The Hindu
New Delhi, 2 April 2013

New thinking by an old hand

Y. V. Reddy studies the linkages between financial flows and the real economy

K. Subramanian

Dr. Reddy was described as "the man who saved India from the global economic crisis." In the years before the crisis, the U.S. Treasury and the rightist lobby used to decry him as one who was "too rigid, conservative and cautious', even as they compared India's 'poor' record with those adopting the Western model. When the crisis struck, it witnessed the crash of those economies and also the loss of reputation of central bank chiefs earlier touted as maestros.

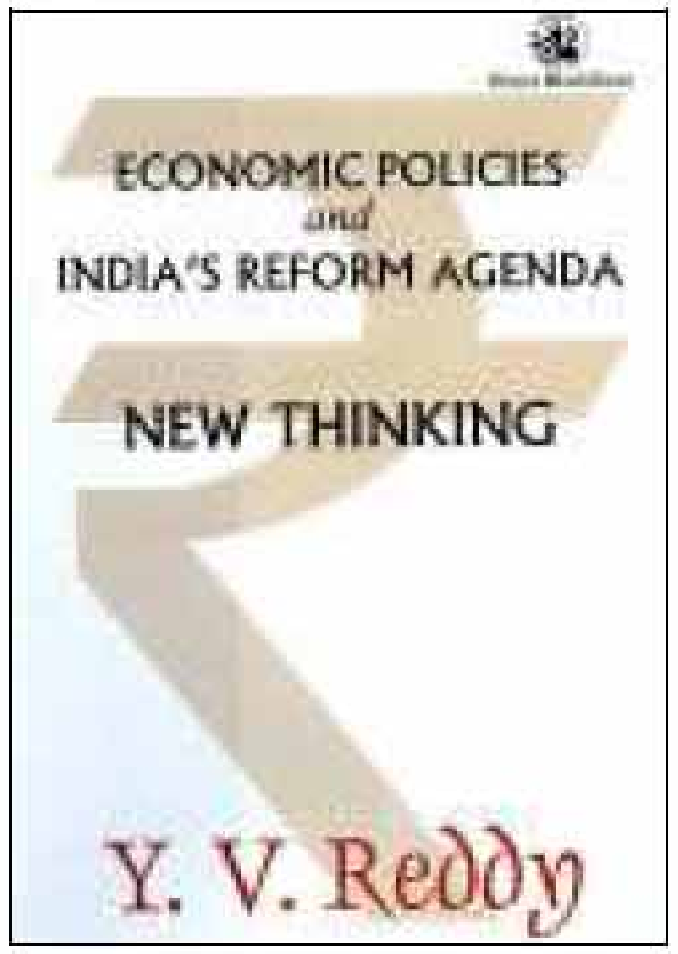
Dr. Reddy has not allowed this adulation to fuddle his thinking. As in the past when he was with the Reserve Bank of India (RBI), he continued to look upon his role as one in search of issues (the more complex the better!) and to suggest solutions. He combines a breadth of vision with an intensity of gaze which is rare among monetarists! He relates monetary issues to the larger fiscal and developmental and weaves them organically. He shuns what he calls a 'silos' approach. At a time when central bankers swore by holding interest rates and price stability as their ultimate faith, he was ready to desert and reach out to multiple objectives. It provided him the necessary leeway to calibrate and ensure harmony and success.

After leaving the RBI as an *eminence grise*, one would expect him to engage in pontification. That is not in his grain. Many, like the present reviewer who have followed his speeches and writings over the past two decades would have observed how there is the same continuity in his style and his search for better understanding of issues. The *Great Recession* has provided grist to his intellectual mill and, perhaps, sharpened his insight and analyses. The book includes speeches delivered during the period 2010-12. In his exposition, Dr. Reddy bursts forth or cascades an array of issues and offers tentative views.

Repetitive themes

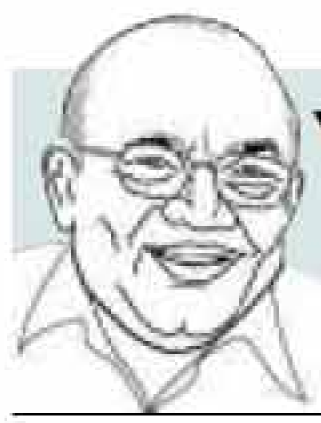
There are repetitive themes or concepts running across pages. In a collection of speeches delivered to several audiences, this is unavoidable. Truly, it is daunting to handle all the issues in a brief review with limitations of space. The idea is to be highly selective.

