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Doing What Has to Be Done*

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Raghuram Rajan:
I do what I do
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Raghuram Rajan is an internationally acclaimed financial expert who served as governor of the Reserve Bank of India (RBI, the central bank of India) in 2013–2016, and his book is entitled: *I do what I do.* Having read it, one might perhaps feel that the title "I do what I have to do" would have been more apt. In his work, which is a summary of his studies and speeches, the author describes what he focused on during his time at the helm of the central bank, the topics he considered appropriate to comment on and the practical steps he took to boost India's economy, and especially the clout of the central bank.

Rajan is committed to society, including all its classes, even the poorest people, while being an ardent supporter of free markets and capitalism. Accordingly, even though the book discusses and answers professionally relevant issues, it is not for experts only, but for anyone interested in social and global problems. This review gives a brief overview of Rajan's impressions, actions and experiences as central bank governor. As the first man of the RBI, Rajan considered himself an influential *public servant* who was nonetheless committed to the people. He placed a great emphasis on central bank independence. He was responsible for managing 17,000 bank officers and USD 400 billion.

Rajan continuously assessed the country's macro indicators. At the beginning of his term, India's growth got off to a promising start at 5-5.5 per cent. In 2013, he pointed out the rapid improvement in the country's important indicators: government debt fell from 73 to 66 per cent compared to the mid-2000s (while central government debt stood at merely 46 per cent). External debt was even more favourable at 21 per cent of GDP, mostly comprising long-term liabilities. The deficit-to-GDP ratio increased on account of the crisis, but it was pushed down by

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1 percentage point in Rajan's first year, 2013. The balance of payments was partly influenced by the fact that large mining projects were stopped or delayed, since goods imports rose. The final chapters contain his statements before and after the eruption of the international crisis, which brought him international recognition.

1. Start of Rajan's central bank policy

At the time of Rajan's appointment, the Indian economy was in dire straits and the rupee was in free fall. India was among the "Fragile Five" developing countries, which scared off foreign investors. Therefore, the first task of the new central bank governor was to stabilise the country and restore the confidence of foreign investors. He had to show a clear intention to reduce inflation and strengthen the international role of the rupee, in other words demonstrate that despite the difficult circumstances, steps were planned towards full convertibility.

Previously, inflation had been measured using the wholesale price index, but the option of switching to the consumer basket was discussed. The central bank did not want to use the consumer price index because it would have been unable to influence the government's overspending, which sometimes undercuts consumer prices. Therefore, Rajan set up an expert committee to establish *inflation targeting*. He had to decide on the interest rate policy to be pursued. Should interest rates be kept high to curb demand or reduced to encourage growth through lending? In his book, he uses the analogy that the central bank was trying to be an *owl* among doves and hawks. Taking advantage of the market environment produced by the otherwise great crop yields, he gradually increased interest rates, and then slowly decreased them after inflation receded. The principles determined by the committee turned out to be right and bore fruit as expected.

The public and politicians found it hard to stomach that price hikes could not simply be prevented by direct intervention, i.e. capping food prices. Rajan argued that reducing average inflation across the country was in the interest of all social classes. The structure of consumption was transformed, the share of food declined steadily, while that of very wage-intensive services increased. The prices of these, however, depend on food prices. If the latter are high, all incomes, even those of farmers, will be *worth less in real terms* when spent. But if inflation is low in the country, it reduces the wage costs of agricultural work and thus also the wage pressure. Although people realise the improvement of real indicators slower than the nominal "veil of money", beyond the short term, the policy is confirmed even if food prices do not drop enough, since the price drops of the other products influencing the consumer price index could be large. This improves the average standard of living. The overall price index did indeed fall, to 6 per cent.

Many people castigated the central bank for "killing" investments with the prevailing interest rates. However, the interest rates did not depend solely on the central bank base rate, but also on the risk premium added by commercial banks. The government tied the interest rate on retail investors' savings to government bond interest rates, which sometimes caused slight distortions in banks' interest rate mechanisms. At the same time, savers and pensioners did not complain because interest rates were high, but, conversely, because they were low. Rajan maintained that as regards performance, factor utilisation was high in the economy, and therefore monetary easing would only strengthen inflation trends. He also argued for relatively high interest rates by claiming that if monetary value falls sharply, savings start to flow towards tangible assets such as gold. Since India is not a gold-producing country, this places a great burden on the balance of payments, exacerbating the foreign currency problem caused by the country's trade deficit. As India relies heavily on imports, its balance of payments is always in deficit, foreign currency demand pushes the exchange rate down and exchange rate developments influence inflation. Thus Rajan believed that one of his first measures should be to stop the exchange rate weakening and acquire foreign, and preferably cheap, funds to cover the deficit. He was lambasted for keeping interest rates near the upper edge of the band, but he believed that the rupee's stability hinged on the relatively high interest rates. He managed to acquire the necessary external financing on account of the highly consistent monetary policy and its successful communication on the one hand, and by guaranteeing a predetermined and favourable repayment exchange rate to the banks providing the funds on the other hand. This attracted huge sums, well beyond expectations. Rajan was able to introduce beneficial measures in easing foreign currency rules, indicating that in the long run, the goal was to bolster the rupee. He progressed cautiously with liberalisation. For example he did not support investment banks' efforts to issue USD-denominated government bonds abroad. Although this would have been alluring to investors, at a time when developing countries were attempting to offload their foreign currency bonds, Rajan did not consider it useful for India to move in the opposite direction. Instead, he urged banks to issue so-called "Masala bonds" in rupees, which were a good quasi-sovereign proxy. To provide more liquidity to the corporate bond market, the RBI initiated an amendment to the central bank legislation that allowed high-quality *corporate* bonds to be used as instruments in repo transactions with the central bank. (The Fed's post-crisis "innovation" was also used by the RBI, although not directly with companies but through banks.)

