HARVARD | BUSINESS | SCHOOL
Knowledge & Library Services
BAKER 3.0

Creating Emerging Markets – Oral History Collection

Dr. Y.V. Reddy, Former RBI Governor
Interviewed by V.G. Narayanan,
Thomas D. Casserly, Jr. Professor of Business Administration,
Harvard Business School
July 2, 2017 in Hyderabad, India
Video interview conducted in English

Research Inquiries & Requests to Cite Oral History Collection: Please contact Rachel Wise, HBS Archivist, rwise@hbs.edu or Laura Linard, Director of Special Collections, llinard@hbs.edu.

Preferred Citation: Interview with Dr. Y.V. Reddy, interviewed by V.G. Narayanan, Hyderabad, India, July 2, 2017, Creating Emerging Markets Oral History Collection, Baker Library Special Collections, Harvard Business School.

Baker Library Special Collections
Baker Library | Bloomberg Center
Harvard Business School
Boston, MA 02163
617.495.6411
histcollref@hbs.edu
http://www.library.hbs.edu/hc

HARVARD | BUSINESS | SCHOOL

Interview with Dr. Y.V. Reddy

Interviewed by V.G. Narayanan

July 2, 2017

Hyderabad, India

Video interview conducted in English

VG: *Thank you, Dr. Reddy, for joining us today at the Taj Falaknuma Palace, built in 1894 in the city of Hyderabad. Sir, welcome to our Creating Emerging Markets project.*

YVR: Thank you for having me over for this project.

VG: *So I would like to start with your early career. What prompted you to join the Indian Administrative Service (IAS)?*

YVR: My father wanted me to become a civil servant. He wanted me to appear for IAS, and that is the reason I joined.

VG: *And did you enjoy starting out in the Indian Civil Service? What were your initial roles and responsibilities then?*

YVR: Basically, I believe in the ideas of destiny and dharma. Destiny takes us to different places, and I have to perform what I consider to be the dharma wherever I am placed—and that's how I started. In any case, the civil service was fairly prestigious, and there was a lot of scope for public service. During my college days, I was somewhat active in politics—somewhat leftist in my views—and I found that the civil service was a profession that gave opportunities to serve the society. Having joined, I didn't really look back. Next to politics, the Indian Administrative Service is one profession that gives you an opportunity to get a pulse on the society… to feel the totality of social change and social dynamics… there is no other profession that gives you that type of kick. It was a learning process in some senses and the service gave me an opportunity to keep learning. And in a way, I was in the thick of independent India.After1947, we were not sure how we would evolve or achieve unity in this country, and we were worried about that issue at that point of time. We went through four or five wars till 1972. Then, there was the issue of national integration amidst huge diversity. When I was going through nation building, I didn't have regrets about being a part of the civil service. At the end of it also, I don't have regrets.

VG: *Excellent, thank you. So you started your career in 1964. Coming back to sort of the state of Indian economics at that time, in 1969, Prime Minister Indira Gandhi made the decision to nationalize 14 of India's largest banks—to take the share of public sector banks, share of deposits, from 31 percent to 86 percent, to control the commanding heights of the economy.*

This is something I remember reading in my textbooks. What was your view of that decision at that time?

YVR: At that point of time, it was generally welcomed as something that could do a lot of good. But, at that point of time, the Reserve Bank of India opposed it. At that point of time, after professional discussion, Mrs. Gandhi—who was the prime minister—said, “It is a political decision.” So in a way, nationalization was at the whim of the prime minister of the day, and recently, I jokingly said, “It will also be privatized at the whim of the prime minister of the day.” But many of us did feel at that time that lot of good could come of it. The resources available to the government to design and implement development planning suddenly expanded and government got a command over the banking system.

The immediate impact, naturally, was that Reserve Bank of India virtually became subservient to the developmental goals set by the government, and by implication, to the government. So in a way, it is a part of the totality, namely, the belief in development planning. And that was not exactly considered inappropriate at that point of time. The role of the state at that point, even in advanced economies, was expanding rather than contracting. So if you ask me, what was the general consensus at that point of time, I would say that, though there are some who had reservations, public sector banking was not considered a foolish or inappropriate move.

VG: *And reflecting back on that, and with the benefit of history and hindsight, how do you evaluate that decision?*

YVR: Actually, I have written my memoirs, *Advice and Dissent,* in which I have described how the thinking evolved. Basically, with regards to the whole country, in the balance between the state and the market, we came to believe in a mixed economy, which was, and I think, still is conceptually correct.

VG: *So looking back on the nationalization of the banks today, what aspects do you think have worked well, and what aspects do you think may not have worked as well as initially planned?*

YVR: Nationalization started off very well. There was impressive penetration of the banking system into the countryside, so that was one good part. But in the 1980s, it became an instrument of populism, rather than developmental banking. So banking was more politicized than what was originally envisaged.

