

INDIA'S EXPERIENCE OF THE CRISIS AND KEY LESSONS

Indira Rajaraman



The North-South Institute
L'Institut Nord-Sud

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GLOBALIZATION

Over the past three decades, the international policy establishment has urged developing countries to lift all borders with respect to flows of goods (real borders) and flows of financial capital (financial borders). It was promised that unilateral adoption would bring advantages, even without reciprocity. The intellectual structure of globalisation was projected as fully thought through.

This paper focuses in particular on the message to developing countries to open their financial borders to international capital. India followed this prescription, starting with the reform of the economy in 1991. It first deals with the monotonicity corollary that went with this injunction: the only permissible direction for the capital account regime was towards liberalisation, without reversals of even a temporary kind along the way to cope with inward or outward surges. The impossible trinity—whereby it is deemed impossible to have a stable exchange rate; free capital movement (absence of capital controls); and an independent monetary policy all at the same time—was recognised, but developing countries were denied the option of resolving this through temporary cessations of free capital flows, once that freedom had been put in place. The year 2010 was a watershed, marking a major change in the international stance on the temporary imposition of capital controls, but until then, any country mindful of its international reputation could not flout the rules. India abided by them, although there were countries that did not.

The paper next looks at policy instructions to developing countries in the aftermath of the East Asia crisis of 1997. Transparency in macroeconomic policy was identified as a necessary preventive to such crises. Fiscal transparency is atheoretic, and therefore encountered no definitional obstacles, finding widespread support among both market-friendly reformers and supporters of the role of the state. Monetary policy, on the other hand, relies on the control of levers affecting private market players. What should be revealed therefore became subject to theorising on the reactions of market players to information. As such, the very definition of monetary policy transparency reflected the modelling of the macroeconomic system. This paper covers the manner in which monetary policy transparency was defined, and the constraints this posed to the sanctioned role of central banks.

The next section deals with the manner in which the Reserve Bank of India

(RBI) coped with a capital inflow surge into India during the pre-crisis period 2004–8. India did not flout the ban on the temporary imposition of capital controls, but instead engaged in the sterilised purchase of dollars to hold down the appreciation pressure on the Indian rupee, so flouting the received definition of monetary policy transparency dictated by stylised models. Thanks to this, India met the crisis of 2008 with a buoyant export sector and a sizeable reserve at end-August 2008 of US\$295 billion (23.5 % of gross domestic product—GDP).

Next, the paper discusses the manner in which the RBI, in its role as banking regulator, handled the housing bubble which was a concomitant of the capital inflow surge. This section also looks at a corollary of the transparency requirement, that public ownership of commercial banks was in itself a violation of transparency. India and China are the two major countries with a sizeable state-owned banking sector.

The paper then goes on to conclude with lessons from the narrative of the preceding sections.

THE MONOTONICITY CONSTRAINT

The imposition of (renewed) controls in countries which had previously liberalised their capital account regimes should perhaps more correctly be termed “capital regulation” or “capital management”, but the term “capital controls” is still used, and much of the opposition to it happened when it had that name. So this latter term is used here in relation to going into reverse gear on capital account liberalisation.

The change in the international stance on capital controls in 2010 was marked by the G20 communiqué after the Seoul Summit in November 2010, and the statement by the managing director of the International Monetary Fund (IMF) at the Shanghai meeting in October of that year, both of which endorsed capital account management among permissible “carefully designed macro-prudential measures”. These are big signals, even if they merely mark recognition of what countries facing the newest round of capital surge that started in mid-2009 had been doing anyway, starting with the temporary tax on short-term capital inflows imposed by Brazil.¹

Prior to 2010, for a period of 12 long years, capital controls met with outright hostility and condemnation, dating back to 1 September 1998, when Malaysia imposed capital controls in what had been the most famously

¹ Ocampo 2010 speaks of the “pronounced swing of opinion against unfettered capital account liberalization which has occurred among a majority of academic economists”.

free capital account regime in the developing world. A fuller description of this episode can be found in Rajaraman (2003). Malaysia had gained current account convertibility status under Article 8 of the IMF's Articles of Agreement in November 1968. Subsequently, the Malaysian ringgit went into a full float, along with the dollar, pound and yen, right from 1973.