2. Financial inclusion

Rajan believed that the next major task was to improve access to credit. Experience showed that people often turned to usurers and rarely took out bank loans. That is why he considered it important to improve the banking system, establish branches and expand services in underdeveloped areas. He also paid attention to deepening the financial system in a way so that those who had some knowledge should be able to profit from it by choosing the appropriate services. At the same time, he set out to spread and enhance financial awareness.

Rajan believed that improving and accelerating the different forms of payment was just as important as ensuring the availability of credit. This is because lenders usually expect some level of savings. But this is difficult if customers need to cover long distances or wait for a long time to get paperwork done just to open a deposit account. Rajan encouraged banks to provide easier ways of opening accounts, although banks – wary of issues related to identifying owners and fraud – dragged their feet, and thus usually requested detailed documents. However, Rajan thought that the losses caused by fraud did not outweigh the advantages of smoother account opening. Accordingly, the central bank regulated the conditions of opening accounts, requiring merely proof of permanent residence. To avoid disputes, he proposed forms to the banking association that clearly stipulated the RBI's requirements.

The development of the payment system also advanced when *post offices* received payment functions. Even though post banks do not extend loans, they are a huge help. Using them to make deposits may facilitate borrowing and transfers.

There are 900 million (mostly basic) mobile phones in India, and therefore it was obvious that they should be used to conduct payment transactions. India's payment system is mature, the central bank has three large technology centres and a robust financial and payment network. Rajan maintains that their text message alert system was more advanced than in the US. However, the publication of the records on non-performing borrowers and the sharing of negative experiences within the financial system acted as slight deterrents and encouraged timely payments.

Another big help was the operation of *credit information bureaus* that also informed costumers about insurance options. Rajan called for the development of a system that would help small enterprises against large corporations, by creating an opportunity to sell their outstanding claims on the market.

The government requires the (mainly state-owned) banks to ensure the financial inclusion of the poor, who often fall prey to usurers. Therefore, interest rates were capped on loans to small businesses, and usually no collateral could be demanded from them. However, interest rate caps need to be set to cover the fixed costs related to lending, monitoring and collection and also generate profits. Rajan argues that it is an impossible trinity to require banks to really strive to perform this mandate while prohibiting them from requesting collateral. He suggests that requesting collateral is acceptable if offered, but then lower rates should be charged.

He also believes that repayments should be flexible. If the insolvency is not due to the negligence of the debtor but inescapable consequences (such as crop losses in a region in the case of agricultural loans or unemployment in the case of student loans), banks should not classify the loans as non-performing. Debtors, however, should not be relieved from all responsibility; debt relief and the option of bankruptcy should be designed so that debtors feel the repercussions (loss of wealth, exclusion from borrowing) and only use this solution as a last resort.

One of the main principles of finance is that customers should be cautious, but the expertise of customers varies widely. That is why Rajan considered it important to improve ordinary people's financial literacy and called for basic financial skills to be included in the school curriculum and the establishment of cheap, high-quality financial *distance learning*. He had high hopes for strengthening the ties between the IT industry and the banking system and the widespread use of IT in banking.

3. The state and state-owned banks

Rajan paid special attention to the operation of state-owned banks. The highly centralised Indian government views banks as proxies of the state and keeps them under tight control. This not only includes the central bank's regulatory role, but also government agencies that can be used for direct intervention. Due to the large number of regulatory authorities and the overlaps between them, Rajan proposed to dissolve the banking department of the finance ministry, which exercised supervisory functions in tandem with the central bank but with broader powers. Although the Indian Bank Board Bureau (BBB) was composed of experts and independents and takes part in the professional assessment of banks' board members, in the case of state-owned banks, the Appointments Committee of the Cabinet has the final say. The author believes that the BBB should take over these decisions, and, as it gains experience, the BBB itself would also become superfluous. It could transform into a National Bank Investment Company, a custodian for the government's stake in banks. The government's banking department should fulfil other functions: preparing expected banking projects, coordinating actions (e.g. determining the conditions for opening bank accounts) or concentrating on institutional development (e.g. setting up organisations for collecting debt). The central bank should only focus on prudential regulation and recall its representatives in banks' bodies.

