THE FINANCIAL EXPRESS
Read to Lead
Tue, 28 May 2013 10:18 IST

# The philosophy of Dr Reddy

**RAGHURAMRAJAN:** APR 28 2013, 00:24 IST

**Tags:** Dr YV Reddy | Reserve Bank | Central Bank Policy | Business News

*New Thinking aims to distill what we have learnt from the financial crisis and how it should guide policy going forward, offering a fascinating insight into the thinking of one of the architects of modern India's financial system*

Few people know more about India's financial system than Dr YV Reddy. And even fewer have the authority that he commands, having held the helm of the Reserve Bank during the exuberant years before the financial crisis, and come out of it with his reputation intact. Dr Reddy did not have to rescue his reputation through a massive bank bailout or through aggressive monetary policy as some of his western counterparts have. He kept his reputation the old-fashioned central banker way by just saying no as the economy started partying.

Dr Reddy's recent book aims to distill what we have learnt from the financial crisis, and how it should guide policy going forward. The book is based on a number of recent speeches he has given, and deserves close study by anyone interested in the financial sector. It offers a fascinating insight into the thinking of one of the architects of modern India's financial system, and by extension, into the mindset of Indian policy-makers.

Dr Reddy's central tenets are, first, "Moderation, moderation, in all things moderation". He believes in "non-corner" solutions, with the aim of being approximately right rather than precisely wrong. Second, Dr Reddy argues that policy-makers can never abandon discretion for the comfort of rules. But here again his moderation moves him towards flexible rules or constrained discretion rather than either extreme. Finally, Dr Reddy is suspicious of markets and the private sector, repeatedly casting doubts on the proposition that markets are efficient or their participants rational. Once again, though, his moderation prevents him from advocating anything more extreme than a mixed system. Let me explain these tenets in the context of examples he gives, suggest where they have served India well, and ask when they may require change.

Consider the objective of central banking. In the pre-crisis years, many of the world's central banks moved towards inflation targeting—whereby the focus of central bank policy was to meet a certain target for inflation, ignoring other objectives such as growth and employment, or financial stability. The logic was that by setting a clear target of low and stable inflation, and thus gaining credibility, the central bank could keep interest rates low and generate high, sustainable economic growth. By contrast, a central bank that was willing to tolerate higher inflation for more growth would lose credibility, and would risk

spiraling inflation that it would have to rein in through very high interest rates and associated low growth. Thus growth and financial stability were consequences of low inflation rather than separate objectives.

The RBI has always been reluctant to espouse such a stark inflation objective, in part because it has been uncertain about its ability to deliver, given the government's typically high fiscal deficits. But it has also worried about locking itself into a one-dimensional view of central banking, ignoring issues such as financial stability or financial development. This reflects Dr Reddy's non-corner solution view, and in the aftermath of the financial crisis, it has been vindicated. Many central banks now say they advocate flexible inflation targeting, which essentially extends the time period for hitting an inflation target. For those not steeped in central bank jargon, this sounds suspiciously like central banks admitting to more objectives than strictly inflation. Indeed, it is now received wisdom that when inflation is low, central banks may have to resort to unconventional policies to jumpstart growth. At the same time, periods of ultra-low rates and unconventional policies may generate risk-taking behavior and asset bubbles that eventually prove problematic. Thus, growth and financial stability have re-entered the central banker's objective function. The world has moved away from strict inflation targeting and closer to the RBI's position.
Yet there are also dangers in overly diffused objectives or too much discretion. A central bank that does not put substantial weight on keeping inflation low can becoming a creature of the political mood, giving in readily to clamours from industry when high interest rates pinch. Moreover, it can open itself up to more influence. Currently, by portraying itself as the only game in town, and suggesting it can do more than control inflation, the US Federal Reserve has opened itself to even more political pressure; from the Left who want more aggressive unconventional policies including direct lending by the Fed, and by the Right who accuse Ben Bernanke of having debased the currency through his policies.

Put differently, non-corner solutions work fine when the policy-maker has a backbone of steel, not unlike the one Dr Reddy was reputed to have. But rules can offer support, as well as signal commitment, when a policy-maker is less well established. Will Dr Reddy's non-corner solutions work as well when the policy-maker is not Dr Reddy?

Let me turn finally to Dr Reddy's suspicion of markets and private motives. Given recent experience, most would agree with him. But an unfettered, unregulated market is not anyone's ideal, and neither is a market such as the pre-crisis US sub-prime loan market that is shaped by political forces to achieve certain social aims. Instead, markets need a basic level of regulation and governance, and distance from political influence, to have any hope of creating the competitive level-playing field that is their greatest strength. Properly supported, markets can work as powerful antidotes to crony capitalism and to risk concentration. Indeed, one of the important weaknesses of the Indian banking system is that it does not spread access to credit as widely as is desirable and too much of the economy's risk is concentrated in it. A vibrant corporate bond market could help in

widening access and spreading risk. But a variety of past policies have hampered the growth of that market, with the result that we are still reliant on banks to fund infrastructure. Dr Reddy is probably right when he suggests that markets have to be viewed with some caution—indeed, the Grossman Stiglitz paradox suggests that markets are efficient only when participants suspect they are not. Yet too much suspicion of markets can be a hindrance to market development. This, of course, harkens back to Dr Reddy's central theme of moderation. We have to be moderate even in our suspicions.

In sum, one may differ with precisely where Dr Reddy takes his stand. But it is hard to disagree with his central tenets. This book allows you to get inside the mind of one of the key shapers of Indian economic policy, and it makes you think. In my view, there is no higher accolade than that.

Economic Policies and India's Reform Agenda: New Thinking

YV Reddy

Orient BlackSwan

Rs550

Pp 296

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