That record of early commitment to borderless capital flows was reversed abruptly in 1998. It was not as though the temporary imposition of capital controls was previously unknown: Colombia had imposed unremunerated reserve requirements (URRs) on capital inflows between 1993 and 2000, and even Malaysia temporarily restricted an inflow surge in 1994. The difference was that those were controls on entry, whereas the 1998 Malaysian move controlled exit. This was immediately condemned as an egregious abuse of sovereign power and a violation of international trust. But what Malaysia did was not extreme. It was a carefully calibrated move designed to give Malaysia the space to lower interest rates without precipitating an outward stampede of capital. For non-resident capital, there was no ban on taking out profits and interest; it was only the principal that was incarcerated within the country. After six months, the ban was converted to an exit levy, and after another six months the levy was reduced to 10 percent on capital gains alone, later further reduced to a levy on capital gains only on capital that had been in the country less than a year. By May 2001, all controls had been fully lifted (although controls on exit of resident capital were retained for a longer period).²

This was not a story of irresponsible monetary policy: it enabled Malaysia to recover from the East Asian crisis with far less macroeconomic pain than other countries in the region. And it was clear that Bank Negara was continually calibrating controls to the need of the hour, and removing them when they were no longer required.

The international reaction was swift and broadbanded, condemning all controls of any kind on foreign capital, at the point of entry or exit. To the basic lesson for developing countries that capital account liberalisation gave access to capital at a lower cost and was therefore good for them was added a corollary, that such liberalisation must be monotonic at all times. There was no formal justification for this requirement, and also no empirical support. And meanwhile, Malaysia offered a clear case of a country that had worked its way out of the East Asian crisis by disregarding monotonicity.

Any country worried about its international reputation was compelled

² Bank Negara, the Malaysian central bank, also introduced a number of institutional measures to insulate the country on a long-term basis from recurrences of external volatility (Rajaraman, 2003).

to abide by these rules. Thus it was that, when capital inflows into India quadrupled over the period 2004–8, regulating the inflow of capital was not seen as an option.³ The RBI had to use such instruments as were available to stop the exchange rate from appreciating wildly as it would have done if the dollars surging in had not been added to official reserves, and to sterilise the rupee inflow from the continued dollar purchase. This task was managed well, albeit at a huge fiscal cost. What also helped was the RBI using its role as a banking regulator to prick a potential asset bubble in its infancy.

Two countries did dare to flout the rules, even after the post-East Asian crisis ban. Colombia re-imposed URRs on inflows in 2007, and Thailand imposed a URR along with a number of other measures in 2006. A recent paper (Gallagher and Coelho, 2010) assesses these actions for their effectiveness, set against the background of a panel of neighbouring countries in each case. Generalisable empirical results are intrinsically difficult to establish, since the kinds of capital control used, their timing and their duration all matter critically for the success of the initiative. An earlier review (Magud and Reinhart, 2006) provided a useful survey of findings on capital controls in the 1990s, and a few cases in the 1980s. Temporary restrictions have been found, with variations in success by country and episode, to enable monetary policy autonomy, control the composition of inflows in desired directions, help stabilise the exchange rate and regulate the pace of inflows.⁴

STYLISTED MONETARY POLICY MODELS⁵

This section deals with received models of monetary policy transparency, and why they do such a disservice in guiding central banks facing a capital inflow surge.

Based on standard stylised models, monetary policy transparency has been equated to credible prior disclosure of an inflation target in the market for goods and services (Geraats, 2002). There is a Geraats transparency index which rates central banks on a scale of 0–15, using which Dincer and

³ See Nachane (2010) for an excellent account of the Indian failure to use capital controls. One study (Balin, 2008) sees some of the instruments adopted, such as intervention to prevent the appreciation of the rupee, altering permissible maturities in debt inflows and tightening some institutional regulations governing portfolio inflows as tantamount to capital controls. None of them directly obstructed the volume of inflow, except for the last, which had a regulatory rather than an obstructive intent.