Currently, the functioning of banks' boards, the process of lending, the management of collateral and pledges as well as the monitoring of outstanding loans leave much to be desired. As Rajan writes, state-owned banks (especially those that received state aid) are in a particularly weak position when faced with the credit applications of large customers. Their professional operation would be ensured if their managers' skills and remuneration would match those in the private sector rather than being manually controlled by the authorities.

The most difficult task of the sector was cleaning up bad debt and bank consolidation. Banks amassed a large amount of non-performing loans, and the sector needed to shed that.

India saw its first comprehensive asset quality review and report on the situation of the banking system in 2015. The central bank's policy was roundly criticised, as the more stringent asset rating systems it introduced hindered lending. However, the problems did not arise from the ratings: they originated earlier because banks had been nursing along huge stocks of problem assets. The slowdown in lending and the credit crunch was caused by the excessive amount of bad debt rather than the level of interest rates or the scarcity of capital. There was capital for housing loans and consumer credit at state-owned banks as well, because, interestingly enough, there was not much difference between state-owned and private banks in terms of growth in outstanding loans. At the same time, a general credit crunch could definitely be observed in the country. Although private banks mushroomed during Rajan's tenure, their capitalisation fell well short of state-owned banks. The new banks' more dynamic lending to the private sector could not offset the shortage of credit arising from the more muted operation of large, state-owned banks. The crux of the problem was the financing of state-owned banks' large corporate projects.

During bank consolidation, the concept of "bad banks" (isolating bad loans and putting them into separate institutions) was considered, but according to Rajan this would have only meant kicking the can down the road. He believed that all banks should clean their balance sheets and perform a capital increase instead.

Banks' predicament can also be caused by transactions when companies consciously "steal" the money received from the bank, by diverting it to their own, foreign operations through overbilling and deals disguised as imports. Yet Rajan was aware that only a smaller portion of the bad loans were due to conscious, corrupt acts, and the majority were attributable to excessive lending during the boom and the bank managers who were unable to handle the new situation. In the absence of an operational bankruptcy law, the central bank had to find temporary solutions. A database containing the lenders taking part in the transactions was created, and then the Joint Lending Forum agreed on a solution, similar to bankruptcy proceedings, excluding certain lenders. In 2015, the restructuring of the loans that certain banks rolled over only to avoid designating them as "non-performing assets" was scrubbed. The large infrastructure projects where the repayment deadlines were not in line with the companies' earnings potential were reviewed, and contractual adjustments were allowed, taking into account rollovers. Temporary debt-for-equity swaps were permitted, thereby crowding out the old owners who were unable to provide a capital injection and promoting the rapid entry of new owners. After that, banks could start financing more promising ventures with renewed momentum.

4. The technocrat and politics

Rajan's term as governor was not extended in 2016. This may have been partly due to the *controversy surrounding demonetisation*. The essence of the action against "black money" or demonetisation was the *changing of the banknotes*. This usually led to tensions in other countries as well. In hindsight, some argued that Rajan opposed the measure, while others claimed that he was responsible for it. The central bank was forced to give an expert opinion on the government's plans. Rajan writes that he listed the counterarguments, including that the poor would have to shoulder more of the burden. However, the framework necessary for the technical implementation was developed by the central bank. Demonetisation occurred one month after Rajan stepped down. (According to some in 2019, the process caused actual distress to ordinary Indians, and independent pundits say that the policy did not really achieve its objective.)

Of course, demonetisation was by no means the only actual point of contention for the RBI governor, because Rajan underlined that – as the governor of the central bank and the macroeconomic crisis manager of the country – he had to warn the government about issues critical from the perspective of financial stability. In a 2014 speech, he examined thorny economic and political questions, focusing on crony capitalism, since that was often a factor behind bad bank loans. Rajan believes that if India, free and independent for 70 years, wants to avoid the middle-income trap, it should make use of all the opportunities offered by democracy.

He argues that change can only happen if the quality of public services improves and reliance on the state is reduced. Both can be achieved only in the long run. Rajan claims that the solution lies in good private sector jobs that help pay for private healthcare and high-quality education. However, this also calls for enhancing healthcare and education. In other words, *to get rid of bad public services, good public services are needed*. Therefore Rajan proposed linking the system of benefits to the education of the children from poor families and supported the introduction of coupons that could only be spent on clothes, food and healthcare.

He realised that even an economy the size of India is impacted by international developments. Due to the diminishing export opportunities, producing for the domestic market became more important. Nevertheless, this should not be achieved by limiting imports and encouraging exports because free trade is also important for India. Finding the right balance is essential. The development of smaller enterprises and services is a key component of growth.

5. Summary

For Rajan, his appointment as governor was like when a child is let into a candy shop, because he could do what he was proficient in and what he loved. After reading his book, it can be concluded that an exceptionally wise man with a sense of responsibility held the reins at the RBI for three years. He was not simply a financial technocrat but an expert in national and world economy developments. Wherever they live, central bankers, financial experts and politicians can all take away something from his work and essays.