Financial regulation for growth, equity and stability in the post-crisis world[1]

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Let me start by telling you about the motivation for the conference theme.

Failure of regulation, by wide agreement, was one of the main causes of the 2008 global financial crisis. It is unsurprising therefore that reforming regulation has come centre stage post-crisis. The progress in regulatory reforms over the last two years has been impressive, but the agenda ahead remains formidable. Regulation will bring in benefits by way of financial stability, but it also imposes costs. There are some ball park numbers for what the Basel III package might entail in terms of growth, but there has been no rigorous thinking on what the whole gamut of regulatory reforms currently on the agenda might mean for growth, equity and stability in terms of costs and benefits over time and in different regions of the world. Thinking through these vital and complex issues is the main motivation for the theme of this conference – Financial sector regulation – equity, stability and growth in the post-crisis world.

There was another strong motivation for the choice of the conference theme. The crisis, as we all know, was brewed in the advanced economies, and much of the post-crisis reforms are accordingly driven by the need to fix what went wrong there. The reform proposals were discussed at international forums like the FSB and the BCBS. What has struck me though is that the agenda and the deliberations have been dominated by advanced economy concerns. As emerging economies, we have had a seat at the table in these international forums, but we haven't been able to engage meaningfully in the debate as we have not related to the issues. The stability of the advanced economy financial sectors is, of course, important to us. After all we live in a globalizing world, and what happens anywhere has impact everywhere. What concerns us, though, is that these global standards are going to be applied uniformly but their implications for EMEs will be different given the different stages of our financial sector development and our varied macroeconomic circumstances. We hope that this conference will provide a forum for generating an emerging economy perspective on issues of growth, equity and stability in the context of the post-crisis thinking on financial sector regulation.

I have great pleasure in welcoming all the delegates to this first CAFRAL-BIS international conference. You have travelled from around the country and across the world to be present here, and we value your participation in this conference. I would like to acknowledge, in particular, the presence here of Mr. Jaime Caruana, General Manager of BIS and the co-host of this conference, Mr. Andrew Sheng, Ms. Stephanie Griffith Jones and Mr. John Lipsky, all three eminent thought leaders, who will be chairing the various sessions, and my predecessor at the Reserve Bank, Dr. Y.V. Reddy who, during his term in office, earned a formidable reputation as a zealous guardian of financial stability.

I struggled to determine what I should say in this inaugural address. One option would be to attempt a comprehensive overview of all the issues that might come up in the subject

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sessions. Such double guessing would clearly be presumptuous on my part given the depth and breadth of experience you bring to this forum. I will attempt something less ambitious. What I will do is raise five questions straddling the three dimensions of the conference theme – growth, equity and stability in the context of financial regulation – and sketch out an answer to each of them in the hope that we will get more informed answers by the end of the conference. I will fall back on the Indian experience, which I know best, to illustrate some of what I say. I believe our experience will be relevant and applicable across a broad swathe of emerging and developing economies.

Question 1: If financial sector development is good, is more of it better?

Development experience evidences a strong correlation between financial sector development and economic growth, with the causation possibly running both ways. Economic growth generates demand for financial services and spurs financial sector development. In the reverse direction, the more developed the financial sector, the better it is able to allocate resources and thereby promote economic development.

In India, we have experienced causation in both directions. We embarked on wide ranging economic reforms following a balance of payment crisis in 1991. Very soon we realized that the growth impulses generated by the liberalizing regime could not be sustained unless we also undertook financial sector reforms. That is an illustration of growth triggering financial sector development. For an example of the causation in the reverse direction, we have to look no further than India's remarkable growth acceleration in the period 2003–08 when we clocked growth of 9+ per cent. Many factors have been cited as being responsible for this – higher savings rates, improved productivity, growing entrepreneurism and external sector stability. But one of the unacknowledged drivers of that growth acceleration has been the impressive improvement in the quality and quantum of financial intermediation in India, evidencing how financial sector can spur growth.

Given the historical experience, it is tempting to believe that if financial sector development aids growth, more of it must be better. I am afraid that will be misleading. We must look for a more nuanced response, especially in the light of the lessons of the crisis.