That public systems could be influenced with politicization was globally realized in 1980s, but we in India did not work to rebalance the role of State. We went on expanding the state and the same thing happened to the banking system. By the mid- or late-1980s, there was a realization that the negatives of the nationalization of banks were more than the positives. But efforts to change the system did not take place until the Narasimham

Committee was appointed in 1991, At that point of time, there was an effort—some recommendations were made for restructuring. The shareholding of government was brought down but government continued to exercise dominant ownership and control. They retain public sector characteristics. Structurally, the governance and the institutional and legal structures that govern the nationalized banks have not been changed. A large number of committees that succeeded Narasimham Committee wanted them to be changed, but in vain.

What have been the consequences? The burden has landed on the taxpayer, number one. Number two, the efficiency of the financial sector, as well as the transmission of the monetary policy, are constrained by the presence of the public sector banks. They cannot respond to the market incentives, as they should in a modern system in view of their governance systems prevalent in our society.

We are now at crossroads, where the government is now confronted with a problem. Either we go forward with the financial sector reform—in which case, the government has to sort out the public sector banks problem—or, India will not be able to develop a modern financial sector and can't go ahead. That's where we are stuck now. But there is this political economic consensus, at least till now, that nothing should be done to change public sector character of our public sector banking system.

VG: *Okay. You talked earlier about using the public sector banks to mobilize resources for the development of the economy. This was a very* *tumultuous period in India's history: we had three wars in the 1960s and early 1970s. To what extent has the external political environment, particularly the three wars, had an impact on the nationalization of the banks and the mobilization of the resources? Was it helping to finance the wars—I mean, is there a connection there?*

YVR: No, no, not at all. Not at all. There was a general cost we paid for all wars till end of 1971. There was no war issue connected to the banking system and its nationalization in 1969. But you know, there was another incidental benefit of banking system. After nationalization, in a way, the middle class got integrated on an all-India basis. Recruitment was on an all-India basis, it was on the basis of merit, for public enterprises in general, and particularly for the banking system. So whether this was a high price to pay to achieve national integration is a different question, but that was the one of the positive impact.

VG: *There was no connection, okay. Now, you talked about the expansion of banking, making it available to more people—did that facilitate a sort of financial inclusion of people that previously did not have access to banking facilities? Did nationalization help expand banking to masses that were earlier excluded?*

YVR: Yes, in the sense, there was a physical expansion of the number of bank branches and bank accounts. You must remember, the public sector bank system was used essentially for credit—the allocation of credit and the expansion of credit. That's not the same thing as financial inclusion. The word financial inclusion was used only very recently, in 2004-2005. In fact, that was my argument soon after I joined as governor, that what banks were doing was not financial inclusion. Soon after I joined as a governor, I said the main purpose of the financial sector is to ensure that a servant maid is able to keep her money safe from her drunken husband, so it's the availability of and affordable access to financial services. Nationalization did not expand access, except incidentally. The focus was more on credit expansion.

But there was something else that happened: the government deficit went on increasing. As a result, the banking system—and in those days, public sector banking virtually was the banking system—gave over 60 percent of its resources to finance the government. So there was not much left to give to the poor people. In a way, the public sector banks were financing the government deficit, and some for government sponsored programs which left very little for own lending programs. Therefore, there was a constraint on what public sector banks could do to expand credit, due to large demands from government.

VG: *Okay, Sir, this is very helpful. So let's move from the 1980s, to the 1990s. In particular, I would like to hear your perspective on the balance of payments crisis (BoP crisis) in 1991. Where were you at that time, what was your role, what is your perspective on that?*

YVR: In 1980s, I was in the World Bank for five years before coming back and working in the state government as Secretary of Planning assisting N.T. Rama Rao, who was Chief Minister of Andhra Pradesh. It was a fascinating experience working with such a charismatic chief minister. At that time, I felt that we were very much behind in understanding the relative roles of state and market in the economy. I saw China entering the capitalist system; I saw Reagan, Thatcher, and the rise of public choice theory.

I took academic leave, and for a year and a half, I studied all of this that was happening. So in a way, mentally, I knew that something different from the past had to be done in India. In fact, I called the new economic policy of Rajiv Gandhi a "technocratic response". In 1980s, what happened was that, the government including political leadership knew that the current economic model was not working. Many top policy makers had decided that it was not working, and there were a number of committees trying to change the system. But what they tried or what they recommended was marginal change, not fundamental change. This marginal change was not enough, and the situation was unsustainable. No doubt, in the 1980s, the growth rates jumped to about five or six percent, but this was done with borrowed money and borrowed time.

I began working with the government of India in early 1990. I remember, soon after I joined, that I called on Montek Singh Ahluwalia, who was in the prime minister's office, and I mentioned to him that I thought we should be ready for a crisis, and he readily agreed. By then, the Gulf Crisis hadn't yet fully blown, but most of us knew it was a matter of time before something burst.

And then the political uncertainty within India intensified. So the necessary corrective actions to face the uncertainties could not be taken. And then the Gulf Crisis hit in 1990. We were very vulnerable, and the world knew that we didn't have proper political leadership.

