Raghuram Rajan: Financial reforms – past and present

Text of the C D Deshmukh Lecture by Dr Raghuram Rajan, Governor of the Reserve Bank of India, at the National Council of Applied Economic Research (NCAER), New Delhi, 29 January 2016.

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I thank Shekhar Shah for inviting me to deliver the C.D. Deshmukh lecture at NCAER. Sir Chintaman Dwarakanath Deshmukh, an ICS officer, was truly a giant of modern India. In 1943, he was the first Indian, as well as the youngest in its history to date, to be appointed the Governor of the Reserve Bank of India. He subsequently served as the Finance Minister in the Union Cabinet. It was during this time that he also became a founding member of the Governing Body of NCAER. After resignation from the Union Cabinet over a matter of principle, he served at various times as Chairman of the University Grants Commission, Vice-Chancellor of the University of Delhi, President of the Indian Statistical Institute, and founding member and lifetime President of the India International Center. Among his many contributions were his insightful interventions at Bretton Woods as part of the Indian delegation to that historic meet. He was awarded the Padma Vibhushan in recognition of his services. Sir C.D. Deshmukh died in 1982.

C.D. Deshmukh was an institution builder. I am currently the caretaker of one he led, the Reserve Bank of India. Let me assure him that the Reserve Bank is in fine fettle. In a country where time has weighed heavily on the quality of institutions, the integrity, capability, and motivation of my colleagues allows the Reserve Bank to continue to stand tall.

The world today, however, is much less comforting. Industrial countries are still struggling, with a few exceptions, to grow. Our fellow BRICS all have deep problems, with confidence about China waxing and waning. Indeed, India appears to be an island of relative calm in an ocean of turmoil. What is different here and how can we be assured that it will continue?

A lesson from Brazil?

Perhaps Brazil offers a salutary lesson. Only a few years ago, the world was applauding the country's thriving democracy, its robust economic growth, and the enormous strides it was making in reducing inequality. It grew at 7.6 percent in 2010, and had discovered huge oil reserves which the then President Lula likened to "winning a lottery ticket". Yet the country shrank by 3.8% last year, and its debt got downgraded to junk. Growth will be no better this year. What went wrong?

Paradoxical as it may seem, Brazil tried to grow too fast. The 7.6 percent growth came on the back of substantial stimulus after the global financial crisis. In an attempt to keep growth high, the New York Times says the central bank was pressed to reduce interest rates, fueling a credit spree that overburdened customers are now struggling to repay.[1] Further, Brazil's government-funded development bank hugely increased subsidized loans to corporations. Certain industries were favored with tax breaks while price controls were imposed on gasoline and electricity, causing huge losses in public sector firms. Petrobras, the national oil company, which was supposed to make enormous investments in oil drilling, instead became embroiled in a corruption scandal. Even as government pensions burned an ever larger hole, budget deficits expanded, and the political consensus to narrow them has become elusive. Inflation touched double digits in the 4th quarter of 2015.

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[1] "As a Boom Fades, Brazilians Wonder How it all Went Wrong", Simon Romero, New York Times, September 11, 2015.

While the Brazilian authorities are working hard to rectify the situation, let us not ignore the lessons their experience suggests. It is possible to grow too fast with substantial stimulus, as we did in 2010 and 2011, only to pay the price in higher inflation, higher deficits, and lower growth in 2013 and 2014. Of course, India is not in the same situation today. Given the inhospitable world economy and two successive droughts, either of which would have thrown the economy into a tail spin in the past, it is to the immense credit of the government that we have over 7 percent growth, low inflation, and a low current account deficit. But it is at such times that we should not be overambitious.

Macroeconomic stability

As Brazil's experience suggests, the enormous costs of becoming an unstable country far outweigh any small growth benefits that can be obtained through aggressive policies. We should be very careful about jeopardizing our single most important strength during this period of global turmoil, macroeconomic stability.

There is a public discussion of whether India should postpone, yet again, the fiscal consolidation path it has embarked on. Clearly, the Government will balance various compulsions in taking its decision. But a number of facts are worth pointing out:

The consolidated fiscal deficit of the state and centre in India is by far the largest among countries we like to compare ourselves with; presently only Brazil, a country in difficulty, rivals us on this measure. According to IMF estimates (which is what the global investor sees), our consolidated fiscal deficit went up from 7 percent in 2014 to 7.2 percent in 2015. So we actually expanded the aggregate deficit in the last calendar year. With UDAY, the scheme to revive state power distribution companies, coming into operation in the next fiscal, it is unlikely that states will be shrinking their deficits, which puts pressure on the centre to adjust more.

