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For Illiberal Finance: Building Dams, Constructing Conduits

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Finance and Real Development

The context of financial liberalisation in India was the inefficiencies created by the government's control of prices and quantities in the financial markets. One alleged legacy has been the stockpiling of non-performing assets in connection with funds requisitioned for given sectors. Here, as well as elsewhere, more discrimination must be exercised in passing judgment. In Appendix Table III.29 (A) of the *Report on Trend and Progress of Banking in India 2006-2007* by the Reserve Bank of India, 2007, it is stated that non-performing assets of public sector banks are 60 percent in connection with the priority sector, and 40 percent in connection with the non-priority sector. Reform has meant the cautious relaxing of these constraints. The recent worldwide conflagration has brought to the fore the inherent fragility of financially sophisticated economies. The dynamics of modern economies is written by real-financial couplings. Over good times, conservative postures give way to excessive risk-taking. Financial innovations abound, securitisation being a recent illustration. At some time during the euphoric upswing, the correspondence between securities and the underlying assets is called and then a downward cascade results. In the case of developing countries as well, the link between financial liberalisation and crises is quite robust.[1]

The response of societies in history has been twofold. Since banks have been the lynchpin of financial systems anywhere, firewalls were constructed between their different functions. The principle was to protect the items on their balance sheets that pertained to deposit taking and lending for productive purposes from investment activity. Thus, the bulwark of the New Deal Financial Reform in the United States was The Banking Act of 1933. The Glass-Steagall sub-sections separated commercial and investment banking on the sole criterion of systemic stability. The Act was repealed in 1999. The Indian trajectory has not been dissimilar, earmarking financial institutions such as the Industrial Credit and Investment Corporation of India, the Industrial Development Bank of India and others for developmental purposes. In the current dispensation of universal banking, the separation of functions is blurred. Perhaps, as a result, a slight downward trend since 2001-02 is to be found in financial assistance, both

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[1] Arestis, P. and L F de Paula, 2008, Introduction in *Financial Liberalization and Economic Performance in Emerging Countries* (eds) P. Arestis & LF de Paula, New York: Palgrave Macmillan.

sanctioned and disbursed by all financial institutions (Tables 85, *Handbook of Statistics on the Indian Economy*, Reserve Bank of India, 2007).

The second response was to build in macro-economic stabilisers in the form of monetary and fiscal policies. Countries in Asia that grew rapidly and in a broad-based fashion in recent times added direction to macro-economic instruments by indicating the sectors such as exports which should be the attractors of policy. At any rate, the development of financial markets was never regarded as autonomous of the development of commodity and labour markets. The late Professor Sukhamoy Chakravarty, the architect of the Chakravarty Committee *Report* which laid the foundations of monetary planning in India, would have recommended an instrumental approach. In the similar modern language of backward induction, we specify the future states that the economy is expected to achieve and then work towards the present ensemble of institutions that must be constructed to deliver. There can be no question that, for a country with deep and extensive poverty, employment generation must be a fundamental objective.

However, the relationship between financial and real outcomes is less than clear. James Ang, 2008, *Journal of Economic Surveys*, 22, 2, 536-576, summarises the tensions in the econometric evidence. Two theses go back a long way. One is where growth leads, output follows; the other is the finance-leading-growth proposition. When financial development is specified as the dependent variable, some country studies show that economic development positively impacts financial development. Recently, Rajan and Zingales have pioneered panel studies, exploiting firm- or industry-level data. However, the regressions are subject to uncontrolled variable problems or heterogeneity bias. When the unobserved country-specific effects are included in the error term, the result is biased and with inconsistent estimates. Holding country-specific elements constant in panel regressions generates a spurious aggregate relationship as the reported relationship is due to inter-country differences rather than intra-country differences over time.

A conclusion is the danger of cross-country regressions. These studies construct a series by averaging out variables. Grouping countries carries more than the obvious dangers. For instance, when legal and social factors have been controlled for, the positive association between stock markets and growth in some exercises vanishes. Time series studies are no less inconclusive. The limitations here are short series and arbitrary choice of lag lengths. Demetriades and Luintel are pioneers. While they conclude that, in India and Malaysia, financial repression negatively impacted on financial development, the South Korean experience was the opposite. The reason is the solid institutional structures in South Korea. The finance, as engine thesis, finds scant support in Mauritius, Pakistan and Thailand. Instead, financial and real development are joint products. In all instances, the neo-classical impetus for financial opening up finds little support as the effects of real interest rates was insignificant. In a study for India using annual data over the period 1951-1995, financial aggregates are shown to have preceded increases in both investment and growth, while the financial sector has no influence on the total factor productivity of manufacturing industries. Annual data for 10 Asian countries reveal that finance pushes investment. At the same time, the influence of finance on output is weak. The explanation might lie in expectations. If businessmen forecast robust economic performance, they might be tempted into financial services-related investments in anticipation of future returns. Then financial development would be no more than a leading indicator. Granger causality would be a misleading conclusion.