To just get a sense of that perspective, we should remember that, in the 1990s, we were under acute balance of payments stress. We had a major economic crisis in 1991. In 1992, we had to undertake reform, big reform. By 1993, we were on recovery path. Over the three years, 1990-93, we had three prime ministers, three finance ministers, three governors of the RBI, three finance secretaries, and three chief economic advisors. During this time, I was heading the balance of payments (BoP) division within the Ministry of Finance. So I was virtually the only person who was aware of what was happening, and yet the remarkable thing is, we managed to handle the crisis reasonably well. And the reform was taken up once P.V. Narasimha Rao and Manmohan Singh came to power (as prime minister and finance minister, respectively). So I think that shows the character of the nation and everybody's commitment to keep the pride of the nation in the economic management.

VG: *And what was the impact of the crisis on your personal views? Do you think it made you sort of anticipate crisis, or make you think about risk management? I mean, what impact did it have on you?*

YVR: In fact, yes, I have been accused of being "too conservative" in some senses, mainly vis-à-vis the external sector. My feeling was that, considering geopolitical factors, we had to take care of the instability or vulnerability in the external sector… So naturally, the weight I gave for insurance against external shocks was perhaps more than others might have—particularly during my time as deputy governor of the RBI, and definitely during my time as governor of the RBI.

But there is another thing I must say. When I was the executive director of the IMF, between my time as deputy governor and governor of the RBI, many of my reservations about the globalization of finance were reinforced. So actually, I became more careful about the markets after that one-year stint in the IMF during 2002-2003.

VG: *Can you tell me little bit more about the reforms that came out of this whole crisis in 1991? Do you think the reforms were beneficial? Did we go far enough, did we reform too much? With benefit of hindsight, how do you think about the reforms?*

YVR: Let me quickly recall, in terms of the big picture, three main features of the reform process. The first feature was really getting rid of the control Raj—the License Permit Control Raj. So we got rid of that. To that extent, it was quite successful; it resulted in quite a lot of benefits. The second feature was that we did not wait for the legal changes." We thought we could have policy changes first, within the existing legal framework, and still manage—

because there is a large area between what law forces you to do, and what law prohibits you from doing. Let us take foreign exchange. We had a draconian law from 1973. It could interpreted in a very draconian manner, but it could also be interpreted very liberally. I will give another example. We had an agreement between the government and the RBI to stop automatic monetization.[1] Later, the law was enacted to reflect this agreement. So in a way, we deregulated first under the old law, and then later created new law to bind us.

The third feature relates to the analytical framework. The reform thinking was designed within the country but was influenced by the IMF and World Bank. For several years, the IMF and the World Bank offered their opinions about what they thought was good for the country. We didn't say openly whether we agreed or not, but that influenced our thinking. And many of the people who were involved in the reform process had worked in them before, so they were more familiar with these ideas already. So in a way, formally and politically, the reforms were "home grown," but with the benefit of outside advice that was taken but not blindly adopted. The IMF also was also confident that, if we deviated from their model, it would be because our country's specific situation. That's why I think the IMF program for India is one of the best programs IMF has developed. And from our point of view politically, it was easy to throw blame for the temporary economic

[1] Automatic monetization refers to the practice of the RBI to automatically create ad-hoc treasury bills when the cash reserve, maintained by the government with the RBI, falls below the minimum level.

hardship that fell on the IMF rather than on the government that mismanaged in the first instance.

This was the good part of the reforms—the areas where reforms took place. There are areas where reforms should have taken place, but did not take place—despite the framework available in 1991-1993. The banking sector is a good example. You will find, again in my book, *Advice and Dissent*, extensive reference to the problems of public sector banks in the financial system—they continue to be there.

VG: *So moving on from this crisis…eventually you succeeded Dr. Rangarajan and Dr. Bimal Jalan in leading the RBI. When you took over as the governor, the situation was quite different. Can you tell us about what kind of situation you inherited when you became the governor, in terms of the economy?*

YVR: Let me start with what I said when I became governor of the RBI. I said, "I believe in continuity, with change as appropriate." There is a reason why I said that. I had been deputy governor, and I had assisted Dr. Jalan, and I had assisted Dr. Rangarajan… so I could not disown what had happened before.

Before my time at the RBI, I had worked in the government. So my advantage was that I knew what the government was like—having been secretary of banking, dealing with the RBI and the banking system. So I knew that side.

I was also on the board of several financial undertakings, like the Industrial Development Bank of India (IDBI) and Industrial Credit and Investment Corporation of India (ICICI), State Bank of India, National Bank for Agricultural and Rural Development. I was also on the Board of securities regulator and the largest mutual fund. My exposure to eminent economists like Rangarajan and Bimal Jalan helped me, just as I would like to believe that my administrative background helped them. So these are the advantages that I had when I came in to the role of governor of the RBI.

Some things were changing, and I could sense that. So I had to balance continuity with change. The first was that the banking system and regulation of both public and private banking required more attention, so I gave high priority to that. The second was the external sector. I wanted to strengthen the external sector. I was fortunate that I inherited a reasonably good economy. Macro was good, so there was no immediate problem on hand—the problems started coming soon thereafter.

