Transcript of the Questions and Answers of the Session "Political Economy of Financial Stability and Equitable Growth"

Panel: Joseph Stiglitz (Chair), Adair Lord Turner, Montek Singh Ahluwalia, Nemat Shafik

Questions to the Panel

Sukhdave Singh, Bank Negara Malaysia: Does the panel believe that as a result of the crisis in the advanced economies, there has been a material change in the view of emerging market policy makers about the role of the financial system in their economy. I noted that before the financial crisis, there were many emerging market economies that had ambitions of becoming financial centers, particularly global financial centers. In Malaysia instead of talking of financial sector as a driver of growth, we are now talking of the financial sector as a catalyst of growth. In recent times, a lot of focus is given to financial inclusion. What I would like to ask the panel is to what extent the view of the financial sector changed materially has.

Second question, is it the case that sometimes government policies in emerging market economies themselves prevent the financial system from performing the appropriate role within the economy, as for example , when you have high liquidity ratios on banks which require them to hold high amounts of government securities on their balance sheet. In fact, if you carry it further, I have some similar concerns on current global regulation, this will push banks to safer assets and potentially that will be at the cost of their normal lending function.

Ajit Ranade, Aditya Birla Group: My question is to Lord Turner. You seemed to endorse subsidiarisation and said that it prevented global flows. Is it because it is proxy for capital controls? If that is your view, why not have directly capital controls instead of subsidiarisation?

Sudipto Mundle: My question is to Minouche. You mentioned that it is all about flows and talked about some of benefits on growth etc., whereas Joe and others focused on risks on the economic aspects. My concern is not economic but it is about the political. Joe mentioned this morning, that large flows could undermine the democratic system. I just wondered if you had a thought on that.

V K Sharma: I have a question and a comment for Dr Ahluwalia. This is about FII inflow into debt. I have some hard numbers which tells some other story. When the crisis happened in July- August 2013–the rupee depreciated by 24% and volatility increased by 26% and rupee depreciated to 68.85 on August 28. At that time, outstanding FII debt was $38 bio, as against FII cumulative investment in equity at $138 bio. When the crisis happened, $9 bio of the $38 bio went out which constituted was 25% of the total outstanding FII investment in debt. As against that only $ 3 billion went out from equity which was only 2%. If the current debt limit of limit of $81 billion was to have been fully used, as against $38 bio, and you apply the same percentage of 25%, the outflow would have been $20 billion. Hypothetically, if the FII investment in debt would have been same as equity, in a hypothetical case, then the outflow would have been $38 bio dollar and rupee would have gone to perhaps 75 vs US $.

Answers by the Panel
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Adair Lord Turner: First of all, on the question from Malaysia, which touched on the role of global financial centers? You are absolutely right. Before the crisis and even afterwards, you traveled around the world and everybody wanted to be a global financial center. I discovered this first when I worked in Eastern Europe in the early 90s; everybody thought that their country could be a bridge between one region and another. The belief was if you develop a global financial center that would be a center of well-paid jobs. I think there is a reasonable proposition that with the total available wealth, we have over produced financial services. A friend of mine said "A lot of what is happening in financial sector is a rent extraction racket. In fact we are rather good at it and we are extracting from the rest of the world." London is very successfully doing that. You can't have too many people doing that! To be serious, at the end of the day, as Joe pointed out, there is a serious job to be done not only in retail financial services but in global financial services as well. I think they will tend to concentrate in a relatively small number of centers in each time zone around the world. I think we will need to regulate them so that they are not over producing, are not doing rent extraction and are doing things that are valuable. At the end of the day we cannot have all that many people who can play that game, without it being something subsidized into existence or is creating not any useful activity. I would want to discourage emerging markets from believing that there is a magic route of yet another global financial center.