⁴ Gallagher and Coelho (2010) found somewhat more modest gains from the URRs imposed in Colombia and Thailand during the 2006–7 period.

⁵ This section reproduces portions of Rajaraman (2010).

Eichengreen (2009) assign transparency scores to 100 central banks, for each year of the eight-year period 1998–2006. The average score rose from 3.4 in 1998 to 5.4 in 2006. The RBI scored 2 in 1998 and stayed there—one of the lowest scores in the whole set and the lowest in South Asia. From the previous section, it is clear that the very reason for the low rating of the RBI on the Geraats index is what saw the country through the years leading up to and after the crisis.

In the model outlined below, when inflationary expectations are set by a credible central bank inflation target commitment, the policy rate of interest is free to target adjustments to supply and demand shocks to the system, and therefore reduce output volatility. Transparency so defined was therefore justified as an enabler of macroeconomic stability.

The central bank maximises the objective function:

$$W = -\frac{1}{2}\alpha (\pi - \tau)^2 - \frac{1}{2}(1 - \alpha) (y - \kappa)^2$$

Inflation target : τ (actual inflation is π)

Output gap target : κ (actual output gap is y)

The actual output gap y is impacted by the rate of interest, r , and unanticipated demand shocks, d , thus:

$$y = -r + d$$

The economy is defined by the following expectations-augmented Phillips equation, which accommodates unanticipated supply shocks, s , thus:

$$\pi = \pi^e + y + s$$

Credible inflation target: π^e

The optimal (policy) rate of interest in such a system will be given by the first order condition for maximisation of the objective function W of the central bank with respect to r , thus (given π^e):

$$r = \alpha (\pi^e - \tau) - (1 - \alpha) \kappa + \alpha s + d$$

If there is a credible inflation target to which inflationary expectations in the economy are equated, so that the first term in the above equation disappears, this leaves (for unchanged output targets) a rate of interest that needs to be changed only for adjustment to unanticipated supply and demand shocks.

The model has severe limitations. The exogenous shocks are all real shocks, and inflation stability refers uniquely to prices of real goods and services. Exogenous financial shocks do not have any play. A capital inflow surge is

an example of the kind of exogenous financial shock that could destabilise the real system in a world of free capital flows. In the face of such a surge, a single-minded focus on stable (inflation in) prices of goods and services could lead to disastrous volatility in another price, the exchange rate of the domestic currency.

The model assumes friction-free market correction. An exchange appreciation spike would lead to a follow-on negative real (external) demand shock, which will be endogenous to policy pursuit of the inflation target. In a friction-free world, the directionality of correction would be perfectly aligned with what it should be to restore the system to the pre-surge equilibrium. The interest rate will be lowered to correct the negative external demand shock, and will reinforce the exchange rate appreciation to choke off the capital inflow surge which caused the problem in the first place.

But the world as we know it is not free of friction. This process of adjustment will not be instantaneous. Ruptured links between exporters and buyers are not easily restored, and could lead to a long-term demand shock which will not be corrected with lower interest rates. The risk is a function of the concentration of products and destinations in the export basket; the importance of exports in aggregate demand; and whether the export production vector is aligned with the domestic demand vector. Developing countries are in general far more vulnerable than developed countries on all three counts.

Single-minded pursuit of price stability would thus result in disastrous instability, both real and financial. Large-scale defaults by exporters, following from exchange rate appreciation, could seriously destabilise the banking system. The comparative statics of stylised models do not factor in the time intervals between equilibria and the economic (and follow-on political) turbulence during such intervals.

