Raghuram Rajan: The five Pillars of Reserve Bank of India's financial sector policies

Speech by Dr Raghuram Rajan, Governor of the Reserve Bank of India, at Bancon 2013, Mumbai, 15 November 2013.

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Good evening. I thank the organisers for inviting me. These are challenging times for the Indian economy, but I have dwelt on those near-term challenges elsewhere. Let me turn instead to the opportunities we have to make India a far better place than it is today, focussing in particular on finance.

Much of the world is ageing, facing the demographic tax of having to pay for an increasingly elderly population with a shrinking work force. Much of the world has run out of easy paths to growth. Having built infrastructure everywhere and exploited natural resources to their fullest, many countries are left with building bridges to nowhere to stimulate growth. Much of the world is also well-educated, well-fed, and well-connected through roads, telecommunications, and finance. India is unlike the rest of the world. Our population is young, our infrastructure inadequate, and too many Indians are poorly educated, poorly fed, and poorly connected. But this is precisely why our low-hanging opportunities for betterment are plentiful in the coming years. All we need to do is to pluck them.

So if it is so easy, why are we not there already? This is an important question, but I don't want to go into the political economy of underdevelopment today. Suffice it to say that India is battling the internal interests that held it back in the past. While victory is not assured, we have made sufficient progress that we can look ahead to what we need to do in the next few years to put ourselves firmly back on the path of strong and sustainable growth.

Some would say we need to focus on manufacturing. Others point to the industries we do not have, such as electronics or computer chips, and say that is what we need. Echoes of industrial planning seem to be heard once again in the corridors of power. I am worried because we seem to be reverting to a dialogue of protection and subsidies that we left behind long ago. Our industrial sector is no longer an infant that needs to be molly-coddled. While we should not enter into free-trade agreements that give foreign manufacturers an undue advantage, that is no reason for us to now respond by giving domestic manufacturers protection. We must remember that one domestic producer's advantage from protectionist profits is paid for by the consumer, or shows up as another domestic producer's cost disadvantage.

Instead of targetting specific industries for governmental attention, which risks bringing back all the baggage of the Licence Permit Raj that we have left behind, let us focus on improving the conditions for growth for all. Our measure of success should be the jobs that are created, not by giving government subsidies or protections to labour-intensive industries or sectors but by developing a facilitating, though competitive, environment that will result in the emergence of the best solutions.

This requires a disciplined focus on four issues:

1. We need to improve the quality of our infrastructure, especially the logistical support and power that industry and services need. Grand plans are on the anvil, such as, the Delhi-Mumbai Industrial Corridor. We need to complete such projects on time, and within budget. The success of the New Delhi Metro suggests that timeliness and cost control are not foreign to the Indian psyche.

2. Our youth need education and training for the jobs that will be created. Some of this will be higher degrees, not just computer science but also design or civil engineering. Some of it will be appropriate vocational education that teaches them

to be good plumbers and electricians rather than unemployable low-skilled engineers. Teaching our citizens can be a stepping stone to teaching the world. India can be at the forefront of providing mass technology-enabled education laced with appropriate human inputs to the world.

3. We need better business regulation. This does not always mean less regulation but it means regulation that is appropriate to the objective and that is enforced. I am told that factories in one state are still required to have a snake trap on the factory floor by law, a law that has not been changed since the days factories were surrounded by jungles. The lack of change may be sheer inertia, but it may be more sinister rent-seeking. All too often, we have too much regulation on the books and too little regulation in practice, with the worst of the regulated finding unscrupulous ways around the regulation while the honest are stymied.

   We have strong labour laws in theory that are meant to protect employees, but in practice we have a very flexible system with no incentive for firms to invest in their workers or hold on to them, and no loyalty towards the firms from workers. This needs to change if we are to have more skilled manufacturing jobs.

4. And finally, we need a better financial system, which will finance the needed infrastructure and the expansion of every producer ranging from the kirana shop owner to the industrialist even as it allows households to save safely with positive real returns, insure themselves against health emergencies or old age costs, and borrow at low cost to finance consumption. Importantly, the financial system should not require constant subsidies to bail it out.

Five pillars of RBI's developmental measures

In the rest of this talk, I want to focus on what we at the Reserve Bank are doing to improve the financial system. We plan to build the Reserve Bank's developmental measures over the next few quarters on five pillars. These are:

1. Clarifying and strengthening the monetary policy framework.
2. Strengthening banking structure through new entry, branch expansion, encouraging new varieties of banks, and moving foreign banks into better regulated organisational forms.
3. Broadening and deepening financial markets and increasing their liquidity and resilience so that they can help allocate and absorb the risks entailed in financing India's growth.
4. Expanding access to finance to small and medium enterprises, the unorganised sector, the poor, and remote and underserved areas of the country through technology, new business practices, and new organisational structures; that is, we need financial inclusion.
5. Improving the system's ability to deal with corporate distress and financial institution distress by strengthening real and financial restructuring as well as debt recovery.

Let me elaborate on each of these measures a little.

First, we are among the large countries with the highest consumer price inflation in the world, even though growth is weaker than we would like it to be. Much of the inflation is concentrated in food and services. Our households are turning to gold because they find financial investments unattractive. At the same time, many industrial corporations are complaining about high interest rates because they cannot pass through their higher costs into higher prices for their products.

