In his speech, Dr. Raghuram Rajan stressed upon the implications of India's medium term policies in a world struggling to attain pre-Great Recession growth rates. The legacy of the financial boom that preceded the Great Recession is debt, and the overhang of debt, whether on governments, households, or banks, is holding back growth. The implication is that growth is unacceptably low relative to potential, and more can be done to lift it, especially given that a number of economies are flirting with deflation. Hence the conventional policy advice urges yet more innovative monetary interventions with an ever expanding set of acronyms, even while governments are urged to spend on “obvious” needs such as infrastructure. While the need for structural reforms is acknowledged, they are typically deemed painful, and possibly growth-reducing in the short run. Hence the accent is on monetary and fiscal stimulus, and as much of it as possible given the deadening effects of debt overhang.

He however noted that a different narrative of the pre-crisis period is now emerging that may explain why the efforts at stimulating economies back to the pre-crisis growth paths have not been successful, even six years after the crisis. The term “secular stagnation” which describes the current persistent economic malaise, has caught on. If secular stagnation persists, industrial countries will have to figure out how to restructure their promises, whether debt, social security, or low taxes, and how to distribute the burden. Slow industrial country growth has made more difficult a traditional development path for emerging markets export-led growth. Indeed, in the last decade, even as China developed on the back of its exports to industrial countries, other emerging markets flourished as they exported to China. Emerging markets now have to rely once again on domestic demand, always a difficult task because of the temptation to overstimulate. That task has become more difficult because of the abundance of liquidity sloshing around the world as a result of ultra-accommodative monetary policies in industrial countries. He therefore, emphasized on the implications of India's medium term policies. He stressed upon the aspects of 1) Make in India; 2) Make for India; 3) Ensuring transparency and stability of the economy; and 4) Working towards a more open and fair global system.

Dr. Rajan noted that the government has the commendable aim of making more in India. This means improving the efficiency of producing in India, whether of agricultural commodities, mining, manufacturing, or services. To achieve this goal, it has to implement its ambitious plans on building out infrastructure. A second necessity for increasing productivity in India is to improve human capital. The government is examining the cost of doing business in India with a view to bring it down. However there is a danger when we discuss “Make in India” of assuming it means a focus on manufacturing, an attempt to follow the export-led growth path that China followed. He counseled against an export led strategy that involves subsidizing exporters with cheap inputs as well as an undervalued exchange rate, simply because it is unlikely to be as effective at this
juncture. He also cautioned against picking a particular sector such as manufacturing for encouragement, simply because it has worked well for China.

Emphasizing on the topic of Make for India, Dr. Rajan noted that we have to work on creating the strongest sustainable unified market we can, which requires a reduction in the transactions costs of buying and selling throughout the country. A well designed GST bill, by reducing state border taxes, will have the important consequence of creating a truly national market for goods and services, which will be critical for growth in years to come. Domestic demand has to be financed responsibly, as far as possible through domestic savings. Our banking system is undergoing some stress. Our banks have to learn from past mistakes in project evaluation and structuring as they finance the immense needs of the economy. They will also have to improve their efficiency as they compete with new players such as the recently licensed universal banks as well as the soon-to-be licensed payment banks and small finance banks. He also noted that we have to work on spreading financial services to the excluded, for once they learn how to manage finances and save they can be relied on to borrow responsibly.

Dr. Rajan also spoke about ensuring transparency and stability of the economy. A sound fiscal framework around a clear fiscal consolidation path is critical. On the monetary side, a central bank focused primarily on keeping inflation low and stable, will ensure the best conditions for growth. In addition to inflation, however, a central bank has to pay attention to financial stability. This is a secondary objective, but it may become central if the economy enters a low-inflation credit and asset price boom.

As a country that does not belong to any power block, and that does not export vital natural resources but is dependent on substantial commodity imports, India needs an open, competitive and vibrant system of international trade and finance. India needs strong independent multilateral institutions that can play the role of impartial arbiter in facilitating international economic transactions. Unfortunately, the international monetary system is still dominated by the frameworks put in place in the past by industrial countries, and its governance is still dominated by their citizens. To be fair, it is changing, albeit slowly. But there is a more immediate reason for faster change. The multilateral governance system, still dominated by industrial countries, may not provide a sufficient defense of openness. Emerging markets may therefore have the responsibility of keeping the global economy open.