The period from 2003 to 2008, as it turned out, became very different from the past, totally different. From 1950s till then, we always had a problem—foreign exchange constraint—with regards to all our public policies. This time, suddenly, there was no foreign exchange constraint. In fact, the problem was one of plenty. The political leadership was not able to accept that there could be something like plenty. People were not equipped to appreciate this. I had a difficult time convincing others that such a problem could exist. That's number one. Number two, financial institutions as well as banks were trying to push credit, and, during my period, it was shooting up to 30 percent. So that was something—constraining credit—that was unaccustomed in the history of independent India.

The third thing that happened was the phenomenon of over-heating[2]—this concept of overheating was unheard of India at the time. When I raised the issue with the finance minister, he was not happy. Afterwards, I didn't use that word.

Fourth, we were trying to globalize, to achieve global integration, and that was another new challenge. At that time, the global economy was trending towards a particular financial sector model. And so with these four things combined, it was a very tense period. But the remarkable thing was that, as luck would have it, India had an extraordinarily strong economic team, including then-Prime Minister Manmohan Singh (former finance minister and former RBI governor), Deputy Chairman of Planning Commission Montek Singh Ahluwalia, former Finance Minister P. Chidambaram (who is known for his brilliance and his capacity to understand), Dr. Rangarajan as advisor to the prime minister, and President of India Abdul Kalam (who was on the board of RBI and a scientist though)… So for me, it was not easy to work with this sort of oversight over the RBI, but in a sense, it was fun.

VG: *So other than banking regulation, what were the other issues you decided to tackle in the first few years of your time as governor?*

[2] Overheating is a phenomenon in which productive capacity is unable to keep pace with aggregate demand.

YVR: Major issue that we decided to tackle was financial exclusion, leading to policy of financial inclusion. So we first said that—"Look, the financial sector is just not money and finance. It's, in a way, a service to the people and society." So I used the word for the first time, financial inclusion, but there I made a distinction. Credit has an element of risk. One idea was an expanded payment system using technology. We experimented using technology for government payments. Virtually all ATM transactions were made free. So the idea was that the common person should have access to transfer money, to get money, to transact, etc.

Overall, I felt that to establish trust in macroeconomic management, number one was taking care of the external sector number and two was taking care of the savers. The way I looked at it was that we should have enough savings to finance investments. I didn't worry too much about the demand side or the investment side, because those decisions were going to be determined more by the government policies. Somebody has to protect the savers and ensure that the savings are available in the financial system.

VG: *And what were the biggest challenges in going ahead with these reforms?*

YVR: The biggest challenge, as I said, was that we were facing unfamiliar circumstances. But I had the advantage of an excellent leadership team in RBI. The second biggest challenge was combatting the prevailing belief that the financial sector was the salvation for the Indian economy. We had to keep saying, "Look, the financial sector can help up to a point, not beyond that." So this was the problem—an ideological thrust towards what I call "excessive financialization." And naturally, the government was trying to put pressure in this regard. I had to convince the government that this was not a good policy, and I am glad that the government was willing to listen to me.

VG: *Now, around the world, you have been heralded as the person who protected India in the 2007-2008 financial crisis. Just before this period, you saw the excessive growth in credit as actually the source of a potential problem. This intuition you had was probably without parallel across the world, because most people believed that the situation was very favorable. People looked at this and said, "Aren't we so lucky," whereas you had a different perspective to anticipate that there could be a downside. In hindsight, everything is 20/20, but to anticipate this before it happened was somewhat unique. Can you tell us a little bit more about what particular decisions you took because of this concern that you had? You already said that you faced some resistance from the government—how about from industry? How about the other central bankers around the world, how were they viewing this at that time?*

YVR: Okay, first I will start with the other central bankers. My impression was that in private, they shared my anxieties. There were a number of discussions, especially within ten or twelve of us. Some believed in the ideology that if the bubble happened, we would clean the mess. They were aware that a bubble may be happening—there was no question—but they said, "Who are we to judge whether there is a bubble or not? "So when it happened, they said, "We will take measures called 'clean' after the bubble bursts. So, that was one view. The other was that, it is better to lean against prevailing views of the situation and take action to moderate or prevent bubble. In this approach, there were two questions. One, are you sure there is a bubble? Two, are you sure that your plan or proposed countermeasures will work?

There were some who said, in private, that the financial sector was too powerful, and the political leadership was such that we could not afford to take action against the bubble. This view, surprisingly, was validated by Alan Greenspan himself, after the crisis. In one of the interviews with Justin Fox, I think, he said that even if he had wanted or decided to intervene, it would have been impossible because of democracy since the going was so good. In fact, the Federal Reserve might have lost its independence, if he had intervened. So I would say, on the whole, that important central bankers across the world did feel what I was feeling, a sense of discomfort.

VG: *But they had constraints in what they are doing?*

YVR: They had constraints. For me, I think I was lucky to have political leadership. Though they did not agree with me, they were prepared to trust and give me some leeway. In fact, often Manmohan Singh used to say to me, "Venu, you must give full weight to what the finance minister is saying, etc.

etc." And then he would say, "But I believe in your judgment." So I think that was good, and we brought out the arguments, particularly regarding India's capacity. Let me be honest—I was not sure that there would be such a big crisis or a problem, but I knew that we could not afford to take any chances. And therefore, I was being a little more careful. Now, what were the measures I had taken? These were the traditional or conventional measures. In that sense, the others were moving away from traditional—I thought, they were moving too fast.

