Beyond neoliberal regulation

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The global financial crisis has shaken public confidence in the neoliberal financial system nurtured since the late 70s.There is anger amongst the people that the regulators have failed them- failed not only to ensure public trust and confidence in the financial system but also to avert the significant fiscal and welfare costs arising out of the global financial crisis. Are the answers that are being found today appropriate and sufficient to ensure a stable and sound financial system that supports global growth and welfare?

There has been a rejig of regulation of the financial system, under the aegis of the G20, the Financial Stability Board and the Basel Committee on Banking Supervision, towards a new global accord focusing on stricter capital and liquidity measures as also on macro prudential measures for dealing with pro-cyclicality and inter-connectedness in the financial system. These apart, there has been a re-look at the size and scope of banks, banks combining commercial and investment banking, the incentive structures, shadow banking, too big to fail entities, resolution mechanisms, and market micro structure related to trading, clearing and settlement.

While the re-jigged regulatory thinking continues to give markets a key role in allocation of finance while making banks stronger, more resilient and able to withstand the impact of financial cycles and Interconnectedness. In the pre-crisis period, the philosophy of regulation was not to stifle market innovation. Now, the emphasis is on stability. The sum of measures being contemplated would tend to reduce the margins in the financial sector compared to the pre-crisis period and this is bound to have a concomitant effect of slowing down of the financial sector.

The issue that countries like India are confronting is whether the new regulatory framework that is being forged serves the objectives of the emerging and developing economies that still need to focus on growth and equity to be able to lift millions of their population above the poverty line. At the same time, given the operations of global companies and global banks across borders, the scale and nature of global financial flows, and the difficulties in administering capital controls, it is apparent that countries cannot evolve their regulatory mechanisms in isolation or evolve a framework which is not in sync with the globally evolving standards. While the focus of the new regulatory framework is on stability and rightly so for the developed North Atlantic world, in countries like India we need the financial sector to grow to provide the intermediation for economic growth. This requires fashioning the regulation to give the right incentives to facilitate equitable growth in the real sector without compromising on financial stability.

In India, for 40 years after independence, till the 90s, the political and economic philosophy was far from neoliberal. Democratic socialism, mixed economy and self-reliance were the underlying principles of public policy with a strong commitment to the equity as well as growth objective. For example in agriculture, industry and services, while private ownership had its role to play, excess accumulation was prevented through ceiling on land holding and restrictions on industrial capacity. Economic policy favored small holdings of land and small scale industry and business even if this meant not reaping the benefit of scale. Administered pricing was quite common. The planning era which commenced in the mid-50s gave the public sector a key role in basic manufacturing and trading, the so- called 'commanding heights'. Industrial and import policy was governed by licensing for setting up domestic industry and for imports which faced high tariff barriers. Foreign direct and foreign portfolio investment was restricted. Tight exchange controls prevailed. Monetary policy was subordinate to fiscal policy and there was automatic monetization of the fiscal deficit.

Nationalisation of major banks in 1969 brought 80 percent of the assets of the banking system under State ownership and control. To the extent State ownership represented an implicit guarantee, the role of regulation and supervision for these banks was somewhat diminished. The legislation which gave Reserve Bank of India the power to regulate banks continued to be applicable to the banks in the public sector insofar as their operations were concerned but their management and governance became the State prerogative. The RBI's main role during the period 1970 to 1991 was developmental banking for giving a boost to banking in rural and unbanked areas. Credit planning and policy directed that bank credit was used for productive activities rather than just based on collateral. Initially public sector banks had to lend one third of their loans to the priority sectors which included agriculture, small scale industry and small businesses. Soon the allocation was raised to 40 per cent and applicable to all banks in private sector and with some modification in coverage and share to the foreign banks. Nationalised banks were pushed to open branches in rural and unbanked areas, even if unviable. Behest and political lending, financing of loss making public sector enterprises, high reserve requirements and other pre- emptions took its toll on the banking system by the late 80s and NPAs reached a peak in the early 90s.