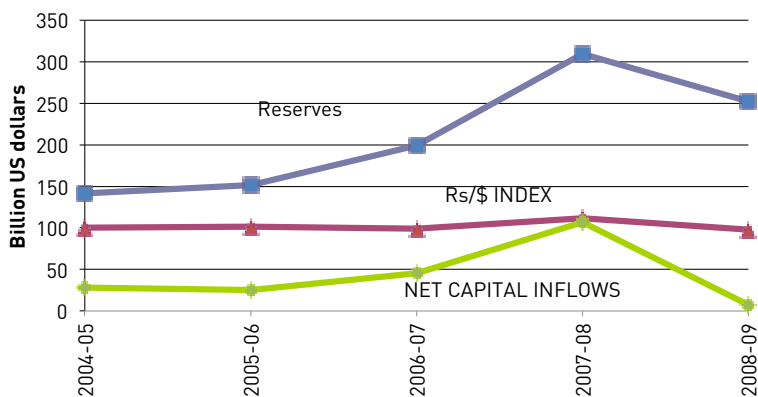
This is an example of a rating index gone astray. The index rewards:

- Prior commitment to a preferably single objective like price stability, when what is needed is macroeconomic stability, whereby the components of that objective are not possible to prioritise independently of context;
- Rigidity in adherence to objectives, when flexibility is needed to respond to unforeseen eventualities as developing countries open up; and
- Predictability in central bank actions, and full exposure of the basis for those actions, which denies discretionary actions towards ensuring real and financial stability.

THE INDIAN CAPITAL INFLOW SURGE 2004–8

Indian capital inflows quadrupled over the period 2004–8. In 2007–8 alone, net capital inflows amounted to US\$108 billion (9.2 % of GDP), at a time when the current account deficit amounted to only US\$17 billion (1.5 % of GDP). Given the international policy establishment ban on any re-imposition of barriers to the free movement of capital once these had been lifted, India was compelled to cope with the flow with such policy instruments as it had in hand. There was heavy appreciation pressure on the Indian currency, which the RBI resisted through the sterilised purchase of dollars. Figure 1 illustrates the policy followed.

Figure 1: Net capital inflows, external reserves and exchange rates to the US dollar in India, 2004-2009



Source: RBI Bulletin (assorted issues).

The need for sterilisation outpaced the RBI's holdings of government securities, and a new scheme had to be invented, named the Market Stabilisation Scheme (MSS), whereby borrowing instruments in a range of maturities were issued and the proceeds sequestered in a separate cash account. These receipts were not available to fund any government expenditure, other than repayment of the securities issued. However, interest payable on these MSS bonds did add to the fiscal expenditure of the government. Table 1 shows the magnitude of issuance of these bonds. At its peak, at the end of the fiscal year 2007–8 (end-March), the stock of MSS bonds amounted to 3.42 percent of GDP. The corresponding interest bill is not directly reported, since total interest paid by the government on its liabilities is not broken down by its constituents. But inferred from the share of MSS bonds of total

domestic market debt, at the 2007–8 peak, 9.43 percent of the interest bill on domestic market debt went towards interest on these sterilisation bonds. The cost of stabilisation went beyond the interest payable on MSS bonds, since the selling pressure raised the interest rate on government securities across the board. Against this, there was the interest earned by the RBI on foreign exchange reserves, which was close to negligible on the form in which they were held, typically US Treasury Bills.

Table 1: Market stabilisation bonds to sterilise a capital inflow surge in India, 2004–09

	2004–5	2005–6	2006–7	2007–8	2008–9
MSS bonds/ domestic market debt (%)	5.03	2.09	4.08	9.43	4.38
MSS bonds/GDP (%)	1.98	0.79	1.47	3.42	1.59

Note: All figures of MSS bonds and domestic debt are stocks at the end of the fiscal year shown. Interest like GDP is a flow figure for the fiscal year. Domestic market debt is called internal debt in Indian documents.

Source: GOI (various years).

The report of a committee constituted to chart the path to financial sector reform in India says: “[...] this Committee believes it is neither possible nor advisable to manage the external value of the rupee”, but goes on to say that, in the face of substantial capital inflows, monetary policy did “strike a balance between managing inflation and stabilising the nominal exchange rate” (GOI, 2009: 28–9).

The test of the success of sterilised intervention in coping with the surge was in the macroeconomic outcomes achieved. Some indicators are shown in Table 2, spanning the two years before and after the global crisis year 2008–9. It can be seen that, after a dip in growth and external reserves in 2008–9, the economy rapidly approached its pre-crisis momentum the very next year.