In the world that existed before the crisis – a benign global environment of easy liquidity, stable growth and low inflation – the financial sector kept delivering profits, and everyone became enticed by a misleading euphoria that profits would keep rolling in forever. Herb Stein, an economist, pointed out the truism that "if something cannot go on forever, it will eventually stop". But no one paid attention. The financial sector just kept growing out of alignment with the real world.

It will be useful to put some numbers on how, across rich countries, this misalignment kept on increasing. 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 around 25 per cent to 12 per cent while the share of financial sector more than doubled from 3.7 per cent to 8.4 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 two thirds from 49 per cent to 15 per cent while the share of profits of the financial sector more than doubled from 17 per cent to 35 per cent. The large share of the financial sector in profits, when its share of activity was so much lower, tells a compelling story about the misalignment of the real and financial sectors.

The world view before the crisis clearly was that the growth of the financial sector, in and of itself, was desirable, indeed that real growth can be got by sheer financial engineering. Our faith in the financial sector grew to such an extent that before the crisis, we believed that for every real sector problem, no matter how complex, there is a financial sector solution. The crisis has made us wiser. We now know that for every real sector problem, no matter how complex, there is a financial sector solution, which is wrong. In the pre-crisis euphoria of financial alchemy, we forgot that the goal of all development effort is the growth of the real economy, and that the financial sector is useful only to the extent it helps deliver stronger and more secure long term growth.

How does financial sector regulation come into all this? It comes in because the financial sectors of emerging economies are still under development. How should they respond to the lessons of the crisis, particularly in reshaping their regulations? Is a larger financial sector necessarily better for growth? For equity? Is there such a thing as a 'socially optimal' size for the financial sector? What are the weights to be attached to growth and stability in the objective function of regulation? Are the weights stable over time, or if they should vary, on what basis? As we seek answers to this long list of questions, the basic tenet that must guide our thinking is that it is the real sector that must drive the financial sector, not the other way round.

Question 2: Financial sector regulation, yes, but at what cost?

Even as efficient financial intermediation is necessary for economic growth, the financial sector cannot be allowed an unfettered rein; it needs to be regulated so as to keep the system stable. This we knew even before the crisis. What we have learnt after the crisis is that the quantum and quality of regulation matters much more than we thought.

In the years before the crisis – indeed even before the Great Moderation – a consensus was building around the view that if the burden of regulation is reduced, the financial sector will deliver more growth. That consensus has nearly dissolved. We now know that financial markets do not always self-correct, that signs of instability are difficult to detect in real time, and that the costs of instability can be huge. Global income, trade and industrial production fell more sharply in the first twelve months of the Great Recession of 2008/09 than in the first twelve months of the Great Depression of the 1930s. Three years on, the crisis is still with us; it has just shifted geography. And there is still enormous uncertainty about when we might see its end and with what final tally of costs in terms of lost output and foregone welfare.

So, the emphasis of post-crisis regulatory reforms on making the financial system stable is understandable. But a relevant question is, where do we strike the balance between growth and stability? In other words, how much growth are we willing to sacrifice in order to buy insurance against financial instability?

For illustrative purposes, let us take the Basel III package. A BIS study estimates that a one percentage point increase in the target ratio of tangible common equity (TCE) to risk-weighted assets (RWA) phased in over a nine year period reduces output by close to 0.2 per cent. It is argued though that as the financial system makes the required adjustment, these costs will dissipate and then reverse after the adjustment period, and the growth path will revert to its original trajectory. A BCBS study estimates that there will be net positive benefits out of Basel III because of the reduced probability of a crisis and reduced volatility in output in response to a shock. An IIF study, however, estimates a higher sacrifice ratio – that the G3 (US, Euro Area and Japan) will lose 0.3 percentage points from their annual growth rates over the full ten-year period 2011–2020.

What are the implications of these numbers relating to growth sacrifice for EMEs? Let me take the example of India. Admittedly, the capital to risk weighted asset ratio (CRAR) of our banks, at the aggregate level, is above the Basel III requirement although a few individual banks may fall short and have to raise capital. But capital adequacy today does not necessarily mean capital adequacy going forward. As the economy grows, so too will the credit demand requiring banks to expand their balance sheets, and in order to be able to do so, they will have to augment their capital.