Some say that fiscal expansion is necessary to generate the growth needed to put our debt to GDP ratio back on a sustainable path. This is a novel argument. Ordinarily one would think that a government should borrow less, that is, run lower fiscal deficits, in order to reduce its debt. But there is indeed a theoretical possibility that the growth generated by the fiscal expansion is so great as to outweigh the additional debt that is taken on. Unfortunately, the growth multipliers on government spending at this juncture are likely to be much smaller, so more spending will probably hurt debt dynamics. Put differently, it is worth asking if there really are very high return investments that we are foregoing by staying on the consolidation path?

Of course, the common man does not really care whether we stay on the consolidation path or not. But the bond markets, where we have to finance over ₹ 10 lakh crore of deficits plus UDAY state bonds, do care. Deviating from the fiscal consolidation path could push up government bond yields, both because of the greater volume of bonds to be financed and because of the potential loss of government credibility on future consolidation. It was James Carville who said "I used to think if there was reincarnation, I wanted to come back as the President or the Pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody." The Government understands the importance of bond market confidence, but I wonder if the economists debating in public put adequate weight on it.

The fall in inflation has been a major contributor to lower bond yields, and is the joint work of the Government and the RBI, aided to some extent by the fall in international commodity prices. This is no mean achievement given two successive droughts that would have, in the past, pushed inflation into double digits. Despite this success, we hear voices suggesting weakening the fight against inflation. Let me reiterate that macroeconomic stability relies immensely on policy credibility, which is the public belief that policy will depart from the charted course only under extreme necessity, and not because of convenience. If every time there is any minor difficulty, we change the goal posts, we signal to the markets that we have

no staying power. Let me therefore reiterate that we have absolutely no intent of departing from the inflation framework that has been agreed with the Government. We look forward to the Government amending the RBI Act to usher in the monetary policy committee, further strengthening the framework.

Macroeconomic stability will be the platform on which we will build the growth that will sustain our country for many years to come, no matter what the world does. Indeed, I am reminded today of the period 1997–2002 when India labored and reformed with only moderate growth, only to see a decade of high growth after that.

Before I turn to the main body of this talk, a word on interest rates. Industrialists grumble about high rates while retirees complain about the low rates they get today on deposits. Both overstate their case, though as I have said repeatedly, the way to resolve their differences is to bring CPI inflation steadily down.

Let me explain, starting with the retiree. The typical letter I get goes, "I used to get 10% earlier on a 1 year fixed deposit, now I barely get 8%", please tell banks to pay me more else I won't be able to make ends meet". The truth is that the retiree is getting more today but he does not realize it, because he is focusing only on the nominal interest he gets and not on the underlying inflation which has come down even more sharply, from about 10% to 5.5%.

To see this, let us indulge in Dosa economics. Say the pensioner wants to buy dosas and at the beginning of the period, they cost ₹50 per dosa. Let us say he has savings of ₹1,00,000. He could buy 2,000 dosas with the money today, but he wants more by investing.

At 10% interest, he gets ₹10,000 after one year plus his principal. With dosas having gone up by 10% to ₹55, he can buy 182 dosas approximately with the ₹10,000 interest.

At 8% interest, he gets ₹8,000. With dosas having gone up by 5.5%, each dosa costs ₹52.75, so he can now buy only 152 dosas approximately. So the pensioner seems vindicated: with lower interest payments, he can now buy less.

But wait a minute. Remember, he gets his principal back also and that too has to be adjusted for inflation. In the high inflation period, it was worth 1,818 dosas, in the low inflation period, it is worth 1,896 dosas. So in the high inflation period, principal plus interest are worth 2,000 dosas together, while in the low inflation period it is worth 2,048 dosas. He is about 2.5% better off in the low inflation period in terms of dosas.

This is a long winded way of saying that inflation is the silent killer because it eats into pensioners' principal, even while they are deluded by high nominal interest rates into thinking they are getting an adequate return. Indeed, with 10% return and 10% inflation, the deposit is not giving you any real return net of inflation, which is why you can buy only 2,000 dosas after a year of investing, the same as you could buy before you invested. In contrast, when inflation is 5.5% but the interest rate you are getting is 8%, you are earning a real rate of 2.5%, which means 2.5% more dosas. So while I sympathize with pensioners, they certainly are better off today than in the past.