Dr. Rajan concluded his speech by noting that India is more dependent on the global economy than obvious and the fact that it is growing more slowly, and is more inward looking, than in the past, means that India has to look to regional and domestic demand for its growth - to make in India primarily for India. Domestic-demand-led growth is notoriously difficult to manage, and typically leads to excess which is why domestic macroeconomic institutions have to be strengthened to foster sustainable and stable growth. India has to take up the fight for an open global system. Rather than being reactive, it has to be active in setting the agenda which requires investment in idea-producing institutions research departments of official bodies, think tanks, as well as universities.

Source: www.rbi.org.in
Addressing the third Dr. Verghese Kurien Lecture at IRMA, Dr. Raghuram G. Rajan discussed the state of India's system of credit, focusing on the problem of debt contract being continuously eroded in India in recent years, not by small borrowers but by the large borrowers. According to him, this needs to change in order to get banks to finance the enormous infrastructure needs and industrial growth that the country aims to attain. The reality is that too many large borrowers see the lender, typically a bank, as holding not a senior debt claim that overrides all other claims when the borrower gets into trouble, but a claim junior to his equity claim. Talking on the risk aspect in business, he said that an economy where there is no default is an economy where promoters and banks are taking too little risk. He also warned against the uneven sharing of risk and returns in enterprise, against all contractual norms established the world over - where promoters have a class of 'super' equity which retains all the upside in good times and very little of the downside in bad times, while creditors, typically public sector banks, hold 'junior' debt and get none of the fat returns in good times while absorbing much of the losses in bad times. This state of affairs is mainly because the system protects the large borrower and his right to stay in control. In spite of setting up of Debts Recovery Tribunals (DRTs), the amount banks recover from defaulted debt is both meager and long delayed. Faced with this asymmetry of power, banks are tempted to cave in and take the unfair deal the borrower offers. The bank's debt becomes junior debt and the promoter's equity becomes super equity.

Emphasizing on the sharing of losses stemming from business risk, he said that one consequence of skewed and unfair sharing is to make credit costlier and less available. The promoter who misuses the system ensures that banks then charge a premium for business loans. A second consequence is that the law becomes more draconian in an attempt to force payment. The SARFAESI Act of 2002 which by the standards of most countries is very pro-creditor; was probably an attempt by legislators to reduce the burden on DRTs and force promoters to pay. A final consequence of the inequitable sharing of losses in distress is that it brings the whole free enterprise system into disrepute. While some businessmen enjoy a privileged existence, risking other people's money but never their own, the public and their representatives suffer.

On account of the above, there is a need to achieve a more balanced system. This can be done through better capital structures and by encouraging more institutional investors, who have the wherewithal to monitor promoters, to bring equity capital into projects. Secondly, banks need to react more quickly and in a concerted way to borrower distress. In this regard, the RBI has mandated the
formation of a Joint Lending Forum (JLF) of lenders to deal with the distressed enterprise quickly, with options ranging from liquidation to restructuring and thus coordinating lenders and preventing the borrower from playing one off against the other. Third, the government's plan to expand the number of DRTs and Debt Recovery Appellate Tribunals (DRATs), and make it effective through expansion in facilities, trained personnel, and electronic filing and tracking of cases, as suggested by the Supreme Court. Further, the system also needs professional turn-around agents, such as Asset Reconstruction Companies (ARCs), who can step in the place of promoters and generate value to repay the debts. The government is working on a new bankruptcy law, which is very much needed. Properly structured, this will help bring clarity, predictability, and fairness to the restructuring process.

Concluding his speech, Dr. Raghuram G. Rajan said that the solution is not more draconian laws, but a rather timely and fair application of current laws. Second, is a need for new institutions such as bankruptcy courts and turn-around agents. Lastly, a change in mind set, where the defaulter is not lionized as a captain of industry, but justly chastised as a freeloader on the hardworking people of the country.