On Subsidiarisation and an indirect way of doing capital flows: The way I think about is this. As I set out in my paper, which sort of takes the thoughts from Helene Rey's paper at Jackson Hole and ties in with the issues I am dealing with in any case. I think the crucial issue on capital flows is the interface between short term debt capital flows and domestic credit and asset price cycles, and it is the way that these feed on one another that really creates the greatest problems. That is far more important to deal with, than foreign direct investment, which is good or foreign institutional investment in equity, even though a bit volatile does not create the same problems even if these are portfolio flows. It is the interface between short-term debt global capital flows and domestic credit and asset price cycles that are at the absolute core of the problem and we want to have a set of tools to focus on that. You could say, we don't need capital controls at all, provided you have strong macro prudential controls against credit cycles and we can control it through counter cyclical capital. The challenge in that is the cross border lending not from the domestic banks. There is an answer to that within the Basel III counters cyclical capital requirements, where foreign banks which are lending in to a country which has decided to impose the counter cyclical capital buffer, are meant to impose at global level, a counter cyclical capital buffer on lending in to that country. Basel III allows for that but I don't think it is strong enough and I don't think or is it going to be effective enough. I want tools that directly relate to that. I think one of those is to focus particularly on lending through branches. In Autumn 2008, I became aware, while meeting several central bank governors from emerging markets around the world, when they talked

about the propagation of the global credit crunch, huge in emerging markets, many of them found evidence of differences between global banks which operated in their countries as subsidiaries and those that operated as branches. The latter were pulling their loans back because they were part of the same balance sheet as they were worried about their domestic sustainability. But where they operated as subsidiaries they could not do that because the funding was in there already and that creates a more stable form of capital flows. It might be insufficient; I don't exclude the possibility that these could be combined with other tools. Jose Antonio's commented on this, that you have to accept there are a variety of tools here and we have to choose from tools. I am simply suggesting that subsidiarisation and the intensity of supervision with which one can look at the maturity of funding of the subsidiary is one potentially important tool, which I don't think we have focused on enough.

Montek Singh Ahluwalia: On the one question of FII, there is a tendency to view all of FII investment, as fly by night. But the fact of the matter there are a lot of people who are simply interested in investing in part of the Indian corporate sector. A lot of that is actually stable and the other advantage of those who invest in stock markets is that if too many of them leave, stock values decline and very soon the asset itself begins to look actually quite attractive. So the idea that huge amount of FII would leave is not credible. One must ask oneself as to what has caused this nervousness. If the nervousness is caused by something which is an underlying disequilibrium of some sort, then you correct it or allow it to correct itself. In the case of rupee for example, most indicators of what would have been a competitive level, taking a base rate and then calculating the real effective rate etc., had come to the conclusion that the rupee was actually overvalued. Many of these calculations said that that any rate somewhere between 60 and a little higher in terms of rupee per $ would be ok. And as it turned out it is where roughly it has stabilized. Government has to reassure markets that in terms of basic macro stability, they are doing the right thing. If you can do that, then one should expect, yes there will be something a little bit of shock here and there, but not something that really destabilizes the economy. On the whole it worked and last year for India was a good demonstration of how a reasonably controlled approach with fair amount of flexibility and reassuring foreign investors particularly in equities that if they came in and they want to leave they are free to do so works, it stabilizes, and I think well, it is a good experience.

Adair Turner: I would like to say one quick comment in addition to what Montek said about equity. It was an obvious comment but important. If you make an equity investment and sell it, from the point of view of company, the equity is still there. It has not disappeared and equity investment is permanent even if one person is selling the claim to another and is fundamentally different from 6 month or 1 year loan, where if at the end of 1 year you are not willing to roll it over, then there is a problem. This again is true domestically, you can imagine in a domestic financial system, an equity market closing permanently for 3 years without it producing a disaster in the economy. But if we have a process of sudden stop in debt, it spins the economy down. There can be problems from sudden sales, fire sales, contagion and confidence effects, but it is not actually a withdrawal of finance, in the same way that a refusal to roll over of loan is a withdrawal of finance, it does not create the same problems as debt finance.