Let us turn to the industrialist. At a recent conference, I met a businessman who complained that his business was getting torn to shreds by imports. He was lobbying for safeguard duties. When asked for evidence of unfair competition, he said his revenues had not grown at all, with his volume growth barely offsetting the price decline for his product. While commiserating with him, I said lower input costs must be a boon, because commodity prices have fallen even more sharply than output prices. He grudgingly agreed they had helped. When asked about his profits, he eventually admitted they were at an all-time high. But nevertheless, he said, we need safeguard duties because foreigners are dumping below cost! Put differently, businesspeople complain about low output price inflation, but the inflation that matters to them is the inflation in their profits, which is higher. For instance, analyzing 2nd quarter results for non-financial non-government corporations, we find that while revenues have fallen by 8.8% year on year, input costs have fallen by an even higher 12.4%, so that gross value added has gone up by 10.8%.

Clearly, there are industries in trouble. We should, however, be particularly careful about raising tariffs at a time when costs are falling everywhere – aside from the inflationary impact, for every happy domestic businessman whose prices are raised by the imposition of tariffs on imports, we have an unhappy domestic businessman whose costs are raised by the very same tariffs, as well as unhappy consumers.

Cleaning up the banks

One very important contributor to macroeconomic stability is healthy banks. Banks in India have a number of stressed loans on their balance sheet. In some cases, the reality is that existing loans will have to be written down significantly because of the changed circumstances since they were sanctioned (which includes extensive project delays, cost overruns, global overcapacity, and overoptimistic demand projections). If loans are written down, the promoter brings in more equity, and other stakeholders like the tariff authorities or the local government chip in, the project may have a strong chance of revival, and the promoter will be incentivized to try his utmost to put it back on track. But to do all this deep surgery, the bank has to classify the asset as a Non Performing Asset (NPA), a label banks are eager to avoid. Alternatively, instead of deep surgery, the banks could apply band aids, they could "extend and pretend", lending the promoter the money he needs to make loan payments. The project's debt obligations grow, the promoter loses further interest, and the project goes into further losses.

A number of good banks in our system have taken the necessary action to recognize and resolve stressed loans in a timely fashion. But some others need to take more proactive action. Over the last few quarters, the Reserve Bank has expanded the tools banks have to recognize and deal with stressed loans. It is now working with the Government and banks to ensure that the stressed assets are dealt with on a proactive basis, and that bank balance sheets both reflect a true and fair picture, and are adequately provisioned. The Finance Minister has indicated he will support the public sector banks with capital infusions as needed. Our estimate is that the support that has been indicated will suffice, especially when coupled with other capital sources that are usually available to banks. Our various scenarios also show private sector banks will not want for regulatory capital as a result of this exercise. Finally, the RBI is also working on identifying currently non-recognizable capital that is already on bank balance sheets, such as undervalued assets. The RBI could allow some of these to count as capital as per Basel norms, provided a bank meets minimum common equity standards.

In sum, we believe enough capital is available. While the profitability of some banks may be impaired in the short run, the system, once cleaned, will be able to support economic growth in a sustainable and profitable way. To be less proactive, as our past and the history of banking across the world suggests, will only see the problem get bigger and less manageable.

Let me now turn to the structural reforms that we intend to implement in the financial sector, which will build on the platform of macroeconomic stability to generate growth. We will increase efficiency through greater entry and competition. We need more participation in our financial markets to increase their size, depth, and liquidity. Participation is best enhanced not through subventions and subsidies but by creating supporting frameworks that improve transparency, contract enforcement, and protections for market participants against abusive practices. Technology can be very helpful in reducing the costs of the supportive frameworks, and can bring hitherto excluded populations into the financial fold. It is these ideas that guide our medium-term reform strategy. Let me be more specific.

Fostering competition

In order to get sustained growth, we need more competition, especially from new entrants who are in a better position to reach hitherto excluded parts of our economy. After over a

decade of no new entry, we have seen two new private banks enter last year, and a number of payment banks and small finance banks will enter this year. We will put licensing for universal banks on tap soon.

