

Duvvuri Subbarao: Financial crises and the impact of the latest one on India

Welcome remarks by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the Fourteenth C D Deshmukh Memorial Lecture, Mumbai, 15 February 2010.

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1. On behalf of Reserve Bank of India, I have great pleasure in welcoming Lord Turner, Chairman of the Financial Services Authority of the UK, who will shortly be delivering the C.D. Deshmukh Memorial Lecture. I also want to specially acknowledge the family members of late Sir C.D. Deshmukh – Smt. and Shri Atul Deshmukh, Shri Ashish Deshmukh and Smt. and Shri Chitnis – who are here with us today. Thank you very much to all of you for rejoining the RBI family today. And, of course, a hearty welcome to all our invitees.

2. Sir Chintaman D. Deshmukh has a special place in the history of the Reserve Bank of India. He was the first Indian Governor of the Reserve Bank, and served here from August 1943 to June 1949. He presided over the transformation of the Reserve Bank from a private shareholders' bank to a nationalised institution and was the intellectual force behind the enactment of a comprehensive legislation for the regulation of banking companies. Shri Deshmukh participated actively in the establishment of the Bretton Woods institutions in 1945 and played a critical role in managing the nascent economy as we confronted the challenges of war financing following the Second World War. After leaving the Reserve Bank, Shri Deshmukh went on to become the Finance Minister of India, a career graph repeated by our current Prime Minister, Dr. Manmohan Singh nearly forty years later. Shri Deshmukh brought to the office of the Finance Minister a passion for newly independent India's development and a humane and inclusive vision for nation building.

3. The Reserve Bank instituted the C.D. Deshmukh Memorial Lecture in 1984 to honour the memory of this illustrious Governor of the Bank and a great citizen of India. This year's lecture, to be delivered by Lord Turner, is of special significance as it forms part of our Platinum Jubilee celebrations.

4. Lord Turner, who has been Chairman of FSA since September 2008, is a familiar, and also a famous, name in financial circles. He has had a multi-faceted career background straddling business, public policy and academia. He became a cross-bench member of the House of Lords in 2005, and has been the Chairman of the Climate Change Committee since January 2008. He is a Visiting Professor at the London School of Economics and the Cass Business School of the City University. Prior to that, he held prominent positions, such as the Chairman of the Pensions Commission and the Low Pay Commission. Outside of the Government, Lord Turner was associated with the Standard Chartered Bank, Merrill Lynch Europe, Confederation of British Industry, and McKinsey and Company. Lord Turner's 2001 book – "Just Capital – The Liberal Economy" has been acclaimed for its insights and lateral thinking.

5. There is a deluge of analysis and writing on what caused the crisis and on how to prevent a recurrence. It is not possible for anyone to keep track of all that. But if you want one source from which you can get the diagnosis and prescription for regulatory reforms following the crisis, I suggest you read the Turner Review conducted under the intellectual leadership of Lord Turner. Spread over four chapters, the Review describes what went wrong, and the extent to which the crisis challenges past intellectual assumptions about the self-correcting nature of financial markets. The Review sets out the actions required to create an effective banking system, better able to serve the needs of the businesses and households and less likely to be susceptible to financial instability.

6. I want to spend a couple of minutes giving Lord Turner a brief synopsis of the crisis and the aftermath in India.

7. The crisis that erupted with the collapse of Lehman Brothers in September 2008 spread rapidly thereafter – sector by sector and economy by economy. Almost every country in the world has been impacted, although to a different extent. India was no exception.

8. Largely driven by the then intellectually fashionable decoupling theory, there was dismay in India that we were hit by the crisis. This dismay arose from two factors. First, there was surprise that we were hit by a crisis with origins in the banking system even as our banks, and indeed our entire financial system, had minimal exposure to tainted assets. Second, there was also concern that we were hit by global recession even though our export sector, at 15% of GDP, was relatively small.

9. The answer to both these points is that India was hit by the crisis because we are more globally integrated than we tend to acknowledge. We were impacted through all channels – the financial channel, the real sector channel and the confidence channel. The impact of crisis on India was, however, relatively muted. India's financial sector remained safe and sound, and our financial markets continued to function normally highlighting the stability enhancing features of our policy and regulatory framework.

10. Just to highlight a few features of our approach to safeguarding financial stability. On financial globalization, our stance has been gradualist. We view capital account liberalisation as a process and not an event. The extent of opening is contingent upon progress in other sectors. Our policy framework encourages equity flows, especially direct investment flows. But debt flows are subject to restrictions, and these are reviewed and fine-tuned periodically. The exchange rate is largely market-determined and we intervene in the foreign exchange market in times of excessive volatility. Our approach to financial sector regulation has been informed by the fact that our system is dominated by commercial banks. Thus, as early as mid-1990s, the Reserve Bank instituted the prudential framework governing banks, especially commercial banks, as a part of the overall structural reforms. As of April 2009, all our commercial banks are Basel II compliant.

