BOOK REVIEWS

India and the Global Financial Crisis Managing Money and Finance

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Y. V. Reddy (2009). India and the Global Financial Crisis Managing Money and Finance (New Delhi: Orient BlackSwan), pp. xvi+397, Rs.595.

This review discusses Y. V. Reddy's book India and the Global Financial Crisis Managing Money and Finance. The book is a collection of 23 select speeches which he delivered as the governor of the Reserve Bank of India during September 2003 to September 2008. It gives us a deep understanding of his approaches to some of the policy issues during those years. In particular, he discusses the positive impact of financial sector reforms on the functioning of the market and institutions in India. He also argues that there is a need for some caution in the pace of liberalisation. He explains some of the causes of the recent global financial crisis and how the Reserve Bank of India's policies protected the Indian banking system and minimised vulnerabilities in the Indian economy from the crisis. He also discusses various complexities and dilemmas involved in the conduct of monetary policy in India. It is a very valuable book.

Reddy explores whether various reform measures have been beneficial to India's financial sector. These include deregulation of interest rates, reduction of cash reserve ratio (CRR), liberal entry of foreign banks, broad-based ownership base in domestic banks, inclusion of various microprudential measures, strengthening the processes of regulation and supervision, constitution of the Board for Financial Supervision (BFS), establishment of Clearing Corporation of India Ltd. (CCIL), introduction of debt recovery tribunal and so on. He thinks that these measures have been quite useful with regard to improving the functioning of the markets and institutions. First, the financial markets have seen rapid growth and robustness. It is so because there has been a rapid growth of structured and derivative products, mortgaged, and asset-backed securities. Second, it has led to the emergence of financial conglomerates due to product diversification. Third, it has also reduced the effects of unforeseen shocks on the financial system and so on. In short, the book gives a clear description of the progress made in the direction of promoting a diversified, competitive and efficient financial system in India.

According to Y. V. Reddy, the financial liberalisation in India was done with a lot of caution. He seems to argue that the government used to put pressure to speed up the liberalisation of financial sector to achieve higher economic growth. Although he agrees with the government that financial sector reform is essential for a healthy financial market, which, in turn, leads to a high economic growth, he feels that one has to be extremely careful with the pace at which it should be done and the areas where it should be done. As per the Reserve Bank of India, given the current account deficit, fiscal deficit and volatile nature of capital inflows, there is a need for some caution in the pace of liberalisation of financial markets. He used to put a lot of emphasis on the development of money market, government securities market and foreign exchange market. It has been stated "there was full agreement on the ultimate objective-the healthy development of financial markets-but the pace of the actions to be taken in that directions and the relative emphasis on the different components were the topics of discussion" (p.10). Looking at his cautionary approach it is not very difficult to imagine what would have happened to the Indian financial system in the recent global financial crisis if he had increased the pace of reforms.

The book also tells that Mr. Reddy was a foresighted regulator. He took a number a policy measures to protect the Indian banking system. For example, he minimised the use of financial instruments called securitisation and derivatives in Indian financial markets. As a result, banks in India were not able to forward loans like that of the United States, as they were not allowed to sell their loan in securitisation. He also increased the capital requirement for banks if they were willing to invest in the construction of commercial buildings and shopping malls. Market participants were not happy with these policy measures. Hence, he writes, "what had been described as 'lazy' banking at the beginning of the decade was being replaced by what could be described as 'crazy' banking, with rapid growth in credit… But that the effort was only to protect the banking system by insisting on additional capital since uncertainties and risks appear to have emerged. The Reserve Bank of India issued guidelines on securitisation, but they were considered conservative at the time they were issued, in 2006" (p.15.) When his policy measures are analysed carefully, it can be seen that they did not allow financial intermediaries to create excess liquidity and they had the incentive to see the loans were paid back. Hence, the Indian banking system was unaffected by the crisis.

We find Mr. Reddy's regulatory approach was quite consistent with what some of the theoretical work in economics suggest. For example, Holmstrom and Tirole (1998) argue that if there is deposit insurance or provision for bank bailout, it may create moral hazard problem. It is so because banks may finance riskier projects. Therefore, unless banks owners - the equity holders - take some of the risks themselves, they won't have the incentive to allocate the savers money responsibly. Hence, they suggest banks are required to infuse more capital if they are financing riskier investment. In another study, Dewatripont and Tirole (1994) argue that since depositors cannot see if their banks investing their money wisely, there is a need for regulation. The regulator must put some restrictions on banks. One among them is to see banks are adequately capitalised; i.e., the leverage ratio should not be high. Looking at the policy measures taken by Reddy, one can conclude that he was a wise regulator of the Indian banking system.