Nemat Shafik: I will take the question on political independence and risks around capital inflows. Some capital inflows are good and some are risky. If you want to minimize the risks, having macro-economic policies, which are stronger and sounder, reduces those risks. When tapering talk started in summer, markets very much differentiated between countries. Countries that had high CAD, high rates of inflation were hit very hard and had large outflows, but countries that had reasonable current account deficits and low inflation were not very affected. It shows there is a differential consequence. The other interesting thing is that the tapering talk that started in May had much more adverse consequences than the actual tapering in December when the Fed reduced the amount of purchases. That also shows that countries learn. Markets adjusted to the idea and countries adapted their policies. My bottom line on political independence is that you can retain it while allowing capital flows, but you have to have your macro fundamentals in good order.

Joseph Stiglitz: Let me make a few comments. On the issue of creating subsidiaries, this was one of the conclusions of International UN commission that has come up several times. We argued in 2009 that this was absolutely essential, and the basic reason actually is related to what has been repeatedly discussed today, it is essential to control the credit flows. If you don't have subsidiaries, you have very little control over the credit flow into the country. That is related to a question that was asked; is the government policy interfering with the ability of the financial system to fulfill its role. The best way to think about the role is historically. Historically, banks were involved in trade credit; they were not involved in long-term investment credit. It did not happen until government in a number of countries created development banks or created new institutions that were related to long term lending. The role of the government to convert banks into long term lending but they have consistently tried to revert away from that role, so they made more money, in predatory lending, abusive credit card practices and a whole variety of things that are not related to equitable growth and in a sense it has been constant battle of regulators to try to bring them back to this role of long term lending as opposed to the kinds of things that are more profitable from one reason or another.

One of the issues is that it is true that if you have capital market imperfections, you raise capital requirements, or reserve requirements, lending might go down. The long run perspective of the Modigliani-Miller theorem says that, if the banks which were described well by the standard models that the financial sector believes in, there ought to be more equity. And all this is about shifting risk mainly to government when they fail, and this happens over and over again. But there is an important point which was raised which is I think that the government has to recognize that the private sector may not on its own engage in not only the level of credit creation that is necessary to keep the economy at full employment, but also the form and direction of credit. That may mean that you may have to create new public financial institutions say for infrastructure. Development banks aimed at infrastructure has been very successful in many other parts of the world. CAFÉ in Latin America is an infrastructure bank that has been very successful. One can dialogue the amount of that to keep the economy at full employment. One of the things that in the US that we ought to be reasonably worried about is whether the private banks that have excelled in predatory mortgage lending can be reformed, or do we need a public institution that does not have the incentives like the private sector. The New York state has a public sector lending institution for mortgages and had no problems during crisis. It lent on the basis of

long-term debt and did not engage in all the financial shenanigans. Fannie Mae and Freddy Mac were both privatized in 1968 and those were the ones that caused the problem. It is important to think about the role and nature of public sector institutions. Montek said maybe we ought to have more private banks, but my response is maybe we need more creative public sector institutions to filling in the needs and kinds of credit that are needed right now, say in India.

Another question that was asked, also a good question- rethinking the role of financial sectors- everybody wanted to be a hub. I want to add two points further to what Adair pointed out. On a global scale, the correct size of financial sector is going to be relatively a small fraction of the economy, it is supposed to be a means to an end, in so many countries it became an end in itself. The irony was that the sector that was supposed to serve other sectors, wound up taking up all the profits from all other sectors. Rather than being a small and efficient financial sector, it became very large. One of the reason it became so large was rent seeking and one of the things that is important in all countries is more competition, it is very good in some places there is inadequate competition. It is not just the number of banks, which could tacitly collude and divide the rent. They would all prefer fewer banks so they would not have to share with each other. But for instance one of the things that is a problem in most countries around the world is that payment mechanism is monopolized and, I mentioned this morning that the cost of shifting money from your bank account to merchant's bank account should be a fraction of a penny for a transaction, and even the full on cost taking into account the hardware should be less than a penny, but they charge much more. That is monopoly. We recognized that in US and we passed in the case of debit card a Durban amendment, which was called, but there we made a mistake to delegate the implementation to the Federal Reserve. But, who controls Fed. Every institution is accountable but the question is to whom they are accountable. They are basically accountable to the banks and financial sector and while the banks agreed that what they were charging was outrageous, and hence wanted a compromise on the reduction of charges; the staff in the Fed over estimated the cost and in fact doubled that. Interesting thing is that we have a judicial process in US and the Judge who heard this said it was outrageous and said you are not following the legislation that was Dodd Frank and he threw it out the case is now under in now under appeal like everything in US that goes in to litigation process. This is one of the dangers of lack of political accountability and too much of operational independence; FED was operationally independent and it decided to give more money to the banks.