11. The Reserve Bank has been proactive in adopting a counter-cyclical approach to financial regulations. Notably, in the years before the crisis, we increased the risk weights and provisioning norms on a selective basis. The intent was to limit the exposure of the banking system to sensitive sectors of the economy posting high credit growth and thereby prevent mispricing of risk. Again, in another counter cyclical measure, as part of crisis management, we reversed the earlier tightening and normalized the risk weights and provisioning norms to facilitate credit flow to these sectors.

12. India's banking system has remained remarkably well capitalized with capital to risk weighted asset ratio (CRAR) much above the minimum prescribed under Basel II. The asset quality post-crisis also remained sound though there has been a slight deterioration in recent months. In recognition of the fact that banks should build up provisioning and capital buffers in good times which can be used for absorbing losses in a downturn, recently, banks have been advised to ensure that the provisioning coverage ratio, *i.e.*, the ratio of provisioning to gross NPA, is not less than 70 per cent. In view of the heightened concerns with regard to financial stability during the recent years, the Reserve Bank is retooling itself to safeguard financial stability. We have also set up a Financial Stability Unit which will make regular and systematic assessment of the stability of the Indian financial system.

13. Lord Turner will be speaking to us today on "*After the crises: Assessing the costs and Benefits of Financial Liberalization*", a topic of great obvious relevance.

14. A study of financial crises shows that almost every crisis is preceded by, if I may use what is by now a cliché, "irrational exuberance" of the financial sector with the growth of the financial sector outstripping the growth of the real sector engendering a belief, bordering on

hubris, that real value can be created by sheer financial engineering. Take this crisis for example.

15. In the world that existed before the crisis – a benign global environment of easy liquidity, stable growth and low inflation – profits kept coming, and everyone got lulled into a false sense of security in the firm belief that profits will keep rolling in forever. Herb Stein, an economist, pointed out the truism that, “if something cannot go on for ever, it will eventually stop.” But no one paid attention. The magic of the financial sector gave it such a larger than life profile that we began to believe that for every real life problem, no matter how complex, there is a financial sector solution. Now, of course, we know better – for every real life problem, no matter how complex, there is a financial sector solution, which is wrong.

16. Take the case of the United States. Over the last 50 years, the share of value added from manufacturing in GDP shrank by more than half from 25 per cent to 11 per cent while the share of financial sector more than doubled from 3.6 per cent to 7.5 per cent. The job share of the manufacturing sector declined by more than half from 29 per cent to 11 per cent while the job share of the financial sector increased by over a third from 3.5 per cent to 4.6 per cent. The same trend is reflected in profits too. Over the last 50 years, the share of manufacturing sector profits in total profits declined by more than half from 49 per cent to 21 per cent while the share of profits of the financial sector increased by more than half from 17 per cent to 27 per cent. Clearly, the excessive risk-taking behaviour of the financial sector raised the value-added of the sector beyond a sustainable level making the melt down, in retrospect, inevitable.

17. Forgotten in the euphoria of financial alchemy is the basic tenet that the financial sector has no standing of its own; it derives its strength and resilience from the real economy. It is the real sector that should drive the financial sector, not the other way round.

18. Financial crises are not uncommon. Then how come we don't learn? I can do no better than quote Reinhart and Rogoff. In their recent seminal book – *This Time is Different: Eight centuries of Financial Folly*, they say, [I quote]:

“Finance professionals and, all too often, government leaders explain that we are doing things better than before, we are smarter, and we have learned from past mistakes. Each time, society convinces itself that the current boom, unlike the many booms that preceded catastrophic collapses in the past, is built on sound fundamentals, structural reforms, technological innovation, and good policy”.
[unquote]

19. Having said that, we must remember that not all financial liberalization is bad; the world has benefitted from financial innovation and liberalization. True, the damage inflicted by the crisis has been colossal, but the world enjoyed the benefits of the Great Moderation – over 15 years of unprecedented growth, price stability and low unemployment.

20. It is important therefore to take a balanced view. Who better than a person with the scholarship and stature of Lord Turner to approach that balanced view.

21. Lord Turner incidentally is the second Chairman of FSA to deliver the C.D. Deshmukh Memorial Lecture. Mr. Howard Davies, the then Chairman of FSA, had delivered the tenth C.D. Deshmukh Memorial Lecture in February 2000 on the subject of “International Financial Regulation: The Quiet Revolution”. In his concluding statement, Mr. Davies had said, “I wish you a volatile, but not too volatile, future”. In many ways, Mr. Davies prediction has come true. We had our share of volatility, and I believe it has been good for us, giving us as it did, an opportunity for us to work on Schumpeterian “creative destruction”.

22. Lord Turner has two important responsibilities. Apart from being the Chairman of FSA, he is also the Chairman of the Committee on Climate Change (CCC). I believe that is a fair balance. As Chairman of FSA, his job is to save capitalism from well, the onslaught of capitalists. As Chairman of CCC, his job is to save the planet from the onslaught of

capitalism. In short, Lord Turner handles recessions with one hand and emissions with the other.

23. Lord Turner, once again, I want to say, we are delighted that you have accepted our invitation. I now have great pleasure in inviting you to deliver the 14th C. D. Deshmukh lecture.