And the type of actions that we took, I think, were nothing very new. The Non-Banking Financial Companies (NBFCs) were one source of the problem, so I wanted to control the NBFCs.[3] Second, was the whole issue of regulatory arbitrage: we had these systemically important financial institutions (SIFIs), and we got the regulators collaborate to watch over them.[4] Third, wherever there was increased lending—including the lending to share markets—we increased the margins for bank lending. We did not prohibit, we increased the margins and made it more expensive. We were very tight with regard to the housing markets…

There is an interesting issue, which keeps coming up with regards to credit specifically for housing. The medium-to long-term objective was to increase the credit for housing, because we wanted people to save and invest in houses. We wanted lending for housing to expand. But the question was,

[3] NBFCs were considered problematic because they were lightly regulated – and by default so were the instruments issued by them.
[4] SIFIs are financial institutions whose failure can trigger a financial crisis, so watching over these institutions is extremely important.

how do you reconcile the longer-term growth in credit with the shorter-term countercyclical policies?

Finally, we were very clear that coordination was important between monetary policy and regulatory policy. We believed that coordination was inherent to our system, because the Reserve Bank of India was a full service bank. I also knew, having worked in the government, that temperamentally, I had a belief in coordination. And that's how the coordination occurred.

But one thing I must emphasize, which not many people have noticed, is that during my five years, the private sector banks cleaned up and improved their governance at the insistence of the RBI—never in history has so much consolidation taken place. We consolidated them, we improved their governance, and we instilled fear in private sector banks by beginning to disclose the penalties imposed on banks for breaking the law. Before that, the penalties were not disclosed. It was a one and a half year fight for me to disclose the penalties imposed on the banks under the law, and to achieve that, I had to get around so much bureaucracy. And I believe that, in the final analysis, two things need to be emphasized. First, when I conduct monetary policy, it is not my business to give forward guidance. I will share my thinking, but the market should take the risk. That's because, I don't know the future. If I knew the future, I should have been on the other side making money, not trying to do the policy. And second, as far as our regulation is concerned, I was very clear that a regulator should be respected.

VG: *Can you talk a little bit about your underlying philosophy in the reforms that you adopted early in your tenure as the RBI governor?*

YVR: First, I felt that monetary policy was not all that technical, as it is made out to be. Yes, forecasting is technical but not so much the measures. Monetary policy interest rates affect different sections of the population differently. In fact, the title of the chapter on monetary policy in my book is, “Interests and Interest Rates”. I wanted to be very clear about how both of these things affect savers. However, more important in the Indian context is the intermediation cost. The cost of financial intermediation is very high, which is a reflection of the inefficiency of the financial sector. So I wanted efficiency to be improved, but I did not succeed. For five years, I tried to improve it, but I did not accomplish much—partly because of the fiscal deficit, partly because of public sector banks, and partly because of the overall financial infrastructure and eco-system determining the credit culture. I didn’t succeed, but I knew the importance.

The second underlying philosophy of my reform agenda was the importance of working constructively with the government. See, while I was dealing with the government, there were three different things we were doing: we were doing the operations, we were doing the macro policy, and we were doing structural reform. There are some overlaps between the three, of course. Now, it’s not as though all three converge at a single point of time. But the underlying philosophy in my relationship with the government was that operations in the RBI must be free—no interference. If the government tried to interfere with me, it would have to convince me that I was doing something wrong. If it were a matter of policy, I would discuss. As far as possible, I believed that we should harmonize, but without compromising the freedom of action. So we tried to keep each other informed about our respective thinking. The third thing relates to structural aspects where coordination is important, and Government is vital.

The third underlying philosophy was the need for a structural transformation. To achieve a structural transformation, we had to work very closely together—the RBI and the government. So these were the three pillars on which our relationship took place. The finance minister said at one point, "I am democratically elected, you can't stop me expressing what I want." I said, "Okay, you can do that, I have no serious problem—but remember, it will have an impact on the markets, and that will make my life more difficult. You keep that in view." So this was the working relationship that we had. So after discussion, if the government took a particular stand on structural aspects despite my advice, there would be no question—we would have to implement their decision most faithfully, because ultimately stability was what was important. This was my relationship with the government.

As for my experience with bringing about reform, we knew that we had to get some outside skill. But we also knew that every reform should still be owned within the RBI. So we insisted that our skills should improve on a permanent basis. We opened up to outside advice and input. We got consultants, initiated discussions, and we interacted with the private sector—

especially foreign banks, as they had lot of expertize in these areas. We used to bring them into all of our advisory groups, and we learned from them. But as a system, we maintained our integrity and ownership of what we thought and did.

I used to encourage our professionals and teams to learn as much as they could and to work together. So for all of us, at all levels, we set certain priorities. First, get hold of the theory, understand the theory. Second, understand what's happening globally. Third, ask, where are we? In what way are these theories applicable to our situation, and how do we move? So that was how the reform path was carved out. Once the reform path was discussed and in the process, we got market participants involved, the final decision and the goal were set by the senior management team. I had excellent deputy governors. Once we agreed on the goal—this is where we want to be—then there was no compromising, we would go after it. But we would also make it very clear that we were prepared to negotiate the path if necessary. We wanted, as far as possible, non-disruptive change.