Dr. Reddy is aware of the benefits of India's integration with global financial markets. However, unlike some "reform warriors", he is also aware of the pitfalls attached to the process. Indeed, this was the approach which guided him when he was at the helm in the RBI. He refers to the 'rethink' on many issues in the wake of the crisis. Though there is search for a new agenda for reform, there is lack of consensus among advanced countries and even within the G-20. He feels that the anticipated global uncertainties and volatilities could be



Economic Policies and India's Reform Agenda

New Thinking: Dr. Y. V. Reddy; Orient Blackswan Pvt. Ltd., 3-6-752, Himayatnagar, Hyderabad-500029. Rs. 550.



Y.V. REDDY is a former Governor of RBI

faced better if there is an agreed national strategy. A new rebalancing is being attempted at the global level on the role of state versus market; policy space at national and global levels; and links between real and financial sectors. This rebalancing is not easily achieved. For this and several other reasons, Dr. Reddy has misgivings over the future of reforms. As he explains, "some of the changes that were considered appropriate by the developing countries as part of the financial sector reform of development in the pre-crisis period may not be warranted."

One theme, which occurs repeatedly, revolves around the infirmities and asymmetries attached to the so-called 'global financial architecture.' According to him, it is a *non-system* which is dominated by a single reserve currency (US dollar) which gives undue advantage to the issuer of the currency. It is populated by a few banks which operate globally with vast capital resources. It is audited by four accounting firms which try to set standards; and rated by two agencies which set the rating for assets despite the conflict of interests noted in their working. By and large, the system is heavily loaded against the interests of emerging economies. Standards and codes are set by agencies like the Financial Stability Board (FSB) which do not reflect adequately the concerns of developing economies and an international agency, viz. the IMF which has "infirmities in terms of governance, ideology, trust and reputation." There is no lender of last resort or a mechanism for resolving and restructuring sovereign debt in cases of potential default. He wonders whether, such a system with all the infirmities "contributes to the comfort of efficiency in the global financial markets."

The most valuable contribution made by Dr. Reddy in this collection is the study of linkages between financial flows and the real economy. It is evident that excessive financialisation wrecked the advanced economies. Unless there is proper balance between the financial and real, the system is not sustainable. He avers, "It would be appropriate for developing countries to consider the paths of development of their financial sectors to reach the optimal level, keeping in view the lessons from the global financial crisis."

Applying this test, he has grave concerns over India's current strategy of seeking (or courting) capital flows to finance BOP deficits or longer term growth. As Governor, he had serious reservations over unrestricted entry of portfolio flows or FIIs. Now, he raises it as a larger theoretical canvas by drawing on global experiences. When large financial conglomerates readjust, the balance sheets of banks and corporates in the country are weakened and national authorities cannot provide succour. He cites a galaxy of economists and academics in arriving at these conclusions.

Dr. Reddy goes over the issue of public debt with what hovers as a major theoretical leap. Indeed, he draws on a body of current research and weaves the relations between fiscal deficit, stimulus, bailouts, current account deficits and how they add up and result in sovereign defaults. He posits it at the heart of the ongoing Euro crisis.

There are two chapters on capital account management complementing each other. One deals with the exegeses attempted by the IMF to bring about controls on capital flows. The IMF which was congenitally opposed to capital control for decades has at last veered round to the view that some measure of control, or what they call 'capital flow measures' may be desirable and that it should be a part of the macro-economic toolkit. Dr. Reddy evaluates them at length and establishes the inadequacies or the weaknesses of the proposed framework.

It is surprising that in their elaborate studies of capital control experience of developing countries, the IMF staffers did not include India or China! While there are esoteric rules to govern the role of emerging economies, there are no rules to govern the behavior of advanced countries which are the sources of volatile flows. As Dr. Reddy explains, whatever the framework, large financial conglomerates with access to huge cross border capital operating from tax havens, etc. can spoil the party.

This book is a veritable smorgasbord of reflections on recent thinking on major economic issues and policies. It can be savoured by specialists and generalists alike.

(K. Subramanian is a retired civil servant)