The Other Side December 05, 2013

The Alchemist

Alchemy, the art of converting base metals into gold, has fascinated many civilizations. The Greeks had King Midas: anything he touched turned into gold. (There is a parallel in Hindu mythology as well.) And, even Sir.Isaac Newton, the discoverer of the law of universal gravitation, and arguably one of the two or three greatest mathematicians ever, spent a huge amount of time and effort in trying to discover the art. In modern economics, central bankers are alchemists, converting paper into precious metals or money. Remember the *mantra* signed by the Governor on our currency notes: "I promise to pay the bearer the sum of rupees……"? At one point of time, this literally meant the promise to convert currency notes into silver rupees. Today, if you go to the Reserve Bank to demand such a conversion, you would be thrown out! To be sure, alchemy is not quite dead – if one goes by the popularity of bitcoins.

The book on central bankers I am presently reading is *The Alchemists: Inside the Secret World of Central Bankers* by Neil Irwin (2013). The book reminds me of two earlier books I read some time back: *Secrets of the Temple: How the Federal Reserve Runs the Country* by William Grieder (1987); and *Lords of Finance: The Bankers who Broke the World* by Liaquat Ahamed (2009). Has our new Governor, Dr.Raghuram Rajan, attained the status of the alchemist, in the eyes of the markets, the media and even respected academics?

Consider some evidence:

⇒ He has calmed down the currency market more than once by half an hour press conferences – and some direct and indirect intervention;

⇒ In 45 years of regular reading of London's Financial Times, the first time I remember seeing the photograph of an Indian central bank governor under a front page banner headline (*Indian central bank chief pledges era of competition*, November 19) is Dr. Rajan's. The next day's editorial heralded *Rajan's Revolution*.

⇒ Prof. Ram Charan, the globally renowned management guru, in an interview (Mint, November 28) listed three reasons why he is bullish on the Indian economy. The first was Dr. Rajan's appointment; the second was the team of Dr.Rajan and the Finance Minister; Indian entrepreneurship was the third! Incidentally, he also believes that India's non-raw material exports (i.e. manufactured, value added goods) should be 40% of GDP: today aggregate exports are barely 24% of GDP.

Recently, Mark Carney, the Governor of the Bank of England, got cheers from the City of London for his defense of and promises of support to the financial sector. This is somewhat strange in the context of the failure of many big UK banks just a few years back: their rescue required a huge amount of public money. (Martin Wolf of the Financial Times described the move as a "*risky bet on big finance*") Governor Rajan has recently announced that should foreign banks form subsidiaries in the country, they would be treated practically on par with domestic banks in terms of freedom to open branches and take over Indian banks.

There is no doubt that Indian banking needs to grow rapidly, not only in terms of coverage but also size: to quote just one number, the commercial credit extended by the Indian banking sector is just 64% of GDP. In most other Asian countries from China to Korea to Malaysia to Thailand it is twice that. The question is whether encouraging foreign banks to form subsidiaries and expand is the optimum way for our banking sector to grow. One's worry arises from the kind of culture prevalent in global banking: manipulating LIBOR; manipulating other benchmark rates; facilitating evasion of taxes; selling complex derivatives; the "obscene bonus culture" (chairman of Barclays Remuneration Committee) that prevails in these banks; etc. To quote just the latest instance, J.P.Morgan was recently penalized to the extent of $ 13 bn for its role in the mortgage securities market. Even in India, most of the banks penalized by the Reserve Bank for regulatory infringements in respect of foreign currency derivatives, were foreign ones. The penalties imposed were, to my mind, ridiculously small. Let alone the

banks, even individual treasury professionals engaged in structuring and marketing the transactions, would have easily afforded the fines without feeling the pinch!

Another instance in India that comes to mind is the so-called “securities market scam” of 1992. My memory is that the large foreign bank at the heart of what was happening in the securities market, escaped unscathed: we were facing a balance of payments crisis, and could not afford to punish a large global bank.

While it is true that the culture of public sector banking needs to be changed, I am not sure whether bringing in the culture of global banks is the optimum way of doing so. In any case, it is difficult to imagine global banks being keen on promoting “inclusive banking”. (Lest we forget, “boring banking” also has its own virtues.) Do we need to learn more from the rising east than the declining west? From Kenya about mobile telephone based banking?

Dr. Rajan chaired a committee on financial sector reforms about five years back. Its strong recommendation was to pluck “low hanging fruits”. To that end, it had made 35 proposals. It will be interesting to see how many of them get implemented during Dr. Rajan’s tenure at the central bank.

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