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FINANCIAL SYSTEM AND FINANCIAL INNOVATION: TEN QUESTIONS

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It is apparent that the pre-crisis model of ideal financial system is being changed to address the problems that have been thrown up by the crisis. However, many of us have an uncomfortable feeling that there are many questions that remain somewhat unanswered. In my presentation, I intend sharing with you ten of these questions.

Since I am retired, I do not have to provide answers!

Q.1 Is there an optimal level of financialisation of an economy?

I agree with Andrew Crockett that financial system is the central nervous system of a market economy, and it is expected to direct real resources to their ultimate uses. The question is whether the financial sector directed a disproportionately large amount of real resources to itself in the recent years, and if so, how did it happen? That does seem to be the case because the growth of financial sector, relative to non-financial sector has been very high in the countries where the global financial crisis originated, and are most affected. My friend, Andrew Sheng has been giving data to prove the point that the financial sector was, in recent years, innovating and expanding to benefit it more than it was trying to allocate resources efficiently in the economy.

At the same time, commonsense tells us, and this is confirmed by a large number of micro studies, that lack of adequate and efficient financial intermediation can hinder economic growth.

Then the question is, whether there is an optimal level of financialisation of an economy? If so, what are the factors that would help us identify such an optimal level?

Q.2. Is there an optimal composition of financial sector appropriate to each country?

In order to enhance savings and channelise them for investments to enable growth, public policy particularly in developing economies, gives priority to development of financial systems. In the recent past, it is found that Asia has posted significant growth, but concentrated significantly on traditional banking activity relative to other developing economies. By traditional banking, I mean domestic diversified credit predominantly funded by retail deposits. We also have examples of Canada and Australia. Therefore, is it possible that, in addition to an optimal level financialisation, there is also an optimal composition of financial sector appropriate to the country?

Which components of financial sector are more conducive to efficient allocation of resources? I agree that it is difficult to demarcate clearly various components, but experience with policy shows that it is possible to do so despite difficulties. For example, a distinction can be made between basic banking and financial innovation or financial services to the customers, and transactions between financial intermediaries.

Q.3. <u>Are there intermediate regimes to financial sector regulation rather than corners of repression and open systems</u>?

Recently, in a meeting of INET in Bretton Woods, Larry Summers was asked about the need to increase the rigour of regulation of financial sector in the U.S.A. after the crisis. He replied that the alternative to a deregulated financial sector of U.S.A. was the Indian banking sector before the reform of 1990 which produced a Hindu rate of growth of 3 per cent per annum. The impression given, therefore, is that there are only corner solutions in the financial sector, viz., you have only a deregulated financial sector of U.S. type in 2007, and the financial repression of the Indian type of 1990. In this corner solutions approach, we are ignoring Indian financial sector regulation since 2003. In the case of exchange rate management, there has been a greater realization than before that intermediate solutions are possible, and perhaps for many countries, inevitable.

In regard to the extent of financial sector regulation also, it should be possible to visualise several intermediate systems between financial repression and soft touch regulation, with varying degrees of regulatory rigour, consistent with the institutional and market environments of individual countries.

Q.4. Should we fundamentally redesign governance structures in public and private sector?

After the global financial crisis, there is a realization that governance mechanisms in both public and private sector have failed in the financial sector as a whole. There is also a realization that lack of coordination between monetary policy and financial sector regulation was one of the reasons for financial instability, and that coordination is critical for macro prudential regulation and countercyclical policies. At the same time, it has been recognized that huge conflicts of interests existed in the private sector, and they were responsible for the crisis. In other words, the financial system suffered because of an effort to avoid conflict of interest in public sector, and in not being able to control the operation of conflict of interest in the private sector.

Hence, it is appropriate to have governance arrangements that promote coordination within public sector and create effective firewalls including splitting of institutions in the private sector to avoid misuse of arrangements for private profit. This may involve loss of traditional independence for central banks but it would still legitimately retain its central role in arrangements for coordination.

Q.5. Is diversity in financial regulation a source of stability in finance: as in case of biodiversity?

We have seen the possible downside of financial intermediaries using a common model for risk assessment. Imagine that we had a uniform global model of regulation five or ten years ago. We would then have had a similar "soft touch regulation" in all our countries, including India and in China. The global economy could have, in consequence, faced worse crisis, if a wrong model was applied universally.

