Regulation: financial and real economies

In a recent article on regulation of the financial sector in this paper, Dr. C. Rangarajan, Chairman, Prime Minister's Economic Advisory Council, argued that "The policy-makers must strike an appropriate balance between the need for financial innovations and the need for regulation to ensure stability." While the point made is unexceptionable, it also raises certain issues. First, apart from stability, the objectives of regulation in general should be the implementation of public policy and protection of the innocent, the unwary, the less knowledgeable. While promotion of financial innovation to make the intermediation between the saver and the borrower more efficient can be regarded as a legitimate objective of public policy, the question is whether the "innovation" of ever more complex products, most of which are completely unnecessary for either hedging price risks, or for efficient financial intermediation, should be considered desirable. Again, if there is a conflict between the public policy of promoting innovation, and financial stability and protection of innocents, what should have priority?

This issue is of great importance principally in relation to financial regulation as distinct from innovations in the real economy. For instance, nobody expects the controller of drugs to have any objective other than the safety and effectiveness of the new molecules; similarly, the regulator of civil aviation would be concerned only with the safety of air travel: we would not expect them to compromise on these objectives to encourage innovations in drug making or aircraft design. Is there a case for treating the financial sector differently? Even if one may not fully agree with the sarcastic comment of Paul Volcker that the only financial innovation to benefit the economy was the ATM, Joseph Stiglitz cannot be faulted for arguing that bankers have been incentivised "not to introduce new products to improve ordinary peoples' lives or to help them manage the risks they faced, but to put the global economy at risk by engaging in short-sighted and greedy behavior. Their innovations focused on circumventing accounting and financial regulations designed to ensure transparency, efficiency, and stability, and to prevent the exploitation of the less informed." ("Borlaug and the Bankers", The Economic Times, October 12, 2009.) After seeing the many complex currency derivatives marketed in India, most imported from foreign markets (not even “innovated” locally), one is convinced that the only purpose of such “innovative products” was to circumvent exchange regulations, to make the pricing and risks as opaque as possible “for exploitation of the less informed”. (The central bank has acknowledged in the Orissa High Court case that many transactions contravened the regulations: something that did not come out during its regular inspections?) The threat to the global economy recently posed by the ever more complex structured credit products is too well-known to be repeated. (Jagdish Bhagwati recently described such financial innovation as “destructive creation” in contrast to Schumpeter’s “creative destruction” in the real economy of capitalism.) Surely the regulator should not permit, or wink at, products which he does not himself fully understand, on the argument of encouraging innovation?

Coming to the real economy, the way the issue of regulatory approval for the Bt brinjal seed was recently handled is nothing short of bizarre. An issue that should have been decided on the basis of scientific evidence was decided on the basis of the reactions in half a dozen meetings the Minister held at different places in the country, meetings in which scientists who had researched the matter were not allowed to participate (Indian Express, February 11, 2010). Surely, public policy requires growth in agricultural output? Surely, the aircraft or drug regulators would not dream of deciding on whether to allow a particular drug or a particular aircraft to be introduced in the country by holding such meetings? The sad part is that the entire political establishment, including the Minister’s boss, have remained totally silent on the whole episode (contrast this with the way the establishment came down on Mr. Tharoor for some light hearted comments “twittered” by him). Surely, political leadership should go beyond bowing before vociferous minorities, should seek to educate the citizens, not always follow the line of least resistance – whether on Bt seeds or the on issue of land for industrialisation?

Monetary policy

One is a bit concerned about one comment in the Third Quarter Review presented by the Governor towards the end of the last month. In paragraph 4, it has been argued that “there is a need to encourage domestic consumption and investment demand.” In terms of the savings investment arithmetic, the only way to encourage both would be to engineer a higher deficit on the current account. In turn, this requires an overvalued exchange rate which may well promote greater consumption of imports, but surely is a deflationary measure which worsens the economics of domestic investment. On the subject of current account deficits, we should also not ignore the caution sounded by Stephen Roach, Chairman, Morgan Stanley Asia, that "the excessive dependence on foreign fund flows is a risk to the domestic economy."

A.V.Rajwade
Email: avrajwade@gmail.com