The Dilemma of Regulation

It is well known that, despite over a decade of financial liberalisation, the appetite of the banking sector in India for riskless government paper has remained as strong. Correspondingly, the inducement to support private investment has been weak. The following numbers from Appendix Table 1 of the *Annual Report 2007-08* by the Reserve Bank of India, 2008, only underscore the familiar pattern.

Scheduled Commercial Banks (% change)	2005-06	2006-07	2007-08
Bank Credit	30.8	28.1	22.3
Non-Food Credit	31.8	28.5	23.0
Investments in Government Securities	-2.7	10.7	23.5

The problem is that, even if Indian banks were to be suddenly seized by an inducement to lend to private enterprise brought about, say, by a spate of interesting projects, Basel I and Basel II norms will effectively stymie such a movement.[2] Almost all studies of the micro-effects of bank capital regulation report that the short-run effects are a reduction in individual bank lending and, in models that include endogenous loan-market adjustments, an increase in the equilibrium loan rate. The longer run effects are an increase in bank capital both absolutely and relative to bank lending. The interesting point is that there is no convincing evidence that the imposition of binding risk-based capital requirements contributed significantly to an increase in actual bank capital ratios. Pre- and post-regulation behaviour of banks remained almost the same.

Since the demand for credit and the supply of deposits varies positively with the level of economic activity, bank activity as well tends to be pro-cyclical. Regulation augments the cycle. The supervisory process obliges banks to constrict lending during contractions to protect bank bottom lines from the risks inherent in downturns. During upswings, on the other hand, regulators tend to adopt a laissez-faire attitude. Capital regulation reduces the ability of central banks to influence bank lending. Banks must employ onerous screening standards and, consequently, would be prone to respond to a monetary expansion by boosting deposits and security holdings, thereby operating like mutual funds. In the long run, however, an expansionary monetary policy stance will induce banks to expand equity which, under risk-based capital regulation requirements, would enable bank credit to expand.

Building Dams: Deposit-Creating Institutions

B. Bossone and A. Sarr[3] of the World Bank/IMF have devised a monetary scheme to initiate activity in a non-destabilising fashion in desperately poor economies. The proposal is to construct a firewall between the lending and the deposit-creating functions of banks. Deposit-creating institutions (DCIs) would collect non-interest-bearing deposits and would distribute money on a non-lending basis, that is, with no condition to restitution. Their liabilities would be backed by the central bank's money. Every deposit balance would be augmented by a

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[2] VanHoose, D., 2008, Bank Capital Regulation, Economic Stability, and Monetary Policy: What does the Academic Literature Tell Us? *Atlantic Economic Journal*, 38, 1, 1-14.

[3] Bossone, B. & A. Sarr, 2005, Non-Credit Money to Fight Poverty in *The Monetary Theory of Production* (eds) G. Fontana and R. Realfonzo London: Palgrave Macmillan

proportion of the depositor's own holdings calculated over a reference period. DCIs would not extend credit but would earn revenue from fees charged for payments services. They would not be permitted to distribute their liquidity to businesses or non-DCI intermediaries. The latter would fund their assets exclusively with non debt instruments. The proposal is distinct from the institution of narrow banking which is concerned with deposit acceptance. At the same time, there are some resemblances. In both instances, the objective is to ensure the complete integrity of the money supply process and both innovations involve a firewall. Banks create the economy's medium of exchange while non-blank financial intermediaries transfer savings from surplus units to deficit units. Under the Bossone-Sarr scheme, these financial institutions would operate under securities firm regulation. Their innovative impulses would not be impaired. Their non-monetary financial activities would be backed by non-guaranteed funds and they would be allowed to fail. The motive force behind the scheme is to kick-start activity from a position of near inactivity. We have extended the model to suggest that the money be disbursed as wages to workers in production.[4] The demand for food, clothing, and housing would rise. Production and production finance for these goods would be stimulated. Higher output would mean greater capital accumulation and so on in second and higher order effects.

Constructing Conduits: Monetary-Fiscal Coordination

The macro-economic dynamics of the private sector of a relatively closed economy like India must be narrated in terms of savings and investment. The components of each of the figures in Appendix Table 11 of the *Annual Report 2007-08* by the Reserve Bank of India, 2008, show a tepid increase over 2004-05 to 2006-07. New capital issues by non-government public limited companies has displayed a steady downward trend from the latter half of the 1990s only to pick up over the last few years (Table 82, *Handbook of Statistics on the Indian Economy*, Reserve Bank of India, 2007). Table 83 shows that bonds issued by public sector undertakings have tapered off since the beginning of this century. Absorption of private capital issues has also been fluctuating in a downward direction since the latter part of the last century. One may recall that, over the 1970s, India recorded a trend break in savings and investment. Gross capital formation increased in tandem. Kaushik Basu (*Journal of Economic Literature*, 2008, XLVI, 2, 396-406) has noted that the cause of the increase in savings was the nationalisation of banks in 1969. Banks had to open branches in remote rural areas.