Table 2: Macroeconomic outcomes in India, 2006–12

	2006–7	2007–8	2008–9	2010–11	2011–12
GDP growth (%)	9.6	9.3	6.8	8.0	8.6
Industrial growth (%)	12.7	10.3	4.7	8.1	8.3
Export US\$ (vol.) growth (%)	22.6	28.9	13.7	(-)-3.6	29.4

Note: All GDP figures are by the new series with base 2004–5; industrial growth is from a grouping of manufacturing, utilities and construction but excludes mining; export growth in 2010–11 covers the period April 2010–January 2011.

Source: GOI (2011), supplemented by CSO (2011). Export data from RBI Bulletin (April 2011).

Table 3: Stimulus measures in India, 2008–11

	Definition	2008–9	2009–10	2010–11
Fiscal stimulus (% GDP)	Actual – target	3.04	3.39	1.69
		1/09/2008– 31/03/2009	FY 2009–10	FY 2010–11
Cash reserve ratio (% demand and time liabilities)	Change	(-) 4.0	(+) 0.75	(+) 0.25
Repo rate (%)	Change	(-) 4.0	0.0	(+) 1.75
Reverse repo rate (%)	Change	(-) 2.5	0.0	(+) 2.25

Note: The fiscal stimulus is calculated as the difference between the actual fiscal deficit and the target of 3 percent of GDP for the final year of the Fiscal Responsibility and Budget Management Act of 2003, as amended in July 2004, extending up to 2008–9. The fiscal deficit target is presumed to have held in the medium term, extending beyond the period of the Act, applicable to 2009–10 and 2010–11.

Source: Fiscal stimulus calculated from GOI Receipts Budget (2011). Monetary policy rates from RBI Bulletin (assorted issues).

The outcome data in Table 2 owed not just to the pre-crisis management of the capital inflow surge, but also to the fiscal and monetary stimuli that were introduced starting from September 2008, the midpoint of fiscal year 2008–9. The stimulus measures are shown in Table 3. It can be seen that the monetary stimulus was decisively unwound in fiscal year 2010–11, as capital inflows began to surge again in the middle of calendar year 2010.

The unwinding of the fiscal stimulus is also visible. The figures in the table pertain to national government. In addition, states' borrowing entitlements, which are controlled at national level, were raised by 0.5% of gross state domestic product (GSDP) in 2008–9, and by +1.0 % of GSDP in 2009–10.

BUBBLES AND REGULATION

A housing bubble built up over the period 2005–8 in India, concomitant with the capital inflow surge. There was huge pressure on the RBI, as the banking regulator, to permit the unfettered growth of securitisation of housing loans, along the lines of the infamous pre-crisis US model. The RBI did not ban the practice, but subjected it to regulations laid down in a document that could serve well as a model for central banks in the rest of the world, for the clarity of its definitions and its prescriptions for the nature of the relationship between the parties to a securitisation transaction.

The document (RBI, 2006) defines a “true sale”, under which no lingering relationship remains between the buyer and the seller. For all transactions where there is a continuing relationship between the two parties to the transaction offering varying degrees of comfort to the buyer, in the form of first and second loss credit enhancement facilities, the originating bank was required to maintain capital against the value of the underlying asset. These were to be deducted from Tier I and Tier II capital of the originating bank, at the amounts the bank would have been required to hold for the full value of the assets, had they not been securitised. Liquidity and underwriting facilities were to be given 100 percent credit conversion and risk weights.

Among other prudential measures, the RBI raised risk weights on commercial real estate loans starting July 2005 in stages, to a peak of 150 percent by May 2006, and provisioning requirements starting May 2006, also in stages. The structuring of these is sufficiently important that Table 4 below displays the distinction made between loans to individual borrowers and to commercial real estate, and how, even as risk weights were high for commercial real estate loans, they were actually dropped for small individual loans and further differentiated by the loan to value (LTV) ratio for them. Both risk weights and provisioning were lowered back to pre-existing levels in November 2008. Commercial banks were further advised to build an Investment Fluctuation Reserve over 2002–7.