Source: www.rbi.org.in
Capital serves as a shock absorber for losses. As long as the banks are wise in identifying projects that have a positive net present value, and as long as asset quality is properly assessed and maintained this activity should contribute to economic growth. Banks are unusually highly leveraged relative to non-financial corporations. Hence insufficient capital could lead to too much risk-taking, with risks shifted to bondholders and depositors. Capital is a means to help internalise externalities related to systemic risk and helps with a number of incentive problems by reducing the imbalance, from the manager’s point of view, between upside and downside risks. Most importantly, bank capital can compensate for the moral hazard coming from deposit insurance or “too big to fail”. To perform all of these tasks effectively, the risk weights in the capital framework need to be proportionate to risks. They need to be calibrated so as to ensure that banks manage their risks rationally and allow for model uncertainty and estimation errors. To achieve that, supervisors and risk managers need to understand the limitations of human knowledge and recognise that, even with state of the art risk management systems, some risks can’t be fully measured and internalised. When the banks actually started suffering losses, markets quickly lost confidence in the banks because, even though their total capital ratios appeared to be strong, their common equity cushions were weak. For this reason, the riskweighted ratios in Basel III are formulated primarily in terms of common equity.

The main concern often expressed is that higher capital requirements increase borrowers’ funding costs and that this will reduce investment and growth. The transition to more and better capital could amplify this funding cost channel by forcing banks which are unable to raise capital from profits or external issuance to restrain lending and/or sell assets rapidly, which could be destabilising. Corporations (and not just banks) are always reluctant to issue new equity, because this tends to drive down the value of existing shares. Banks tend to be even less willing than other corporations to issue new shares. They’re also reluctant to cut dividends. So they may find that selling assets, or slowing asset growth as they build up capital through retained earnings, is the easiest path to increase their capital ratios. It’s been a few years now since the basic outlines of Basel III were agreed. If banks tighten standards, or widen their lending spreads, thereby cutting into investment and growth, this could have negative real effects. If banks choose to reduce dividend payouts or issue new equity, this would minimise the real economy impact.

Task force members of a Basel Committee determined that the main costs would be wider lending spreads, they then compared the cost of this, in terms of lower investment and GDP, to the benefits in terms of reduced GDP losses in the future due to a lower frequency and impact of financial crisis. This calculation depends on what one assumes about the cost of financial crisis in particular, whether they have a permanent, long-term effect on output, or whether output eventually recovers to its pre-crisis trend. The discussion has assumed added relevance as regulators look at additional ways to ensure that, in the event of resolution, global

systemically important banks have sufficient loss-absorbing capacity to implement an orderly resolution that mitigates risks to financial stability, ensures continuity of critical functions and minimizes taxpayers' exposures to losses. There were points during the crisis when policymakers were reluctant to impose haircuts on bondholders of failed or failing banks, for fear that this would be a source of contagion to other weak banks. This approach may have been called for at the time, given crisis conditions, but it generates moral hazard. For this reason, work to strengthen resolution frameworks since the crisis, including the FSB’s Key Attributes of Effective Resolution Regimes for Financial Institutions and the resolution frameworks developed by the EU and a number of other jurisdictions, has emphasised the bailing-in of bank bondholders in resolution.

The speaker summarized with remarks about the transformation of leverage and the need to broaden our attention to these new developments.

Bank capital ratios have improved steadily since the crisis. Banks have achieved this primarily by accumulating retained earnings. The material negative impacts that some feared for the real economy and financial system have not materialised. Banks' returns on equity have fallen with lower leverage and lower risk-free rates. Banks should be able to achieve this comfortably as long as they have enough time to implement the new requirements. Details and proper calibration are important and will be based on the ongoing consultations and data collection.

Jamie Caruana concluded by briefly pointing out some areas outside banking where leverage is growing and may be giving rise to systemic risks which may affect banks even if the origin of the distress is not banking. He also briefly pointed out some other areas of concern such as the steady growth of global corporate bond issuance, particularly, the high-yield segment, most of which has been utilized for share buybacks; in other words, simply an increase in corporate leverage. Increased corporate debt issuance has properly focused attention on global investment funds and their managers. While the funds themselves are generally not highly leveraged, they may exhibit “leverage-like” behaviour in some circumstances. In the end he underlined that financial stability will continue to require attention that goes beyond banking.

Source: www.bis.org