1991 represented a watershed year. The balance of payments came under pressure and the country faced severe external liquidity problems. Although economic policy started moving away from central planning towards liberalisation in the latter part of the 80s, 1991 represented the turning point when the country embraced market economy. The structural reform programme put in place post 1991 saw a much more open trade and investment regime, a more favourable growth environment to private industry, largely removed industrial /import licensing, administered pricing, quantitative controls and lowered tariff barriers. Freer market pricing for many commodities and services which had seen price control for several decades was introduced. While some elements of capital controls continued, market forces by and large determined the exchange rate with some intervention from RBI from time to time. While there was some privatisation, it was not whole scale and the State continued to have dominant role in the financial sector and in some of the crucial infrastructure and sensitive sectors. Given the extent and degree of inequality and poverty, small and marginal farmers and small businesses continued to enjoy subsidies in some form or the other.

In short, India represents a case of a country moving from highly regulated, controlled and insulated economic system for 40 years to a more open market based system with some elements of economic policy that continue to give the State an important role for the last 23 years. While first recounting the manner in which the liberalisation was undertaken in the financial sector as an example of such liberalisation, I will then try to draw out the outcomes and the implications for regulation.

The major areas of reform towards a more market based or market oriented system in the financial sector were

- Move away from administered interest rates on loans and deposits and deregulating interest rates. All deposit and loan rates were administered till 1991. Since then, through a gradual process, banks have been given freedom to set their deposit and loan rates. The process has taken a long time and the last vestige of control viz. savings banks rates was removed only very recently.

- Market related rates were brought into pricing of government borrowing. These rates used to be administered till 1994 or so when the auction system for pricing primary issuances was introduced. However, banks continue to have a minimum mandatory liquidity ratio of 25 per cent which implies that one fourth of bank deposits have to be invested in government securities. Thus, while pricing is free, there is an element of policy control in ensuring that government borrowing needs get met.

- The RBI stopped subscribing to the primary market for government debt. This meant that automatic monetization of the fiscal deficit through issuance of ad hoc treasury bills which marked the pre 1991 era was stopped completely by the early 90s. This was truly a historical step ending a system that had prevailed since mid-50s.This meant a certain degree of independence to monetary policy. Coupled with other measures which spurred growth and reduced government deficits meant that private sector credit was no longer crowded out and the pricing became competitive.

- While banks' Boards, including those of public sector banks, got freedom to decide overall policy, the obligation of lending to the priority sector at 40 per cent of total loans has been continued - largely as a matter of public policy. Banks have an obligation for adopting a financial inclusion plan. Such a direction is applicable to public sector as also private sector banks and to a certain extent to foreign banks as well. Banks are however free to set their own lending rates to this sector.

- New players in the private sector were allowed to enter and grow in the banking and insurance sectors while capital markets were freed and modernised. These new private sector banks have proved to be competitive and have gained market share. The role of foreign players in the banking and insurance sector continues to be somewhat restricted, although more liberal than in the pre-90 era.

- All international prudential norms were introduced and no discrimination made between priority and non-priority sector while doing so. Similarly there is no distinction in the application of these norms between public and private sector banks. All aspects of regulation and supervision are uniformly applied to public and private sector banks. Specifically, banks face regulatory restrictions on lending to commercial real estate and capital market activities not only to insulate then to asset bubbles in this sector but also to ensure that credit is directed to more productive activities.

- The country opened up for foreign trade and investment. The foreign exchange market was freed up for new players and types of transactions. While moving over to market determined exchange rate system and convertible current account, the central bank continued to intervene in the forex markets for managing the volatility in the exchange rates.

- Although the country opened up for foreign investment, there was a clear preference for equity flows over debt flows. Given the high fiscal deficit, interest rates and inflation compared to the rest of the world, it has been felt prudent not to restrict foreign investment in Indian rupee debt or allow residents to borrow unlimited amounts from abroad. Hence external borrowing is controlled in terms of overall volumes.