We regard it as incontrovertibly true that the purpose of financial liberalisation must be the generation of employment and growth. Furthermore, given the fact that the deceleration of employment has been particularly acute in the rural sector and that over 60 percent of the labour force is sustained by agriculture, our task is cut out. The agenda must be to plan in terms of agriculture-industry linkages, between items consumed by the working class and those consumed by others. The macro-economic counterpart of the requirement would be captured by reviving the "employer of last resort" function of the Reserve Bank of India.[5] The notion dates back to the 17th century in the period after the Industrial Revolution when it was seen that existing enterprises were in no position to facilitate a state of full employment. In 1662, William Petty recommended a scheme for public employment for the purpose of building infrastructure. The government was to become a market maker for labour by

[4] Correa, R., 2008, Heterdox Macroeconomics and the Design of Monetary Institutions, Working Paper 26/4/2008, Department of Economics, University of Mumbai

[5] Papadimitriou, D.B., 2008, Promoting Equality through an Employment of Last Resort policy, Working Paper No. 54, The Levy Institute of Bard College

building up a 'buffer stock of labour'. Thus, the government, in a sense, would purchase all the unemployed workers at a fixed price or sell them to the private sector at a higher wage. Counterpart government spending would increase commercial bank reserves. Excess reserves drive down overnight interbank rates. In order to keep them positive, the government would borrow from these reserves. As borrower of last resort, it can effectively set the interbank rate. Interest rates, then, are not constrained by the willingness of the private sector to buy government debt or by the size of the government deficit. Fiat currency absolves the government from borrowing or issuing debt to deficit spend. Governments can spend by crediting bank accounts and tax by debiting them. Excess reserves are drained as part of the interbank interest rate targeting procedure. This is the agenda of functional finance.

A proposal to direct credit into appropriate channels can be culled from a scheme of Asset Based Reserve Requirements (ABRR) proposed by Thomas Palley.[6] Under such a system, financial intermediaries would hold reserves against their assets. The reserve requirement for each asset class would be set by the monetary authority. In order to prevent regulatory arbitrage, the ABRR would apply to all financial intermediaries. Thus, a wedge would be created between interest rates on asset classes and the central bank's policy rate. By varying the size of the wedge, the authority would change relative returns across asset classes and, thereby, influence portfolio and lending decisions. For instance, if the central bank wants to pierce a property bubble, it would impose reserve requirements on new mortgages. The cost of mortgages would rise without raising the general level of interest rates. Similarly, if the authorities want to direct investment to particular areas, it could impose zero or negative reserve requirements on loans directed at those sectors. Some merits in connection with our discussion are relevant. The ABRR are counter-cyclical. When asset prices fall, reserves would be released as required reserves are based on the market value of the asset. Relatedly, the ABRR are automatic stabilisers. When asset prices rise, financial firms need to increase their reserve holdings, thereby putting brakes on the upswing. Finally, the ABRR restore the demand for central bank liabilities. Any process of disintermediation would be halted and the monetary transmission process strengthened.

The Spectre of Financialisation in India

We have indicated that the relationship between finance and growth is complex. One thesis is that financial markets are best described in the words of Charles Kindelberger as arenas of manias and panics. All regulatory measures that arise in response will suffer a version of Goodhart's Law, that is, financial entrepreneurs will arise to work around what we have called dams and conduits. Is India, then, condemned to financialisation? The term connotes the increasing role of the financial circulation relative to the real and the attendant atrophy of the real. Consider the former characteristic. In India, the lure of exotic financial fruits has not been tempting. All the same, it is worth noting in Appendix Table III.11 of the *Report on Trend and Progress of Banking in India 2006-2007* by the Reserve Bank of India, 2007, bank group-wise lending to the sensitive sectors, exposure to the capital market by other public sector banks has increased from 2.8 percent to 4.16 percent while the comparable figures for the new private sector banks are 2.3 percent and 2.19 percent respectively. All banking groups display decent and increasing advances to real estate. The financial markets in India display the same flux as financial markets anywhere. For instance, the net resources mobilised by mutual funds display wild year-on-year fluctuations (RBI, 2007, *Handbook of*

[6] Palley, T., 2008, Asset Price Bubbles and Monetary Policy: Why Central Banks Have Been Wrong and What Should be Done, Macroeconomic Policy Institute Working Paper 05/2008

Statistics on the Indian Economy, Tables 78-80). As for the latter aspect, allowing for the qualifications about provisional, quick, and revised estimates, the following numbers do not paint a sanguine forecast of the economy by conventional standards (RBI, 2008, *Annual Report*, Appendix Table 2).

Sector	Growth Rate		
	2005-2006	2006-2007	2007-2008
Agriculture & Allied Activities	5.9	3.8	4.5
Industry	8.0	10.6	8.1
Services	11.0	11.2	10.7

The performance of the services should be noted particularly since its share in real gross domestic product continues to be high and increasing at around 60 percent.

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