Y V Reddy: Financial sector competition and monetary policy – comments

Observations by Dr Y V Reddy, Governor of the Reserve Bank of India, as a panellist at the Annual General Meeting panel of the Bank for International Settlements, Berne, Switzerland, 25 June 2006.

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Mr. Chairman, Professor Mario Monti, Co-panellists and fellow Governors,

I am honoured by the invitation to participate in the Annual General Meeting Panel in this historic and beautiful location. When I got the enquiry on my willingness to be a panelist on "The Relevance of Competition and Monetary Policy for Financial Stability" for the Per Jacobsson Foundation lecture this year, I initially felt that the topic of the lecture was rather unconventional. But on deeper reflection, the significance struck me immensely. It is a fascinating subject as we realised today after hearing the Foundation Lecture. I am grateful to Professor Mario, the "anti-trust tsar", also known as 'Super Mario', who is said to be "politically tone-deaf", but tried hard to establish an international network of national competition authorities.

My brief comments will be on:

a) The link between competition and monetary policy;

b) Recent developments that reinforce the link, particularly for the developing countries;

c) Some issues relating to competition in the financial sector and monetary policy, especially from the perspective of the developing countries;

d) Indian policies to enhance competition in the financial sector; and

e) The implications for India's monetary policy.

There is a two-way linkage between competition and inflation; the latter is the major objective of monetary policy. Professor Monti explained the link and similarities as well as dissimilarities in detail and so I will refer to one aspect only.

Inflation reduces uncertainties and enhances competition. Competition leads to more efficient pricing, which in turn, contributes to low inflation. There is, thus, in some ways, a convergence between the ultimate objectives of both competition and monetary policy.

There are three recent developments that reinforce the linkages especially for emerging markets. First, central bankers are increasingly using indirect instruments of monetary policy and are thus, in a way, competitive players in the market, to achieve their objective. Second, fiscal rules, which are closely related to monetary policy, operationally require that governments use markets to raise their borrowing requirements. Third, increasing liberalisation and global integration of financial systems enhances competitive pressures, amongst major players and instruments, which central bankers cannot afford to ignore.

There are some issues relating to competition in the financial sector and monetary policy, which are worth flagging.

First, both efficient markets and successful use of market-based policy instruments, require a strong legal framework and effective implementation.

Second, competition in the financial sector appears to be a little more complicated than in the non-financial sector. For instance, consensus is still lacking on the separation of commercial and investment banking. Further, there are differences on issues of commercial affiliations of otherwise 'fit and proper' owners of banks. This issue was raised in the discussion today and Professor Monti also felt that it calls for deeper reflection. Major issue here is the potential for conflict of interest, in particular, the possible perception of such a conflict of interest in the realm of public opinion in respect of banks, which are highly leveraged with acceptance of uncollateralised deposits. Moreover, banks continue to be viewed as enjoying a special status in the financial sector, especially in the developing economies – which could be construed as unfair competition between banks and non-banks. It is also possible that banks have regulatory burdens disproportionate to their special nature and relative to non-banking intermediaries.

Third, financial sector competition has two dimensions, namely, amongst the intermediaries and in terms of price discovery in financial markets. Here I am deliberately not referring to the fundamental issue raised in the discussions on the Address by Prof. Jacob Frenkel on central banks' monopoly over domestic money supply, and supply of foreign currency, in some ways. That has been responded to by Professor Monti and Chairman Roth has also touched on this aspect in his remarks.

Fourth, by its very nature or as a matter of current practice in regard to most of the goods and services, the degree of financial sector competition varies across countries. In other words, variability in the degree of competition in the financial sector across economies is perhaps more than those in the non-financial sector.

Fifth, the increased competition in the financial sector will enhance efficiency and stability, if there is an acceptable minimal degree of competitive efficiency in the product markets and, to some extent, factor markets, supported by some comfort of sound institutions and practices. The markets are mutually reinforcing, but, ideally, the competitive conditions in all the markets need to be broadly in sync and avoid serious mis-alignments with each other.

Sixth, some of the multi-national banks have assets exceeding the Gross Domestic Product of many large emerging economies and hence their proper functioning in such emerging markets is critical for genuine competition in financial sector in such economies.

Seventh, in the context of consolidation of commercial banking, there may be considerable merit in recognising the usefulness of several categories of local banks particularly in larger economies. A classic example of co-existence of large banks with locally active banks is the USA, where regulatory regime enables such possibilities without, perhaps, diluting underlying competitive pressure.

Now, a few words on the policies to enhance financial sector competition in India:

a) We had, till reforms of early 90's, an over-regulated, virtually administered financial sector. So, the process of deregulation implied gradual removal of restrictions on the operation of the pricing mechanisms, especially interest rates and statutory liquidity and reserve requirements – a process which is still underway.

b) Markets have to be created, nurtured and developed, in the case of financial assets – especially money, forex and government securities. In emerging economies, there are complexities in parallel implementation of measures for both development and integration of domestic as well as external markets in the financial sector, in contrast to being sequenced and spread over a period as it happened in major financial centres. A nurturing policy is necessary for a simple reason. In developed financial centres, each centre evolved over a period in an organic fashion. For developing countries, there are external compulsions which affect the pace and nature of development of markets. This involved, in the Indian case, putting in place appropriate policies, institutions, practices, etc., including efficient market infrastructure and robust payment and settlement system.

c) Enhanced competition in both banking and non-banking financial sectors has been gradually introduced – through a dynamic mix of public and private as well as domestic and foreign ownership – along with deregulation or adaptive regulations.

d) Simultaneously, regulation and supervision of banks, financial markets and infrastructure were improved to increasingly align them with international standards and best practices.

To conclude, let me mention four of the implications of enhanced competition in financial sector for our monetary policy.

First is the positive impact on both growth and price stability – especially due to the competitive pressures in the banking sector. Bank-finance still dominates the financing of the corporate sector, through loans and advances, subscription to corporate bonds as also assisting in overseas operations in several ways, both in trade and investment.

Second, in view of the enhanced competition, there is a clear evidence of improved monetary transmission mechanism – both through interest rate and credit channels.

Third, we, as the monetary authority, feel that increasingly competitive financial markets are playing enhanced feedback role in the financial system. They help us not only in terms of information content on yield curves, but also in gauging market expectations and designing better communications.

Fourth, while competition in the domestic markets is in many ways, enhancing effectiveness of the monetary policy, the increasing integration of our financial sector with global markets is, arguably, making the monetary policy transmission somewhat more complex than before. My co-panellist Governor Axel Weber made a mention of this aspect in his intervention.

Finally, let me also respond to Professor Jacob Frenkel who raised the general issue of focussing on the core-inflation in policy and not the headline inflation in spite of persistence of high oil prices for a long period. In India, we could not consider core-inflation for several reasons, especially because the two major sources of supply shock, food and fuel, account for a large share of the index. In our case, pass through of higher oil prices has been halting and not full. Thus, the headline inflation in our country in a way understates the problem. So, in our monetary policy communications we emphasised the fact that there is clear evidence of a permanent component in the oil price increase, and hence the headline inflation may be understated till that component is fully passed through. While the permanent component is judgmental, broad magnitudes could be perceived and articulated. Such an explanatory approach to headline and underlying inflation pressure in monetary policy has added credibility to the policy and influenced and guided the inflation expectations in India.

Thank you.