We cannot be certain that after learning from the crisis, we know the right model of regulation by now. Is there merit in having diversity in regulatory regimes in different countries? Perhaps, the global effort should be to encourage diversity as well as innovation in regulation of financial sector, while focusing on common regulation of cross-border operations and institutions that operate significantly across the borders.

Q.6. How far should we go in applying non-level playing field?

The principle of non level playing field in financial markets has been accepted when systemically important financial institutions are sought to be identified, and higher capital charge is being suggested. Once the principle of non level playing field has been accepted, it can as well be invoked, if necessary, to design differentiated regulatory regimes for categories, as long as there are reasonable grounds for such discrimination. In other words, systemically not important ones could have less stringent capital requirements, particularly in the developing countries. For example, in India we adopted a three track approach for capital requirements: differentiating between internationally active banks, nationwide banks and local banks.

Q.7. What are the areas of special concern to developing countries now?

a) The review of regulatory philosophy is focused on using state-intervention to correct market failures in ensuring stability. There appears to be an implicit assumption that markets will continue to be efficient in bringing about growth, as long as stability is ensured. Is there enough empirical evidence to assume that it is so?

b) It is difficult to distinguish between cyclical and structural components in an economy undergoing significant structural transformation. There may be credit expansion in real estate and credit contraction in agriculture. Hence, the regulations may spillover into credit allocation in some form or other. This is what we did in India, where we restricted growth of speculative credit and not growth enhancing credit.

c) There is inadequate attention in the debate on use of regulatory regimes for countering volatility in capital flows as distinct from the net flows. Major sources of volatility in forex markets are operations of financial intermediaries, as distinct from households and corporate sector in real economy, which undoubtedly, are sources of capital allocation also.

Q.8. Who should assume the burden of proof that financial innovation is not toxic?

Like all innovations, some financial innovations may be good, some may be bad and self-serving, and many susceptible to multiple uses, and thus good as well as bad. Much depends on the magnitudes of transactions, context, use, user and rules of the game. In regard to food and drugs, there is basic information asymmetry between seller and buyer, and that phenomenon should not be ruled out in regard to financial innovations.

There are also externalities and systemic implications, especially if the products are traded by entities with leverage or with limited liability and such products are synthetic assets. Hence, the issue is: where does the burden of proof of social value of financial innovations lie - with the market participants or the regulator?

Our approach in India was on the side of regulatory caution for several reasons. The market players, in particular the entities with underlying exposures, were not fully familiar with such new forex derivative products. The contribution of financial innovations to efficiency in other jurisdictions was yet to be established. The capacity of our financial systems to absorb possible downside risks was less than in other countries. The brief point is, the good or bad of a financial innovation depends not only on the product but also on who are selling or buying them, and in what environment.

In India, we were comfortable with innovations that reduce cost of credit but does not promote risk taking that regulator cannot assess. Of course, we were willing to listen and learn.

Q.9. <u>Should regulators seek to encourage good financial innovation or those that could add social value</u>?

Why do we assume that only markets should have monopoly over financial innovations? In my view, the scope for financial innovation by regulators should not be ignored. Regulation should have a possible positive role also and regulator could sponsor innovation for public good. In India, initiatives have been taken by RBI in introducing technologies and products to facilitate financial inclusion; and also to establish a unique clearing and settlement mechanism for money, forex and government securities markets. In developing countries at least, there may be merit in central banks and market players sharing the credit for financial innovations which add to social value.

Q.10. <u>Should we be concerned only about relative failures of state and market, or also about: how state and market interact with each other in different situations? Is independent central banker, in the ultimate analysis, part of state or market or neither</u>?

Finally, the current debate on regulation of financial sector proceeds on the assumption that serious market failures can be avoided through intervention by state, after accounting for the latter's failures. One lesson from the crisis is that there were elements of failure of both state policy and market practices that reinforced each other to bring about the crisis. In a way, the problem in regulation of financial sector is technical and also one of political economy. The dynamics of relationship between state and market may be critical for designing a good financial system for future.

So, the real issue may be not state versus market, but often state and market versus people. We central bankers, if we are really independent, may have to often decide on which side of contrasting positions we are: state or market, or government as state or market. May be we need brave central bankers to take on, on occasions, state as well as markets in the larger public interest.

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