Incumbents have expressed fears about unfair competition. Competition is only unfair if it is not on the same playing field. In fact, new entrants have no privileges that incumbents do not already enjoy. We hope, though, that the new entrants will find innovative ways of giving customers better services at lower prices, thus shaking up and changing the banking sector for the better. Payment bank kiosks, post offices, or business correspondents could be the means by which the remote villager traverses the last mile to the formal financial system. Small finance banks could be the low cost assessment and monitoring mechanism to lower lending costs to small urban and rural firms.

Clearly, public sector banks (PSBs), with their large branch network, will have to adapt because some of these new entrants will go after their customers. This is no bad thing because, hitherto, those customers have had limited choice. Public sector banks will need to automate more so as to reduce transactions costs, cut administrative overheads and improve response times, even while improving their risk assessment and monitoring systems so that they can use the wealth of information they have gathered over the years to make sound lending decisions. Almost surely, this transformation will require more lateral hires at market wages, including skilled loan officers, risk managers, forensic accountants, IT professionals, lawyers, and human resource professionals. While PSBs can undertake contractual hiring at market wages, it remains to be seen whether they can attract professionals without promising them the means for career advancement within the bank.

Public sector banks will also require more professional boards that can chart a differentiated strategy for them. The Bank Board Bureau, which will select board members, will come into operation soon. We have to pay board members of PSBs a market compensation if we are to attract decent talent – otherwise we risk attracting an unwieldy mix of the truly patriotic and the truly unscrupulous, with the latter intending to profit by their board position. When thousands of crores can be diverted by a bad board decision, should we not ensure we have adequate integrity and talent on bank boards?

More decisions need to be decentralized from the Government to the PSB boards, once they have been fully professionalized. For instance, should boards not determine strategy as well as the appointment or renewal of their chief executive? What about their executive directors? Can bank boards have more freedom in choosing these? Can boards be given the freedom to set compensation structures and performance measures for their senior executives, including long term stock options? If we want to address the concern that many public sector banks have identical strategies and are competing for the same pie, we have to allow the boards more freedom to differentiate their banks.

Finally, as bank health recovers, the issue of PSB mergers can be addressed. Almost surely, some banks will have to merge to optimize their use of resources. But talking of bank mergers, which take a lot of management attention, especially when each bank management is preoccupied with dealing with stressed assets, is probably premature. At the same time, some banks could benefit from governance help to deal with their current problems. Is it an opportune time to induct skilled financial firms as strategic investors into public sector bank boards, perhaps with a 10 or 15% stake? Certainly, the experience of countries like China who inducted such investors is worth studying.

Technology and innovation

Regulators are naturally a conservative lot. It is good we are that way else there would be no speed breakers in the economy to slow its propensity to get into trouble. But we also should not stand in the way of innovation. There is a Chinese saying: "Cross the river by feeling the stones". The RBI has tried to follow that path of experimentation and incremental liberalization. So, for example, as increasingly innovative new services want their customers

to have the ability to make payments quickly, we have allowed small value card payments without two-factor authentication. As we and financial institutions gain experience, and as new technologies ensuring security emerge, we can liberalize further. More generally, our philosophy is to allow innovation in institutions, instruments and practices so long as they do not present a clear and present danger. Once we understand them better, and they grow to a material size, we can do a deeper analysis on how they should be regulated.

A number of innovative structures are likely to be implemented soon. NPCI will go live soon with the Unified Payment Interface, which when fully rolled out will allow anyone to make a payment to anyone else with a bank account simply via a mobile and a unique email-like address. The Trade Receivables Exchanges will be a boon to small businesses. Essentially, any business that has a receivable against a large firm can sell it as a bill on the exchange, after the large firm acknowledges it has been supplied the goods. Not only will the small firm get paid quickly, buyers will discount the bill at the rate associated with the large firm, and thus pay the small firm more. Importantly, the three Trade Receivables Exchanges that have been licensed will get a fillip if public sector firms and government departments are required to allow their receivables to be traded. This will also discipline these entities to pay on time, a huge boon to the system.

Yet another technological development to watch is the alliance between internet marketplaces and financial firms. The information obtained from monitoring sales and cash flows of the online merchant can be the basis for making him a loan and recovering payment. I am especially excited by the possibilities afforded the carpet seller from Srinagar, who can display her wares across the globe, with the marketplace arranging marketing, logistics, and finance for her.