One important advantage we had was that in India, there were not many experts outside the RBI in the financial sector or in the ministry of finance. The number of economists we had in the RBI was a lot more, and we had at least 70 who had gone to Ivy League universities. So in a way, we had the skills, and this helped us have a say in India's monetary policy. In fact, the Fiscal Responsibility Legislation was drafted by the RBI. We also assisted the government in drafting legislation on foreign exchange management. No, I was always very clear—sovereign, you are supreme. We respected the authority of the government, so long as the government allowed us to do our work. We had three fundamental principles of management. The first was, I used to call it, "haddu, paddu" in Telugu. So Haddu means, "the limits." What are the limits of my power, my effectiveness? I must recognize that first. Then, paddu means, "keep an account of all the consequences"—on all the risks. So that was the first principle in our action for reform. The second was "samayamu, sandarbhamu." That is, the timing and the context—you have to see the timing and the context, and then you have to act. And the third was the concept of non-disruptive movement and change after getting an agreement. These were some of the common sense principles we adopted, and I think they happened to have worked at that time.

VG: *Okay. And how has the role of the RBI governor changed over time?*

YVR: First, I must emphasize that, even in advanced economies, the independence of the central bank and the personality of the governor are phenomena that have gained prominence for the last 20 to30 years. It was only after the 1970s, when the high and volatile inflation came in, that the idea of independent central banks focusing on price stability became the global best standards. So India was not much different from the rest of the world, except that it was a latecomer to acceptance of the idea. In the rest of the world, these notions of independence arose in the 1970s and 1980s; for us, they arose in late 1990s.

Second, the RBI had one advantage compared to all other emerging market economies. In the last 70 years, we didn't have a serious banking crisis, and as a result, people had a lot of trust in the banking system in India. In many other developing countries in Latin America, as you know, many people kept their bank accounts outside the country. In some Latin American countries, even the central bankers kept their money outside their home countries. We didn't have that. If you look at the last 40 to 50 years, compared to many other countries, we rarely crossed ten percent inflation. As a result, India now has a reputation for economic stability, and I think the political leadership also recognizes this reputation, built over several decades. So these are the strengths of the RBI.

No doubt, the RBI's role became subordinate to government during the planning era up to 1990. After the BoP crisis in the early 1990s, then the issue of autonomy had to be revisited. At that time, what happened was that the RBI in a way negotiated with the government for autonomy. The RBI of course had skilled employees who were very knowledgeable about the financial sector. Through negotiation, the RBI made the government cede its control over the financial sector to both the markets and the RBI. So the RBI and the RBI governor started coming into prominence when the government ceded its power in these areas—partly to the markets and partly to the RBI. So the governor and the governor's personality became a public face only since the mid-1990s.

Legislative measures, taken between the mid-1990s and 2008, strengthened the RBI and the position of the governor.

After 2008-2009, several amendments were made, and I think these amendments have, in some ways, disturbed this trend.

VG: *Can you give some specific examples of things that concern you in terms of the putting constraints in the role of the RBI?*

YVR: Yes, first let us take the institutional identity. The Reserve Bank of India is a full-service bank. Recently, a Monetary Policy Committee (MPC) has been created, and the impression is that the governor is accountable to the government with regard to inflation. Then what happens to everything else that falls under the purview of the RBI? Suppose the governor performs well with regards to inflation. Will his success be judged solely on this target, with the rest of his responsibilities such as regulation and external sector neglected? Then you get a question mark. Is the institution going to be governed entirely by an inflation target? It's unclear. So in that sense, there is a problem with the institutional identity.

Second, let's look at the position of the RBI governor. Till recently, the governor was not considered equal to the finance minister, but was also not entirely subordinate—he was virtually above the traditional civil service, very much above. Now, with the amendment to the act constituting the MPC, the members of the Monetary Policy Committee are appointed by a selection or search committee, which is headed by cabinet secretary—and the RBI governor is a member. By implication, the RBI governor has become equal to a second rank bureaucrat in the government.

Third, earlier there was no defined responsibility, but it was well understood that ensuring financial stability was the business of the Reserve Bank of India. The governor was generally looked upon to lead the way. During our days, that was what we did, financial stability was a concern of RBI. Then, suddenly, a Financial Sector Stability and Development Council was created under the chairmanship of the finance minister. In developing countries, very often financial crises occur when there is political instability. Now, if you are handing over the issue of financial stability to the finance minister, a crisis may happen when the position of finance minister himself is uncertain. So, in developing countries, it is better if responsibility for financial stability vests with central banks.