In a structurally transforming economy with rapid upward mobility, credit demand will expand faster than GDP for several reasons. First, India will shift increasingly from services to manufactures whose credit intensity is higher per unit of GDP. Second, we need to at least double our investment in infrastructure which will place enormous demands on credit. Finally, financial inclusion, which both the Government and the Reserve Bank are driving, will bring millions of low income households into the formal financial system with almost all of them needing credit. What all this means is that we are going to have to impose higher capital requirements on banks as per Basel III at a time when credit demand is going to expand rapidly. The concern is that this will raise the cost of credit and hence militate against growth.

A familiar issue in monetary policy is an inflexion point beyond which there is no trade-off between growth and price stability. Is there a similar inflexion point in the growth-financial stability equation? If there is, how do we determine that point?

Question 3: Does regulation have a role in achieving equity?

That takes me to my third question: does regulation have a role in achieving equity?

The dichotomy between growth and equity is standard stuff of development economics. For a long time, the orthodoxy was that if we took care of growth, equity followed automatically a la a high tide raising all boats. Experience has taught us that reality is more complex. Received wisdom today is that growth is a necessary, although not a sufficient, condition for equity. To achieve equity, we need growth that is poverty sensitive – that is growth to which the poor contribute and growth from which the poor benefit.

How does this standard question translate in the context of financial sector regulation? This is a question that we in India struggle with. Should stability be the sole objective of our regulation, with other instruments being deployed to achieve equity? Or should equity be a variable in the objective function of regulation?

To seek answers, we must ask a variant of the above questions. Is the financial sector inherently equity promoting, or at least equity neutral? Our experience in India has been that left to itself, the financial sector does not have a pro-equity bias. Indeed, it is even possible to argue that the financial sector does not necessarily reach out to the bottom of the pyramid.

Our response to counter this bias has been to use regulation to encourage socially optimal business behaviour by financial institutions. Let me just list a few of our affirmative action regulations. We have a directed credit scheme, called priority sector lending, whereby all banks are required to ensure that at least 40 per cent of their credit goes to identified priority sectors like agriculture and allied activities, micro, small and medium industries, low cost housing and education[2]. We have a 'Lead Bank' scheme under which there is a designated commercial bank identified for each of the over 600 districts in the country with responsibility for ensuring implementation of a district credit plan that contains indicative targets for flow of credit to sectors of the economy that banks may neglect. We have largely deregulated licencing of bank branches; banks are now free to open branches freely in population centres of less than 100,000 – with two stipulations: first at least a quarter of the branches should be located in unbanked villages with a maximum population of 10,000; and second, their performance in financial penetration will be a criterion for giving banks branch licences in metro and large urban centres.

[2] The ratio and the composition of the priority sector are different for foreign banks in consideration of the fact that they do not get 'full national treatment' on some regulatory aspects.

By far our most high profile campaign in recent years has been our aggressive pursuit of financial inclusion. Why is financial inclusion important? It is important because it is a necessary condition for sustaining equitable growth. There are few, if any, instances of an economy transiting from an agrarian system to a post-industrial modern society without broad-based financial inclusion. As people having comfortable access to financial services, we all know from personal experience that economic opportunity is strongly intertwined with financial access. Such access is especially powerful for the poor as it provides them opportunities to build savings, make investments and avail credit. Importantly, access to financial services also helps the poor insure themselves against income shocks and equips them to meet emergencies such as illness, death in the family or loss of employment. Needless to add, financial inclusion protects the poor from the clutches of the usurious money lenders.

The extent of financial exclusion is staggering. Out of the 600,000 habitations in India, less than 30,000 have a commercial bank branch. Just about 40 per cent of the population across the country have bank accounts, and this ratio is much lower in the north-east of the country. The proportion of people having any kind of life insurance cover is as low as 10 per cent and proportion having non-life insurance is an abysmally low 0.6 per cent.