The impact of this and of the larger macroeconomic prudential action to fend off exchange rate volatility and secure financial stability taken by the

RBI is evident in the non-performing assets of Indian banks, shown in Figure 2 below.⁶

Table 4: Risk weights on real estate lending and mortgage-backed securities

	Risk weights		Loan loss provisioning	
	Individuals	Commercial real estate	Individuals	Commercial real estate
Before December 2004	50%	100%		
December 2004	75%			
July 2005		125%		
March 2006		(a)		
May 2006		150%	Raised 0.4 to 1.0% (b)	Raised 0.4 to 1.0%
January 2007				Raised to 2.0%
May 2007	50% (b)			
July 2008	50–100 % by LTV (c)			
November 2008		100%	Reduced to 0.4%	Reduced to 0.4%

Note: Prior to May 2002, housing loans to individuals and commercial real estate were assigned risk weights at 100 percent. In May 2002, the risk weight on loans to individuals was dropped to 50 percent, in order to encourage housing finance by banks.

^a Disbursements of approved loans were subject to clearances from all relevant government authorities and statutory agencies for start of construction.

^b These applied to loans with a value of <2 million rupees.

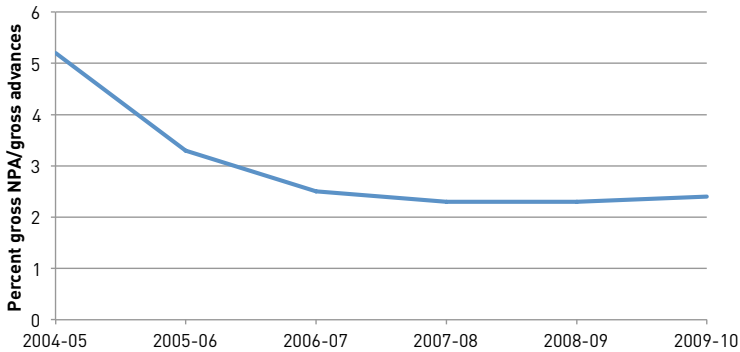
^c Risk weights varied according to whether the LTV ratio was > or <75 percent and whether the value of the loan was < or >30 million rupees.

Source: RBI Bulletin (assorted issues), circulars relating to the housing sector.

India and China are the two major countries where commercial banks are largely state owned, a longstanding ownership pattern which is under attack by the international policy establishment for its supposed lack of transparency. A passage in the report of a major official committee to design the liberalisation of the Indian financial sector reads as follows: “Out of 138 countries only nine had a predominantly state owned banking sector. India and China are in this group [...] No high income country has a state dominated banking sector” (GOI, 2009: 81). The report sees

⁶ See also Kohli (2010) for an endorsement of these actions.

Figure 2: Gross non-performing assets (NPA) to gross advances of commercial banks in India, 2004–10



Source: RBI Report on Trends and Progress of Banking in India (assorted issues).

public sector inefficiency as an inevitable consequence of promotion based on seniority and the inability to fire employees for non-performance. It states: “A majority of this Committee does not see a compelling reason for government ownership” (91). The ineffectiveness of public sector ownership is specifically pinned on the inability to price risk: “Public sector entities do exactly what private sector entities do, though less well because they have more constraints, a poorer skill pool, and poorer incentives [...] the skill deficit will make public sector firms less effective at pricing risk. And the costs will partially have to be borne by the government when the under-priced risk eventually hits public sector balance sheets” (78).

After the crisis of 2008, precipitated by ineffective pricing of risk by privately owned banks in the US, in turn because of the distortion in the incentive structure when employee remuneration is tied to short-term enhancement in shareholder value, this statement has a comical ring. In fairness, the report does commend the performance of the Indian banking sector: “Steady growth has come without significant instability, in contrast to the experience of some other emerging markets. Historically, (Indian) banks have attracted some of the best talent available” (80). A McKinsey survey in 2007 is also cited in the report: “Indian banks have done exceedingly well in providing high returns to shareholders, registering the highest regional growth rate in assets, deposits, and return on equity as well as one of the highest total returns globally” (82).