VG: *So broadly stepping back and looking at the role of the RBI governor—you correctly pointed out that, over last 70 years, it developed a very high reputation. Do you have concerns about the reputation? Is this reputation domestic or international? How should we think about this word "reputation" in the context of the RBI governor?*

YVR: One important aspect of reputation is global reputation. The RBI was rated very high professionally, and even globally, in terms of its record of performance. Also, when the financial sector underwent reform, it was led by various committees headed by central bankers: the Narasimham Committee, the Malhotra Committee, the Tarapore Committee…this was the case until 2008. Then, we had non-RBI people in various committees, including a judge and a commercial banker. So I think the dependence of the government on the advice of the RBI was not as much as it used to be. But globally, I don't think the RBI's reputation has changed—that professionalism has not gone down in my view. And as far as the faith of the people at large in the RBI, I don't think it is shaken. I don't think there is any need to be worried, at least not yet.

VG: *So the competence or the integrity of the RBI is never in question. So it's only with regards to role of the government vis-à-vis the RBI that there is concern?*

YVR: Absolutely, yes.

VG: *Okay, now I understand what you are saying. I'd like to talk about two issues that are of personal interest to me. You know, I am an accountant, and I look at disclosure, and I sort of believe that sunlight is the best disinfectant. In India, the non-performing loans have been talked about in the media quite a lot. In particular, large defaulters…*

YVR: Sorry, can you repeat the question?

VG: *Of course. So I wanted to ask you about the non-performing loans, and in particular large defaulters of loans. I was very surprised to learn that the list of defaulters and their identities is confidential information that* *cannot even be shared publicly. In a way, I understand, because it's a commercial relationship, and privacy is important. But there is another side to it. These are nationalized banks and the private citizens of India are sort of bearing the cost of defaults. What is your opinion on regulation that says that this cannot be publicly shared? Are you in support of it, or do you think the law needs to be changed such that, after you cross a certain threshold of default, the public has a right to know this information?*

YVR: In fact, this issue came up when I was secretary of banking, before I was in the RBI. As secretary of banking, I was representing "democracy, government" And so when this discussion came up, I said first thing, "I am one of the defaulters, according to the defaulters list disclosed by Reserve Bank of India." So to provide background: the Reserve Bank of India only discloses defaulters where a case has been filed in the course of debt recovery proceedings. These are called suit-filed cases. Up to then, it is secret; after this point—the moment you put it in court—it is in public domain.

Anyway, I was on the list of defaulters. You know why? There was a sick company, and I was nominated to the board to solve the problem. But since it owed money, I became a defaulter. So I began to ask myself, at what point of time does a fellow there, trying to do good, become a fraudster? I mean, just because it's a sick company and has defaulted, it does not mean that every board member is a fraudster. To me, this is something important to consider. I explained this to my colleagues—that this happened to me. I said, "When something like this happens, people will start worrying whether they will be seen as a cheat." So it's unfair, number one. But once it has gone to the court, at least you can explain the situation, and then it's left to the court to decide.

I also think that if you allow naming and shaming, it should serve a purpose. In our culture, it has not been shown to serve much purpose, in any context. Moreover, if you want to do that, you should not discriminate between private sector banks and public sector banks. Governments can ask for the identity of defaulters, because taxpayers' money is involved. But in my opinion, you cannot have a situation where a private sector bank can keep this information confidential and a public sector bank can't. Another problem is that, given the legal systems in India, nothing gets settled quickly. Therefore, in terms of the bargaining power between the bank and the borrower, the bank is weak. The moment they go to the court, it will be 10-20 years before the matter is settled. So if the bank files a case in the court, it means that it has given up hope of getting any money without dilution of assets. And therefore, given the systems of debt settlement, not much purpose would be served by disclosing this information and going public. In India, the bank really has to negotiate with the borrower to recover debts. Recently, things have changed. A new bankruptcy law has been passed and new system put in place. Still, putting names of Loan defaulters in public domain may have more downsides than upsides.

VG: *Okay. So that is very helpful. The other issue that I would like to get your perspective on is your role in protecting India from the financial crisis* *and anticipating this bubble. There have been some concerns raised about whether you were being too cautious and too conservative, and I would like to take one particular example: the cost of housing loans and intermediation cost. I get to borrow money in the US at 2.625 percent. My father here pays north of 12 percent for a basic loan, from when he borrowed money to buy a house. The inflation levels are different, but a big part of the cost is the cost of intermediation. I believe, as a naïve observer, that the securitization of home mortgages, while it led to the financial crisis in 2008 in the United States, has also had some benefits. For example, the whole world is now able to participate in lending for housing in the US, and that drives down the cost. Moreover, liquidity is very high—you can very quickly sell the securities, etc.—whereas in India, it has not been as high. The regulatory regime has not looked that favorably on securitization. Isn't there a cost in terms of financing that the end customer has to be bear, because of this regulation?*

YVR: Absolutely, good logic. But let me narrate what happened. At first, when we wanted to increase the risk weight for housing internally, others within the RBI said, "Look, housing is a safe asset." And therefore, according to global guidelines, it has less risk weight than anything else. So why are we increasing the risk weight? My point was simple. If we see the housing prices and the rental income, it's very clear that everybody is buying, hoping their investments will increase in value. It is very simple, you cannot ignore this fact. And it's far better in our system to be safe when it comes to the bank, so I felt it made a lot of sense to increase the risk weight. Then, when we announced this decision, there was a meeting of commercial bankers, and one of them—a very highly qualified expert—asked me, "On what basis did you increase the risk weight?" So I said, "There is not much of a credit record—we have just started lending for houses in the retail space. So, I need to ask you, on what basis did you determine this risk premium in determining your lending rates? You tell me, then I can tell you why I did what I did." The database on this was not there. The market was very illiquid, and in India, if you wanted to sell a house, the registration expense was eleven percent. And the legal systems were such that, then—and I don't know about now—recovery was possible in barely ten percent of the suit filed cases—not even ten percent. There were illiquid housing markets—there was no housing market, in reality.