These statistics, distressing as they are, do not convey the true extent of financial exclusion. Even where bank accounts are claimed to have been opened, verification has often shown that the accounts are dormant. Few conduct any banking transactions and even fewer receive any credit. Millions of households across the country are thereby denied the opportunity to harness their earning capacity and entrepreneurial talent, and are condemned to marginalization and poverty.

Over the last few years, the Reserve Bank has launched several initiatives to deepen financial inclusion. Our goal is not just that poor households must have a bank account, but that the account must be effectively used by them for savings, remittances and credit. Our most ambitious initiative has been the ‘Business Correspondent’ model or branchless banking which, leveraging on technology, helps reach banking services to remote villages at a low overhead cost.

In the context of this conference theme, the issue is the following. Financial inclusion is equity promoting. Banks, however, may see this more as an obligation rather than as an opportunity. Given that scenario, should we pursue financial inclusion through moral suasion or issue a regulatory fiat? What combination of regulatory incentives and disincentives would be optimal?

As I leave this topic, I must also add that using regulation, or political direction in a larger sense, for achieving equity has not been a practice unique to emerging and developing economies. It is quite common in rich societies as well. In his bestselling book, Fault Lines, Raghuram Rajan persuasively argues that America’s growing inequality and thin social safety-nets created tremendous political pressure to encourage easy credit and keep job creation robust, no matter the consequences to the long-term health of the financial system. That is a thought we must ponder over.

Question 4: Should we make banking boring?

Post-crisis, there is a deluge of ideas and suggestions on reforming banks, banking and bankers. Analysts with a historical perspective believe that the seeds of the 2008 crisis were sown when the separation of banking from securities dealing was undone. What really contributed to the disproportionate growth of the financial sector relative to the real sector that I spoke about earlier was investment banking and securities dealing. It is the huge leveraging by this segment that fuelled the crisis. Hence, as the noted economist and Nobel laureate Paul Krugman has argued, the way to reform banking is to once again make it boring. It is worth exploring this question as it has implications for growth, stability and equity.

Taking a long term historical view, Krugman argues that there is a negative correlation between the 'business model' of banking and economic stability. Whenever banking got exciting and interesting, attracted intellectual talent and bankers were paid well, it got way out of hand and jeopardized the stability of the real sector. Conversely, periods when banking was dull and boring were also periods of economic progress.

To support his thesis, Krugman divides American banking over the past century into three phases. The first phase is the period before 1930, before the Great Depression, when banking was an exciting and expanding industry. Bankers were paid better than in other sectors and therefore banking attracted talent, nurtured ingenuity and promoted innovation. The second phase was the period following the Great Depression when banking was tightly regulated, far less adventurous and decidedly less lucrative – in other words banking became boring. Curiously, this period of boring banking coincided with a period of spectacular progress. The third phase, beginning in the 1980s, saw the loosening of regulation yielding space for innovation and expansion. Banking became, once again, exciting and high paying. Much of the seeming success during this period, according to Krugman, was an illusion; and the business model of banking of this period had actually threatened the stability of the real sector. Krugman's surmise accordingly is that the bank street should be kept dull in order to keep the main street safe.

Krugman's thesis of 'boring banking' is interesting, but debatable. It raises two important questions. Is making banking boring a necessary and sufficient solution to preventing the excesses of the pre-crisis period? And what will be the cost of making banking boring? Both questions cause much confusion, the first because it has too many answers and the second because it has too few. The Dodd-Frank Act of the US is a response to the excesses of investment banks. In Europe, the responses are somewhat different. Abstracting from the specifics, I will argue that it is neither possible nor desirable to make banking boring.

The narrow banking of the 1950s and 1960s was presumably safe and boring. But that was in a far simpler world when economies were largely national, competition was sparse, pressure for innovation was low, and reward for it even lower. Bankers of the time, it is said, worked on a 3 – 6 – 3 formula: pay depositors 3 per cent interest, lend money at 6 per cent and head off to the golf course at 3 pm. From the 24/7/365 perspective of today, that may appear romantic but is hardly practical.

