectations of continued high growth. However, housing markets were not liquid and there was not much of credit record of the past to make a realistic assessment of pricing of risks. In any case, a differentiation had to be made between sensitive sectors where speculation was a dominant factor as exemplified by, say, rental value to loan ratios in housing and those sectors which financed directly productive activities. Prudential measures such as enhanced provisioning and risk weights, in addition to specific limits to exposure were introduced, but these were taken up in different

combinations depending on an assessment of the risks involved in rapid growth in credit in the relevant sector.

Among the banks, risk assessment capabilities may be uneven, particularly in Emerging Markets such as India. Hence, the general dispensation in regard to exposure limits had to be coupled with special dispensation to those institutions which are able to convince the regulator of their expertise in relevant sectors and risk management systems in place. In fact, excess credit may be concentrated in a few institutions warranting supervisory review of such institutions with a view to prudential guidance specific to an institution. Exercise of such discretion by the regulator may have risks and could justifiably be resisted, but such a review served India well.

There has been a temptation among banks to use non bank financial entities or what has been described as shadow banking to circumvent restraints imposed by regulators on excess growth in credit by banks. It was, therefore, necessary for us to monitor and regulate the exposure of banks to non banking financial companies.

While the prudential measures and supervisory actions could help in moderating the credit growth through the banking sector, the foreign capital could make its way into the country through legally recognised channels of capital inflows especially through non bank financial

intermediaries. This capital flow had blunted the Reserve Bank of India's effort to contain the asset price inflation, but saved the banking system from the subsequent bust significantly, though not entirely.

In brief, the link between credit growth and financial crisis can be explored further by researchers in terms of the level, the rate of growth and the composition of credit, and perhaps, financial sector as a whole.

Claudio had, a few months ago, referred a paper to me on the possible non-link between global imbalances and the financial crisis. In my response, I raised the issue as to whether the analysis based on the experience of advanced economies would be relevant for emerging markets. I am inclined to agree with his response that there are many similarities between advanced economies and EMEs, and possibly the global financial crisis is a result of advanced economies not learning the lessons of experience of EMEs, especially of Asian crisis. Claudio indicated that EMEs will have to face problems similar to those of advanced economies sometime in future, and hence their relevance. Yet, from the practical point of view and for policy purposes in the medium term, there seem to be very relevant differences. It is, therefore, useful for research on financial crises to specifically recognise both similarities and differences in challenges and policy responses of advanced economies and EMEs.

Professor Taylor makes an important point about the relative roles of bank assets to GDP and sovereign debt to GDP. When we in India were analyzing the vulnerability of India to a possible global financial crisis, we adopted a system of analysing the leverage in different categories of balance-sheets and their inter-relationships, viz., households, corporates, financial sector, in particular banks, and government. The links between the balance sheets of the banks and the government were the highest in India where banks are obliged to hold almost a quarter of their assets in government securities. Consequently, the monetary management and regulation of financial sector as a whole was oriented to ensuring financial stability and smooth execution of the government's borrowing program. It is interesting that despite high public debt to GDP ratio, India has maintained reasonable growth rate and inflation, perhaps on account of built-in elements of financial repression.

There could be excess leverage that leads to crises, but it is possible that relatively less leverage does not necessarily restrain growth, under some circumstances. It will be interesting to pursue research into the link between growth of financial sector and economic development keeping in view experience of India and China. Both of them recorded impressive growth rates relative to other EMEs, but have been less enthusiastic than many others in development of their financial sector and liberalizing capital account. Further, consequences of global financial crisis on

countries with moderate credit growth and those with high credit growth among Emerging Markets may give interesting insights.

The approach to foreign exchange reserves was, no doubt, as mentioned by Professor Taylor, insurance, but insurance has to be defined in a very broad sense. In India, our approach takes into account both potential for current account shocks (import of food and fuel) and the potential for capital account shocks, in particular the difference between gross and net flows. Capital account shocks are more difficult to manage since adjustment in stock of financial assets and liabilities take place. Further, shocks on capital account may be induced by shocks on current account reinforcing each other. It may be necessary to view the reserve accumulation in the context of the overall national balance sheet of external assets and liabilities as well as vulnerability of economy to shocks.

The adequacy of reserves should also be viewed in the context of the asymmetrical effectiveness of intervention by central banks at the time of appreciation relative to depreciation. So, a bias against excessive appreciation may warrant central bank's intervention, without immediate insurance objective, though it is insurance if defined very broadly. Recent interventions by Japan and Switzerland may fall in this category.

It is true that credit growth provides predictive information, but it is not clear whether credit matters more than money in all circumstances. Perhaps, relative emphasis between credit and money will depend on whether credit is essentially demand driven or supply driven. Since 1997, in India we adapted a multiple indicators approach to monetary policy and one of the relevant indicators is growth of credit. In particular, caution may be warranted in using across the board "credit indicators" by macro-prudential authorities without reference to the structural and cyclical factors in the country context, especially for EMEs. Financial Stability Board may have particular interest in research on the appropriate indicators of excess credit growth in diverse economic systems.

To conclude, Professor Alan Taylor's presentation is very valuable since it reinforces the importance of monitoring, and if essential, managing credit growth. Hence, presentation has significant pointers to policymakers and it also opens up several areas for further research.