Mr. Reddy seems to argue that the Reserve Bank of India took some measures to prevent the possibility of asset price bubble in India. He argues that although price stability is the most important goals of the monetary policy, it is not at the cost of neglecting other considerations. He seems to think that one among those other considerations is asset price bubble and, hence, took some measures to prevent the asset price bubble. For example, when he sensed the possibility of asset price bubble in India, he made the lending standards stricter. At some point of time, he did not allow banks to finance purchase of raw land. He would grant construction loan only when a developer was about to start construction. It has been stated that, "the RBI conceded that it could not take a view on whether there were asset bubbles or not, but it did note the possibility of such a build-up of bubbles in the domestic economy. Consequently, to protect the banking system from a possible adverse impact, counter-cyclical regulatory measures were undertaken while the monetary policy was leaning against the wind of excessive growth in credit and money supply"(p. 352).

Was it an appropriate policy stance? As per the conventional wisdom, the Central Bank should not try to prevent asset price bubble because of two reasons. First, it is very difficult to identify an asset price bubble. Second, even if it is identified, there is no guarantee that it would take the economy out of it without deflating it. So the Central Bank should ignore it. But after analysing his policy measures, it is not at all difficult to see some of the consequences. First, no banks in India have failed. Second, there was little requirement of injections of emergency capital. Third, there were no write-downs. So price stability should not be the only goal of the Central Bank. It should also see that the entire financial system is stable.

Mr. Y. V. Reddy also discusses the difficulty of conducting monetary policy in India. According to him, it arises because there are some specific features. First, there is an informal mandate for the Central Bank to maintain an acceptable rate of inflation. There is no explicit mandate for price stability. Second, the monetary policy in India continues to ensure financial inclusion of all segments of the population. It is so because the commercial credit penetration is very low. Third, the monetary management is constrained by the lack of information about the natural rate of unemployment and a comprehensive measure of consumer price inflation and so on. He also writes that besides these constraints, the monetary policy also faces a number of dilemmas. They were due to the public policy with regard to capital inflows, the allocation of credit to some sectors, reduction SLR and so on. Together all these factors resulted in complexities and dilemma in the conduct of monetary policy. So he writes, "the monetary policy has to address dilemmas, which exert conflicting pulls at every stage, and blend the desirable with feasible. We have to recognize that judgments are involved at different stages which call for both knowledge and humility" (p.211).

Looking at the macroeconomic performance of Indian economy, one can conclude that notwithstanding the constraints and dilemmas, the monetary management in India was very successful during his tenure. Compared to many developing countries, India was able to maintain a moderate rate of inflation, dampen the volatility of economic growth and manage exchange rate quite successfully. He managed the economy quite successfully.

In the last part of the book, he explains the causes of recent global financial crisis. According to him, some factors are related to the macroeconomic management and some are related to the regulatory environment in which financial markets were functioning. In macroeconomic management aspect, he argues that some countries, particularly the United States, had large current account deficit and some countries had current account surplus. So the market required the correction. Second, the monetary policy in the United States was extremely accommodative, which created excess liquidity. Such excess liquidity caused speculative activities and asset price bubble. Third, few Central Banks had formal mandate to maintain financial stability. Hence, they gave relatively low emphasis to financial stability and more emphasis to inflation targeting. Four, even though some of the Central Banks perceived underpricing of risks, they did not act or intervene. He writes, "the Central banks seem to have ignored the economic imbalances and asset bubbles that were building up and thus failed to act in a counter cyclical fashion to moderate, though not eliminate, the boom bust cycle" (p.341). In regulatory environment front, he argues that the regulators did not have adequate skills to cope with complexities of financial market innovations. They failed to tighten regulation when the economy was experiencing an excessive exuberance. They also ignored the developments in the shadow banking system. These are some factors that together caused the crisis.

While explaining the stance of accommodative monetary policy as a reason for creating excessive liquidity and asset price bubble in the United States, he has made no reference to natural rate of interest or Taylor rule. Knut Wicksell developed the concept of natural rate of interest, which is also called neutral rate of interest, in 1898. In its modern form, it is defined as the rate of interest, which is consistent with output at its potential level and actual inflation is equal to the target rate of inflation. If the actual real rate of interest is less than the natural real rate of interest, the monetary policy is accommodative, and if the actual real rate of interest is more than the natural rate of interest, the monetary policy becomes contractionary. Measuring the natural rate of interest has become a very active field of research among central bankers very recently to judge the stance of monetary policy. But the book does not mention about it.

In conclusion, we can say that it is an excellent book to read. It shows Y. V. Reddy's perspectives on a wide variety of issues. In particular, it reflects his regulatory approaches to many issues relating to the financial sector. If someone is interested in knowing the reasons behind the strong and robust financial system in India, he/she must understand the thoughts that were there in Reddy's mind in formulating his stance on various policy issues. It can certainly be achieved by reading this book.

References

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Pradyumna Dash is a Faculty in Economics Area at Indian Institute of Management Indore. He has earned his Ph.D. in economics from Indian Institute of Technology Bombay. He has a Golde Medalist for securing first position in MA in economics at Sambalpur University. His published articles have appeared in refereed academic journals, sucha as *Indian Economic Journal, Indian Journal of Labour Economics, Prajna, Praductivity, Journal of Global Econoly* and forums like *The Hindu Business Line* and *Asian Analysis News Letter.* His fields of research lie in the areas of macroeconimics, monetary economics, and applied econometrics.