The boring banking concept does not appear persuasive even going by more recent evidence and on several counts. First, recall that during the crisis, we saw the failure of not only complex and risky financial institutions like Lehman Brothers but also of traditional banks like Northern Rock. What this demonstrates is that a business model distinction cannot be drawn between a utility and a casino; and if it can, it does not coincide with the distinction between what has to be safe and what need not be. Second, in an interconnected financial sector, how can a 'boring' bank realistically ring-fence itself from what is happening all around given all the inter-connections? Third, will not the co-existence of utilities and casinos open up arbitrage opportunities? During 'tranquil' periods, financial institutions with higher risk and reward business models will wean away deposits from narrow banks. But when problems surface and stresses develop in the financial sector, the position will reverse with the deposits flowing back into the so called 'boring banks', triggering procyclicality. Finally and most importantly, what will be the cost of boring banking in economic terms? Does restraining banking to its core function just to keep it safe not mean forgoing opportunities for growth and development?

What is the lesson from this discussion of 'boring banking' for the EMEs where universal banking is in early stages and trading of the kind witnessed in the North Atlantic systems is nowhere comparable? It is important for the EMEs to draw the right lessons – markets may not be self-correcting but they cannot be substituted by central planning and micro management. Making markets competitive, open and transparent while putting in safeguards to curb excessive trading can help EMEs to enable financial markets to play their rightful role in efficient allocation of resources.

Question 5: Why is burden sharing across countries still off the reform agenda?

The last question I want to raise concerns cross-border equity, in particular the burden sharing on account of the external spillovers of domestic regulatory policies. Why is cross-border equity still off the agenda in any international meeting? I know I am asking that question somewhat provocatively, but that is deliberate. Let me explain.

The crisis challenged many of our beliefs, and among the casualties is the decoupling hypothesis. The decoupling hypothesis, which was intellectually fashionable before the crisis, held that even if advanced economies went into a downturn, EMEs would not be affected because of their improved macroeconomic management, robust external reserves and healthy banking sectors. Yet the crisis affected all EMEs, admittedly to different extents, discrediting the decoupling hypothesis.

The decoupling hypothesis was never persuasive given the forces of globalization. But the forces of globalization are asymmetric. What happens in systemically important countries affects EMEs more than the other way round. The regulatory policies that the advanced economies pursue have knock-on impact on the growth and stability of EMEs. I need hardly elaborate – capital flows engineered by the multi-speed recovery and the consequent volatility in exchange rates, the spike in commodity prices triggered by their financialization, the shortage of the reserve currency because of the flawed international monetary system and the constant threat of protectionism.

As all these problems confronting EMEs are a consequence of the spillover of advanced economy policies, should their solution remain the exclusive concern of EMEs? Isn’t there a case for sharing the burden of adjustment? How do we evolve a code of conduct for building in cross-border equity concerns into financial regulation? I do hope these questions will figure in our discussions over the next two days.

Conclusion

Let me now conclude. I have raised five questions straddling growth, equity and stability in the context of the post-crisis approach to regulation:

(i) If financial sector development is good, is more of it better?

(ii) Financial sector regulation, yes, but at what cost?

(iii) Does financial regulation have a role in achieving equity?

(iv) Should we make banking boring?

(v) Why is burden sharing across countries still off the reform agenda?

I realize I have raised more questions than answers. For considered answers, I look to the insights and intelligence of the delegates at this conference.

One last thought. Even as I have annotated my five questions from the perspective of emerging economies, I realize that these concerns are not unique to them. We only have to look around the world. What began with demonstrations in Madrid this spring has coalesced into something on a much grander scale. The discontent has traversed from southern Europe across the Atlantic and has inspired the ‘Occupy Wall Street’ movement in New York’s

Zuccotti Park and beyond. Despite its amorphous nature and its refusal to formulate a set of demands, the protest campaign across the world is fired by a simple, but powerful idea – that the elite cannot go on doing obscenely well even as the rest keep moving backwards. The message from this collective rage is that growth itself can be destabilizing if it has no equity dimension. That is a sobering thought.

Before I leave this platform, let me place on record my deep appreciation for the intellectual and logistic effort that has gone into organizing this conference by the team at CAFRAL led by Usha Thorat and the counterpart team at BIS led by Philip Turner. We owe them a great deal.

I wish the deliberations over the next two days all success.