Although public sector banks in India account for 74 percent of gross assets of commercial banks (at end-March 2010), there are as many as 27 public sector banks, out of a total of 81. The variation within the set of

public sector banks in terms of efficiency is very wide, which in and of itself questions the overwhelming importance given to ownership as an explainer of efficiency. Furthermore, some, though by no means all, public sector banks in India outperform private sector banks, whether domestic or foreign owned (Rajaraman and Vasishtha, 2002). More recently, in a data envelopment analysis, public sector banks were on the efficiency frontier and privately owned banks inside it (RBI, 2006–8). However, a recent paper (Gupta et al., 2011) using bank-level data from 1991–2007 finds that public banks even after liberalisation allocated a larger share of their assets to government securities than did private banks—larger than the statutory minimum—thus establishing that ownership does influence banking behaviour to some degree.

The limited purpose of this section is to sound a cautionary note about predicating financial sector reform on dogma rather than on a considered examination of the empirical evidence. The committee report mentioned above also delineates the directions for reform if a change of ownership is not feasible. Among these, the recommendation that the compensation structure be changed for top executives clearly has a pre-crisis ring.

CONCLUSIONS

The year 2010 has fortunately seen a radical alteration in the international policy establishment stance on temporary impositions of capital controls in countries facing an inward or outward surge. This is a long overdue recognition that granting countries autonomy in dealing with surges can go a long way towards reconciling the impossible trinity. Clearly, the success of capital management interventions will be a function of their timing, nature and duration. But equally clearly, the central bank of a country, which is ultimately accountable for its actions, is best positioned to take a call on when and how much to intervene, in place of an externally imposed condemnation of such actions.

The purpose of the focus on the policy response to a particular episode of capital inflow surge in India in the years leading up to 2008 is not to defend the particular choices made, but to highlight the practical policy imperative to factor in costs of adjustment between comparative static equilibria in stylised models. A narrow-focus watch by a developing country central bank on prices in the market for goods and services alone, and not in any other markets, can be devastating where the exchange rate of the domestic currency in international markets is an all-important price. The exchange rate in such countries, especially those with a small domestic

market, underpins domestic inflation, growth and financial stability. In particular situations, the central bank may choose to limit itself to a watch on prices in the market for goods and services, but this limitation should be a choice rather than a compulsion. Most of all, the compulsion should not be dictated by the desire to do well on a misguided international monetary policy transparency rating.

The lessons from the Indian episode detailed in the paper are essentially three.

First, macroeconomic policy transparency remains paramount, but it cannot be equated to rigidity in central bank targets and instruments. Outcomes are what determine the credibility of a central bank, not prior straitjackets adopted. The reputation of a central bank for delivering financial stability is what the international policy establishment should ultimately be interested in. Transparent functioning of a central bank should be redefined to permit flexible responses to unforeseen eventualities and the use of any discretionary actions needed to ensure real and financial stability. It should permit the full range of supervisory discretion under Pillar 2 of Basel II and at the same time require full disclosure of sales and purchases by the central bank in securities and exchange markets and full disclosure of policy decisions, with effective dates, and pre-announced finite, or indefinite, durations.

Second, macro-prudential regulation is as important for financial stability as narrow-focus micro-prudential regulation.

Third, the episode highlights the need to recognise that allowing policy competition will bring to the fore the best and most prudent ideas on financial sector regulation. It is best if the regulator in each country which is vested with the task of ensuring the soundness of banks is left free to permit or obstruct the introduction in developing country markets of financial innovations originating in developed country markets. The independent path charted by the RBI in India, which is also the banking regulator, on regulation of the market for securitised housing loans, and on sector-specific risk weights and provisioning, affords an admirable example of fruitful resistance to international fashions in risk taking and innovation. As a corollary, it is important not to enforce international conformity to a single regulatory template, for example separation of banking regulation from the role of the central bank as lender of last resort. Here again, each country should be free to chart its own path. What matters ultimately is effective regulation of the banking sector, not where regulation is vested.

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