- In the capital markets major reforms including free pricing and setting up of modern trading and clearing systems led to vastly increased volumes; the entry of foreign institutional investors aided this process.

What have been the outcomes of these major changes in economic policy?

The overall outcome has been extremely positive. Growth rate which hovered around 3 to 4 per cent till the eighties steadily rose to 7 per cent in the 90s and 8 to 9 per cent in the period till 2008, while moderating somewhat in the recent period. This has implied opening up of opportunities for Indian enterprise and population. Growth has been sustained and stable with no significant downturns. Even in the years after global crisis ,growth rates have not reduced below 5.5 to 6 per cent. Growth has taken place in a fairly benign inflationary environment especially in the period after the 90s. There have not been any major upheavals in the financial system and the country has not confronted any serious banking or payments crisis. The country withstood both the Asian and global crisis fairly unscathed. Poverty has been significantly reduced although not eliminated. There are intra and inter regional disparities which have political implications as well. Growth has taken place with healthy demographics. This implies a strong demographic dividend over the next fifteen to twenty years provided the education and skilling challenges are overcome. Growth has been driven by the services sector although the contribution by industry is not insignificant. The potential for growth in the agricultural sector has not been harnessed and there are several vestiges of policy in this sector that deter growth which has also limited the capacity to reduce poverty in the rural areas. Infrastructure is another area where there is still tremendous supply gap. Private investment in infrastructure tends to move into the profitable projects and public sector investment is constrained by the size of the revenue deficit. This acts as a drag on growth. Pricing of public services such as supply of free power and water to farmers and other areas of subsidies such as pricing of energy and food absorb significant public resources.

In the financial sector, the outcomes have been extremely positive as well. The phased and gradual liberalisation and applicability of prudential norms for the entire banking sector (including public sector) has enabled the financial sector especially the banking area to become quite resilient. Due to their restricted exposure to real estate and capital markets as a matter of policy, banks are not vulnerable to shocks in these two sensitive sectors. Capital adequacy ratios in the banks, even by Basle 3 standards, are higher than the minimum norms and banks have strong liquidity buffers. Transparency, competition and efficiency have improved significantly. The areas of challenges are the large parts of the economy and society where banking has yet to penetrate and provide financial services for mobilising savings, supporting livelihoods and economic activity.

What are the learning points from the Indian experience?

1. The period prior to the 90s showed us very clearly the costs of excessive control and regulation and the need to benefit from more competition, international trade and investment. The period also clearly demonstrated the perils of financial repression and State control over banking without sufficient prudential safeguards.

2. From a longer term perspective, keeping a balance between unfettered markets and regulatory controls have enabled the system to ensure stability. There has been no currency crisis, no banking crisis, no serious financial or economic disruption even in the aftermath of the global crisis. India's approach to regulation has been a calibrated and gradual one with focus on financial stability and attaining best international standards

while fashioning them to the underlying structural, institutional and operational issues specific to Indian market. This is best illustrated in the approach to capital controls which today are being recognised as part of the macro prudential tool kit The first Dufrénoy Prize for Responsible Innovation, awarded in collaboration with Mines Paris Tech in February 2012 to highlight remarkable and outstanding initiatives in the area of responsible innovation in finance was given to the Reserve Bank of India. To quote one of the jury members “the RBI has achieved an outstanding job adopting a responsible behaviour towards financial innovation. Such an approach preempts some of the causes of the 2008 financial crisis we are still suffering from. A number of financial products and practices are too complex to be understood by clients and even bank managers. Regulators do not always have sufficient tools or authority to stop the diffusion of new financial products. Whether RBI approach can be transposed to other countries is an open question; many countries have adopted behavior, a more “market friendly one”. But the issue is to what extent financial innovation is efficient to economic growth and social welfare. I would like to underscore that RBI has been a pioneer in its approach to OTC derivatives".

