Questions and Answers

Following the formal presentation, Dr. Reddy took questions from the audience.

GUILLERMO ORTIZ: Well, thank you very much, Dr. Reddy. I'm sure that the audience is not disappointed at your incredible breadth and insight that you have brought into this lecture. Let me just make a brief comment, and I think a central point that you made, which is the question of whether there is too much finance or too little finance, and the implications for regulation.

I think that you have pretty much correctly pointed out that there should be a kind of a threshold or a limit of financial development or financial deepening, if you want to call it that. It's pretty clear what's going on today in the two worlds, in the developed world where perhaps the expansion of financial capacity went on for too long and that translated, of course, into financial innovation and so on and so forth, and huge financial institutions that eventually got the world in a lot of trouble—not only the institutions, but also, I think it was a failure of regulators, rating agencies, everything that you know—and then you have the world of emerging markets where you have almost 2.7 billion people in the world outside of financial services where financial inclusion is, I would say, the centerpiece of economic policy in many of these countries. And luckily now with the adoption of new technologies and so on, that is to be facilitated.

But then in going back to the regulation part, you have to have a balance in these, because most of the regulation that has been put in place regards precisely the excesses of financial development, financial innovation, how do you reduce systemic risk, and so on and so forth, and too little attention has been paid to the other side of the question, the basic fundamental question: How does finance contribute to the economic world and to economic development? And until we get these two things together—I think the subject of the next panel is what society expects

from the financial sector, how to regain trust in the financial sector—it would be very difficult to point out.

So let me finish here and just use my privilege of the chair and ask you a brief question, the first one: You seem to be charging central banks with a lot of responsibilities. I think that central bankers here are already pretty overwhelmed about all the world that's falling on their shoulders, and on top of that you also say that central banks have to play a role in restoring confidence in the financial sector. But then you do specifically talk about consumer protection and central banks, and this is a subject that I think there's a lot of different views on here.

So how do you view the role of central banks in terms, not only of regaining the trust of society, but specifically, should consumer protection be a part of the central bank function? Or should it be a separate entity with some sort of connection to the central bank, and so on? And of course it has to do with new products and the assessment of financial innovation, so should that also be part of the responsibility of the central bank?

Y. V. REDDY: Thank you very much. I think even in India, this whole issue of competition and consumer protection in the financial sector is debated. As we know from experience, the practices vary. Some countries have separate consumer protection agencies, and some countries continue to have consumer protection as part of the banking regulation. So, I think the practices vary, and there is no universal rule on that.

In terms of functioning of the central banks, my submission is that if we look back before the crisis, we have been told to look after only price stability. However, as it turned out, the totality of stability in the financial sector had to be managed by the central banks, because the central bank is the lender of last resort.

So, in a way, therefore, the central bank's role in this regard is like the default option. When the society doesn't find anybody specifically responsible for a particular item in the financial sector, it tends to place it at the door of the central bank. So that's why I would say that society's trust in the financial sector rests with the central bank, because there's nobody else who has generally been kept in charge. One institution which is central to financial stability is the central bank, and central banks generally command public trust also. Financial stability has two dimensions: financial stability in terms of systemic stability, and financial stability in terms of extending the financial services widely and getting or maintaining the trust and confidence of the society.

I would say that the maintenance of trust and confidence becomes a subtheme of financial stability if you define financial stability in a broader fashion.

Yes, it is a wide mandate, but when we did not have a wide mandate and when we looked only at price stability, we ended up with a problem. So a wide mandate is part of life, I suppose, especially when there is nobody else in charge. Nature abhors a vacuum, as you know.

GUILLERMO ORTIZ: Thank you, Dr. Reddy. So let me open this to the floor for questions. Maybe we should pick up two or three and then have Dr. Reddy answer them. Please.

QUESTIONER: *Thank you, first of all, for an excellent presentation, Dr. Reddy. My question relates to an area that you covered very aptly. I agree fully that the authority and the powerful rating agencies have elevated themselves into an era that is very important for influencing the banking sector. They're also the only agencies that are not regulated.*

How would you propose that accountability be set for these rating agencies and the business groups that they're intertwined with? And how would you set up a regulatory framework so that they may be regulated themselves?