Financial inclusion

The Prime Minister's Jan Dhan Yojana has created accounts for much of the excluded population. Government has taken the next step of attaching a variety of financial services such as accident and life insurance to these accounts, and sending Direct Benefits such as scholarships, pensions, and subsidies to these accounts. We also have to ease access to bank accounts through Business Correspondents, payment banks, and point-of-sales machines so that they are used frequently. Easy payments, access to cash-in and cash-out facilities, and widespread availability of safe savings instruments have to be our next objectives in the financial inclusion of households.

When credit leads the process of financial inclusion, we risk lending to people who have little ability to manage money and overburdening them. By drawing them into the formal system through savings and payments first, then insurance, we get them accustomed to managing money before tempting them with credit. This is the successful method we have followed with Self Help groups, and is what we should do more widely. Importantly, we need a variety of firms and NGOs to help small businesses with management advice so that they can flourish.

Technology will also help reduce transaction costs, facilitating inclusion. We now have an internet portal (Vidyalakshmi) where students can apply to a variety of banks for education loans. We are exploring a similar portal for MSMEs, where MSMEs can apply easily to banks and where we can monitor timely responses to the loan applications.

In all such lending, we need to address the issue of collateral. Credit flows easily only when the lender is persuaded that he will get his money back, so easier access to credit necessitates harsher consequences of default, including the loss of collateral. Aadhaar has given individual borrowers the possibility of using their future access to credit as collateral. I do hope the Supreme Court clears up the cloud over its use quickly. But there are also situations where borrowers have physical collateral they can use to lower their cost of credit and improve access. We really need to reexamine mandates that banks should lend without collateral to certain segments. While the intent is laudable, the consequence may simply be

that banks fear taking collateral even when available, and thinking the borrower is too risky, do not lend.

More generally, the best way to facilitate lending to the excluded is to reduce transactions costs, improve borrower information and frameworks for recovery, and create institutions that have lower costs and easier access to the borrower than existing ones. For this, we need to improve the structure and working of credit information bureaus, collateral registries, and debt recovery tribunals. Perhaps the most important source of collateral value is land. We need better digital mapping and clean records of land ownership across the country so that land can be used more effectively as collateral. Andhra Pradesh's pattas for tenant farmers is also an innovation that will help tenants get access to credit.

Consumer protection and literacy

Finally, newcomers and outsiders need protection against unfair practices. As one example of what we are doing, RBI has developed a Charter of Consumer Rights after public consultation. Bank boards have been asked to put in place frameworks that ensure those rights are protected, including creating an internal office of ombudsman. Soon, those frameworks will have been in operation for about a year. After studying practices, RBI will take a view on best practices and even regulation, if any is needed. In the meantime, incognito field visits by RBI, to check mis-selling as well as the proper functioning of bank infrastructure such as branches and ATMs, will be expanded. We are also working with state law enforcement authorities through State Level Coordination Committees to try and nab fly-by-night operators before they do real damage.

As access to finance improves, we need customers to protect themselves. Higher education is not sufficient protection. Many of you must have received an email from me saying that the RBI had concluded a pact with the IMF or the British Government to take over the gold found on pirate ships in the sixteenth century, sell it, and give the proceeds to deserving citizens like you. In return for a small transaction fee of ₹20,000, the email goes on, I would be happy to transfer the sum of 50 lakh rupees into your bank account. Without pausing to think why I need ₹20,000 when I supposedly have ₹50 lakhs of your money with me, some of you send ₹20,000 as requested into an untraceable account. My office then gets repeated phone calls from you asking what happened when the ₹50 lakhs does not show up. The truth is that we are all gullible – no amount of warnings that the Reserve Bank does not ask you for your money helps. The central theorem of financial literacy is "There is no such thing as a free lunch". In the context of financial investments, it can be restated as "There is no return without risk". We need to imprint these two statements in everyone's head and we intend to roll out campaigns to do so.

Conclusion

I have described some of the ways we will position the financial system towards sustainable growth on a base of macroeconomic stability. Of course, finance can only facilitate growth, the true engine of growth is the real economy, where the government's structural reforms are facilitating the way.

Throughout its 81 year history, the RBI's staff has always risen to the challenges posed by a dynamic, growing economy. We have never hesitated to say no when the stability of the system is at stake. At the same time, we have liberalized when it is needed. Following the traditions set by our past leaders like Shri C. D. Deshmukh, we will help take India forward. Thank you very much again for inviting me to give this talk.