

## **Mother of All Bail Outs: Some Immediate Lessons for India**

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These are unprecedented times. The post independence generation in India gets to experience its first real financial sector crisis and near meltdown. Thank the Lord that it is elsewhere where a trillion dollars is less than one eighth of the GDP! This will hopefully add to its growing confidence by realizing that 'they in the developed west' can also make mistakes, can falter and are not infallible. The success of India's software and outsourcing industry had, to our great surprise, already seen senior economics professors in the US questioning the merits of liberal and open economies. Now we see a theologically devout Republican President of the US urging the Congress to pass a bill that would effectively nationalize large parts of the financial sector, having already taken into government care the world's largest insurance company by pumping in \$85 billion of tax payers money.

With these goings on, one wonders what happens to all that we had heard from financial sector puritans about moral hazard, market determined incentives structures and no financial institution ever being too large to cause systemic distress. Clearly, all these mantras, so often parroted and cited by 'believers' of financial sector's prowess to optimize across markets and achieve equilibrium, must look outdated and even foolish. But I suspect there will be some who will see this episode also as yet another exception that according to them would prove the rule that there is simply no role for government intervention or even careful regulation. They will I am sure continue to insist that financial sector whiz kids armed with Xcel sheets and technical models, even if they in their teens, should be allowed a free run for their money (literally so). These are the same people who called the earlier Asian financial sector crisis an exception and who have waited, thankfully in vain, for the Chinese banking sector to come crashing down because it did not follow the free financial sector nostrums. These financial sector theologians begin to sound increasingly like the Marxists who continued with their misplaced faith despite Stalin and Pol Pot on grounds that these were exceptions to the general theory of dialectical and historical materialism. We know that history treats such dogmatists rather unkindly.

Others who are concerned with sustaining inclusive and rapid growth and with ensuring that the financial sector plays its due role in the development process, would do well even at this stage to try and draw some preliminary public policy lessons from the unfolding events. The first lesson must be a rather prosaic one that trying to make economics in to a natural science with its inviolate laws that are universally applicable is simply foolish and should be actively discouraged. Economics has been and will retain its Adam Smithian characteristic of being enmeshed with ethics on the one side and political philosophy on the other. This necessarily implies flexibility in approach to suit the prevailing circumstances and the ability to find the second best solution where the first best, even when clearly identified, will simply not work. The second lesson specific to the financial sector would be to not surmise that the financial sector must necessarily be administratively controlled and not be allowed the freedom to innovate, compete and use market based incentives as far as possible. A liberalized, market based and effectively

supervised and regulated financial sector has played a significant role in promoting and sustaining rapid growth. But its contribution to inclusiveness or equity is surely open to question and the third lesson must be to put greater attention on incentives (and not only through administrative dictates) that will direct the financial sector to contribute more meaningfully to inclusiveness as well.

We can now move on to those lessons that we in India can at this stage draw for future of public policy for the Indian financial sector. The first would be improve the quality of information that banks, capital market operators and other financial sector entities normally put out and which is available to the regulatory agencies. We cannot off hand detail the nature of additional information that would be needed. Clearly one of the major reasons for the on going US turmoil is that the Fed or the SEC could not see the real quantum and nature of risk that had been piled on to the balance sheets of all these financial sector goliaths who then collapsed under their weight. Second, the assumption that some entities like investment banks and hedge funds should remain outside the regulatory regime must be discarded. Even if it is true, as has been argued, that these entities deal only with the rich investors and not the general household savers and therefore do not need to be regulated or supervised, it is clear that their actions (greed in most cases) ultimately do create systemic distress. This of course affects one and all. To bring these entities under the regulatory regime would require a substantial strengthening and revamping of the regulatory capacities. The sooner that can be done the better. The third immediate lesson would have to be that short of creating a single financial sector regulatory authority, there needs to be much more effective and real time coordination between regulators dealing with different segments of the financial sector. The recommendation that a working group be established to examine the feasibility of a single financial sector regulatory authority in India should be implemented as soon as possible. Its mandate should include that if a single authority is not considered appropriate, the working group will suggest modalities for effective and real time coordination amongst sector specific regulators. Finally, we should examine the role of the credit rating agencies and identify the weaknesses, including possible conflicts of interest situation that they suffer from. While there may be no straightforward answers, it is important to make a beginning and generate real research, and not advocacy as some government financed groups tend to do, which can then inform public policy in this important area. Those who convert crisis in to a learning opportunity will deservedly move forward while dogmas must and should fail.

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