3. Another big lesson learnt is the need for a central bank and regulator to be sensitive to markets but not capitulate to it. Quite apart from the need to take away the punch bowl when the party is going, the regulator has to be able to shown independence and courage in resisting pressure from markets, industry and media to deregulate further and further in the interest of market development. Further, when required, the regulators need to bring in prudential regulations. When the while world was allowing the development of the securitisation market, the guidelines in India stipulated amortising the profit earned on securitisation transactions over the period of securitisation which prevented the development of an “originate to distribute” model that was at the heart of misaligned incentives in securitisation process in the advanced economies particularly, USA. Similarly, the leading market players wanted to develop the corporate bond market by providing bank guarantees or comfort which was not allowed. At that time, RBI was labeled as being ignorant of markets by of the press and markets but later the experience of some of the countries (China, South Korea etc.) validates the RBI apprehension. Similarly, when markets were heating up in the period 2004 to 2007 and credit was growing at more than 30 per cent year on year especially to sectors like real estate, RBI brought in additional capital and provisioning in 2006-07 as counter cyclical measures for specific sectors.

4. There is a need to take the right lessons from crises. It is tempting to halt the efforts to encourage innovation in the financial sector and bring in more controls. Countries like India need the right kind of innovation in the financial sector to be able to meet the risk reward profiles of savers and borrowers and facilitate the right kind of finance for development of small businesses, new enterprises and infrastructure. While the focus of the new regulatory framework focus is on stability (and rightly so), the needs of inclusive growth in countries like India require the use of national discretion in the application of the international norms and standards. For example, bringing in countercyclical buffers when credit to GDP is higher than trend as is advocated under Basle 3 may not be appropriate when the country needs more credit intermediation. In fact in the past sector specific buffers have served us well. Similarly, the experience of 'too big to fail' entities and needs for universal banking should not discourage the regulators from encouraging scope and size as Indian banks are too small by global standards even though they may have a larger market share within the country.

To conclude, there are a few issues I would like to flag for discussion.

First, what should be the objective of regulation? In the financial sector, consumer protection and financial stability at the individual and systemic level are usually put forth as objectives of regulation. Should providing a conducive framework for access to finance or what one may call inclusive finance is not an objective of financial regulation? Should regulation also try and provide incentives for right finance? Or is this something that can only be an objective for the fiscal authorities?

Second, what should be the perimeter of regulation? For serving local communities and low income clientele smaller, regional and community based are often found to be more suitable. When regulatory perimeters are very tightly drawn and regulation made tough, there is a tendency for shadow banking to grow and the regulators often quite incapable of dealing with a large number of such shadow banking entities. Further, today banking regulation has become too complex often increasing the cost of regulation. How can one have a regulatory framework that deals adequately with shadow banks and keep costs or regulation manageable? How can the principles of proportionality be applied so that one size fits all approach is not required? The Indian experience of dealing with non-banking micro finance institutions holds some lessons in this context.

Third, what should be the principles of a good governance system for financial sector regulation? How should regulators be made accountable? How do we create public confidence in regulators and thereby in the financial system? In his talk yesterday Professor Levine made a compelling case for more suitable for setting up of an informed, expertly staffed and independent institution that evaluates financial regulation from the public perspective. Is this the answer?

Finally, the basic assumption underlying the benefits of globalised finance is the existence of competitive efficiency in global financial markets. The assumption can be, and has been, questioned on several well-known grounds, namely: the lack of a sound international reserve currency system; the absence of credible lender-of-last-resort facilities at the global level; and the dominance of a handful of rating agencies and accounting firms without adequate evidence of market discipline or effective rules for their functioning. (Reddy 2012). In this context is the evolving global framework for financial sector regulation adequate to meet the needs of global welfare? Are national and regional interests tending to dominate the consensus? With different countries at different stages of development and differing fiscal regimes, is such harmonisation possible?

To end with a quote from Chairman Ben Bernanke when referring to striking the right balance between consumer protection and responsible innovation he said , "our goal should be a financial system in which innovation leads to higher levels of economic welfare for people and communities at all income levels" (Bernanke, 2009). Is it possible to have a regulatory system that meets this objective?