GUILLERMO ORTIZ: Thank you. Please.

QUESTIONER: *First, thank you very much, Y. V., for such a wide-ranging and insightful presentation. Obviously, a lot has gone wrong in the financial sector in the last several years, and you referred to the excessive financialization and various other aspects. Faced with those kinds of failures, there are essentially two differentiated conceptual responses. One is to say, let's try and make markets work better and rely on markets as the best mechanism there is for effective regulation, competition, allocation of resources, and to deal with the problems that have arisen as a result of market failures. Another is to say, this is an area in which the market never will work perfectly and therefore we need regulation in order to suppress market forces or to supplant market forces.*

Given that kind of optic, what would you consider to be the most appropriate way of dealing with these problems that have arisen? How far is regulation, in your view, there to supplant market practices that will never reform and how far should it be used to strengthen market functioning?

GUILLERMO ORTIZ: Thank you. Perhaps take a last question. Please.

QUESTIONER: *Thank you. Sir, you did mention that some of the macro regulations, such as risk weights, do have a redistributive power, therefore inviting some lobbying pressures. My question is, Should the responsibility for redistribution or redistributive policies rest with the central banks or with elected fiscal authorities? And do you think that taking too much of redistributed power will put in danger the central bank's independence?*

Y. V. REDDY: Thank you. Thank you very much. On the issue of rating agencies, the basic point I would submit is that, to the extent regulators are using rating in their regulation, they have a responsibility to ensure that the rating agencies are functioning effectively by including, if necessary, monitoring of matters related to governance in their operations.

You have two types of rating agencies which are relevant to the regulators, namely, national rating agencies and international rating agencies. But as long as the regulator is using rating by an agency for the purpose of regulation, the rating agency becomes, though indirectly, an official agent of the regulator, and the regulator cannot disclaim responsibility for the failures of the rating agency. That is my limited point. The agent, namely, the rating agency, should be continuously monitored by the regulator, taking some responsibility for the conduct of the rating agencies.

If the regulators are not using the rating by the agencies, it is different, but regulators are using the rating for a variety of purposes, whether it is risk assessment or whether it is for permitting investments.

Second, the questioner has raised a very interesting issue about the markets and regulation. My submission is that traditionally we have focussed on state versus market, but actually the issue is a lot more about the relationship between the state and the market. That has come to the fore during the crisis. It is not that the state always functions in a particular manner, or that markets always function in a particular manner. So the relationship between the state and markets has become more important in determining the ideal mix of relative roles of the state and market.

In the financial sector, in particular, there are two types of relations: one is the relationship between the state and the market, and the other is the relationship between the real sector and financial sector. So we may have to slightly restate the current debate: in regard to financial markets, some regulation is required. If some regulation is required, the issue is how to make the relationship between regulation and markets or the balance as well as the relationship optimal. Let me put it this way. The issue is not only a continuous view of the balance between state and market in finance, but a continuous view of the balance in the context of the rela-

tionship between the real and financial sectors. That is the only submission I am making.

The third, with regard to redistributive policies, the questioner's statement is absolutely right. There is no question about the redistributive policies being ultimately a fiscal responsibility. It is not a monetary responsibility. But if the financial sector regulation itself is generating redistributive forces, one cannot be indifferent. For instance, if you get a semimonopoly for certain financial services and those services are being provided at an exorbitant cost for poorer people, it is a matter of concern for regulation. The regulator who has licensed these institutions cannot disclaim responsibility. I would like to repeat: inclusive finance is not there to subsidize credit for some; inclusive finance is not at the cost of prudence; inclusive finance is not simply provision of credit; inclusive finance means that the regulator takes responsibility for ensuring that the services are available at an affordable price for all. What is advocated is inclusive finance, not subsidized finance.

GUILLERMO ORTIZ: Well, thank you very much, Dr. Reddy. Let me bring this session to a close and thank the audience and thank Dr. Reddy for his wonderful lecture.

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