We can spend a long time debating the sources of this inflation. But ultimately, inflation comes from demand exceeding supply, and it can be curtailed only by bringing both in balance. We need to reduce demand somewhat without having serious adverse effects on investment and supply. This is a balancing act, which requires the Reserve Bank to act firmly so that the economy is disinflating, even while allowing the weak economy more time than one would normally allow for it to reach a comfortable level of inflation. The weak state of the economy, as well as the good Kharif and Rabi harvest, will generate disinflationary forces that will help, and we await data to see how these forces are playing out. No single data point or number will determine our next move.

I think the market understands what we are trying to do. But we do need a more carefully spelled out monetary policy framework than we have currently. Action on the framework will follow the submission of the Dr. Urjit Patel Committee report, which is expected to submit its report by end December 2013.

Second, we have already announced measures to free bank branching, and to incentivise foreign banks to incorporate domestically. Going forward, we have to give our public sector banks, which are a national asset, the means to improve their competitiveness. Many of them have made enormous strides in the last decade – for instance, the extent to which they have digitised their operations is extremely praiseworthy – but because competition in the banking sector is likely to increase in the next few years, they cannot rest on their laurels. In the coming months, we will discuss with stakeholders in public sector banks about what needs to be done to further improve their stability, efficiency and productivity.

Third, we need to enlist markets in the aid of banking. Liquid markets will help banks offload risks they should not bear, such as interest rate or exchange risk. They will also allow banks to sell assets that they have no comparative advantage in holding, such as long term loans to completed infrastructure projects, which are better held by infrastructure funds, pension funds, and insurance companies. Liquid markets will help promoters raise equity which is sorely needed in the Indian economy to absorb the risks that banks otherwise end up absorbing. Rather than seeing markets as being inimical to the development of the banking sector, we have to see them as complementary – of course, this requires you bankers to build on your risk management capabilities so that you can use markets effectively.

In the coming weeks, we will roll out more recommendations of the Gandhi Committee report to improve the liquidity and depth of the G-Sec market. We will then turn to money markets and corporate debt markets. We will introduce new variants of interest rate futures and products like inflation indexed certificates, and work to improve liquidity in derivative markets.

Fourth, we have to reach everyone, however remote or small, with financial services. Financial inclusion does not just mean credit for productive purposes, it means credit for healthcare emergencies or to pay lumpy school or college fees. It means a safe means of remunerated savings, and an easy way to make payments and remittances. It means insurance and pensions. It means financial literacy and consumer protection.

We have made great strides in inclusion, but we are still some distance from our goal. We have adopted a branch based strategy for inclusion, but it is not enough. Too many poor people in so-called “over-banked” urban areas still do not have access to banking services. We have many experiments under way to use technology, mobile phones, new products such as mobile wallets, and new entities as business correspondents to link people up to the formal financial system. Much as with cell phones where we created a frugal Indian model, we need a frugal, trustworthy, and effective Indian model for financial inclusion. The Dr. Nachiket Mor Committee is helping us think through possible models, and I am hopeful that when we outline measures based on its recommendations, our fine banks, NBFCs, IT companies and mobile players will rise to the occasion. At a more detailed level, we have set up committees like the Sambamurthy Committee to advise us on how to expand mobile banking in India through encrypted SMS based funds transfer in any type of handset.

I should emphasise the need for banks like the ones represented in this room to move beyond simply opening bank accounts to ensuring that poor customers are confident and comfortable enough to use them. Innovation in reaching out to the underserved customer, rather than simply posting higher numbers in branches or bank accounts opened, has to be part of our efforts.

And last but not least, with have to deal better with distress; The natural, and worst, way for a bank management with limited tenure to deal with distress is to “extend and pretend” to evergreen the loan, hope it recovers by miracle, or that one’s successor has to deal with it. The natural incentive for a promoter to deal with distress is to hold on to equity and control despite having no real equity left, and to stand in the way of all efforts to resolve the underlying project while hoping for an ‘Act of God’ to bail him out. Not all bankers and promoters succumb to these natural incentives but too many do.

We have to ensure that the system recognises financial distress early, takes steps to resolve it, and ensures fair recovery for lenders and investors. We could wish for a more effective judicial process or a better bankruptcy system, but while we await that, we have to improve the functioning of what we have. In the next few weeks, we will announce measures to incentivise early recognition, better resolution, and fair recovery of distressed loans. We will focus on putting real assets back to work in their best use. Here again, you bankers have a critical role to play by fighting the natural incentives that are built in to the system. You have to help those with genuine difficulty while being firm with those who are trying to milk the system. The RBI will help you with every means at our disposal.

Let me conclude. We are going through a period of great cynicism about what India can do. That cynicism does not just permeate the foreign press and their audiences, but also infects our domestic debate. Every policy is greeted with suspicion and scrutinised for evidence of malfeasance. With no upside to making decisions, it is no wonder that decision making has slowed. The solution, however, cannot come through inaction but through action, action that is, and is seen to be, purposeful, unbiased, and effective. No doubt mistakes will be made, but if the weight of clean actions builds up, the miasma of suspicion that pervades our society today will ebb. The Reserve Bank of India intends to play its part in making this happen.