One more point is on controls and operational independence. These are continuum variables. It is really difficult to say what is or is not independent. US officially have an independent central bank and we had good central bankers that recognized their political accountability. Paul Volcker said that Congress created us and Congress can uncreated us. There are other central bankers who have not recognized that. ECB was created as an institution with excessive independence. What really come down is to what kinds of decisions they make. What we recognize years after 2008 crisis that the Fed was engaged in quasi-fiscal operations. It was giving away hundreds of billions of $ to banks at almost at 0% rate and banks in turn lent back to government at 3% and then the bank officers were giving themselves bonuses on the base of the profits they made! It was a brilliant politically that they could get them to do this, but as for level of genius in managing a bank, it was not. The point I want to make is that when you have

central banks that are giving away money, and all central banks have effectively the scope for doing this, then you have to worry a little bit more about political accountability.

The final issue is what banks do and what the central bank does in making sure that banks do, what they should do. I want to come back to one of the elements of the title of this session, about equitable growth. There has been the view that has been articulated that equity basically is something that has to be done through fiscal policy and that is not the purview of financial markets. IMF in general has taken a much more positive stand on these issues and they have recognized that there is an actually a link between equity, distribution and inequality, stability and growth. The two can't be separated. I would like to go a little bit further and suggest that central banks policies do affect inequality in a whole variety of ways, both by what they do and what they don't do. Inadequate regulation creates more instability. More instability creates more inequality. If you aren't regulating for example the payment mechanism, that is a tax that everybody in our society pays and it goes to the bankers, its trickle up economics that we have been practicing. Even in the basic macroeconomics, there are inevitably, at times, tradeoffs between inflation and unemployment. While it may be true that inflation imposes a cost on everybody in society, if you have high levels of unemployment, the cost is particularly high on workers. Of the 25% of the people in Spain who are unemployed, 50% of young people who are unemployed. They will be willing to have inflation go up from 2% to 5% and if we could get the inflation rate down, they would say this is no brainer. Moderate increase in inflation versus lowering of the unemployment has very important equity consequence. Historically, the excessive focus on inflation led to a ratchet effect that has contributed I believe to declining share of wages. When you had a recession, the share of wages will go down; the moment the economy started to recover and wages started going up, they say that we have to be worried about inflation. The moment wages started recovering, they started increasing interest rates and dampening the economy when you do this you ratchet it down and in next recession it goes down even more and the process goes on. Conduct of monetary policy has very strong equity implications and when we have central bankers who are drawn from financial sector and are so independent, and then the likelihood of doing this is much higher. Interestingly, few countries like in Sweden has some body from labor union who represents interest of workers is on the central bank board, at least then the voice of workers can be heard. For most of the economies it is not true. Interestingly, a few countries in Latin America do not allow any body from financial sector on the central bank board, because they realize there is conflict of interest. I think this issue of governance of central banks is a complicated one. One of the lessons of 2008 is that we need to think about it a lot more.

Finally, I think central banks do have an important role in making sure that access to lending is equitable, and access to lending to SMEs and to micro credit. The reason why this is so important is that in our economy, particularly where we have bubbles, which gets the money to participate in the housing bubble, determines who is going to become wealthy. In the former Soviet Union countries you saw that most dramatically, where you got access to credit you became a billionaire and if you do not, you died. In US, the access to credit is a major determinant of inequality. We have to understand the links between what the financial sector does at the macroeconomic level, at the micro and access level, have lots to do with shaping our economy including shaping the degree of inequality that we have. Thank you all.