And finally, the issue of mortgage companies came up. A set of foreign banks sponsored mortgage companies, and the government wanted us to prepare the guidelines for them. The mortgage company said, "When all other legal processes are exhausted, then I will give you money." In India, where exhausting all other legal processes will take 15 years, that means that the bank will never get the money. So I said, "No, this will not work for us." So that was the background in which we took this decision. But as things change for better, I think what you say is right.

VG: *Thank you, that's very helpful. One piece of this that I would like to think about now is the future. How do you see technology affecting banking, and what do you see as the role of the RBI going forward?*

YVR: Well, that's a very big question. My worry, if you ask me, is about the future broadly. I would put it this way: globalization is inevitable because of technology itself, it drives globalization. People also want to move, so that drives globalization. But people, for any problems, still look to their sovereign. The ultimate risk bearer is the national government. So recent events have shown that the national government wants to acquire policy space to handle national problems, wherever they come from. The policy space available to national government to take care of such risks, and to support the aspirations of their citizens, has been undermined in the recent past. There has been a slowing down of growth in global capital flows, global trade, etc. Now, where would this lead to? How are you going to reconcile the pressure of technology and globalization on social institutions? I think that will be a question mark, and banking is one part of it.

Moreover, unlike with other commodities, global finance globalizes capital, but people can't move—the bargaining power of the workers and the labor is restricted. So the globalization of finance empowers the global capital and weakens the labor. And therefore, there is a downward pressure on share of wages all over the world, heightening existing inequalities.

After the crisis, there has not been much improvement globally in regard to the regulation of the financial sector. When all was said and done, at least in the telecom industry, there was some sort of global coordination—there are many technical areas where there is now some degree of global coordination. In the finance industry, it is a global advisory, there is no real coordination—meaning each country can do what it likes. And therefore, the way I look at it, global finance requires a lot of churning to reconcile these forces, and the people who currently control global finance are not enthusiastic about the changes required.

And then comes the issue of money. We cannot review global finance without talking about the monetary system. The international monetary system is governed by USA, and whatever problems exist, there is no alternative to this system that is emerging at present. Multiple global currencies will not work in the final analysis, so I think, if you are talking of money and finance in broader terms, that there is a big challenge to carve out a space for national management of monetary and credit policies. If the global monetary non-system and globally inappropriate financial architecture persists, I think there will be a big challenge for central banking.

VG: *Okay, thank you, that's very helpful. I want to turn now to the domestic side of things, and specifically the role of technology within India. If we look at the last 20 years, the increase in access to information and smartphones has been dramatic. Now there are probably more phones than there are people in India. And now there is the possibility that, in a way, banking comes to you—you can use smart phones to make payments, maybe even to save or borrow. I don't know what the future has in store, but it seems that banking might come closer to people than it has been in the past. Is this an opportunity? Is this a concern and a risk? What are your thoughts on this?*

YVR: No, no, how can it be a concern? Basically, it makes the matter of banking easier. So let us just take one example, the ATM. As you know, I agree with Paul Volcker when he said that the only socially relevant innovation in the financial sector was ATM—but that's not really a financial innovation, that's a technology. The way I look at it is that, to the extent that financial transactions are made easier and cheaper, it is good for the people. But there is also a negative side, and that's what I am worried about. The negative side is that you get algorithmic trading. To the extent that this undermines competitive elements, it goes against efficiency. So I think the bigger challenge will be for the regulators to ensure that there is still competition. That is the bigger challenge. But overall, the more technology, the better service for the people.

VG: *And do you see India taking the leading role here? It's traditionally been a powerhouse in information technology, so do you see a convergence of the availability of technology, and the needs of common people coming out of India?*

YVR: Let me mention my own experience when I joined as governor. The issue of getting foreign banks to come in to improve our banking system came up. I said, "Look, globally, the financial sector (and the best manpower in financial sector), is supplied by India. Banking technology globally is supplied by India. And there is a good demand for economic activity in money and finance in India. Then why do you think that you require foreign banks to come and save India?" Simple, the policy is inappropriate. So my point was, if the government would change the current policy, our banks would become strong enough to compete with foreign banks in India. At that time, we can open up. So, we had a road map for increased presence of foreign banks and finally taking over of our banks by foreign banks can be allowed.

So, I agree with you that India can be a leader in banking technology serving the common person and reducing transaction costs, if the policy is not wrong.

Incidentally, the RBI had established years ago, an institute devoted to research and development of technology in banking (IDRBT) here in Hyderabad. It is doing a pioneering work.

VG: *And what is your take on the policy right now? There have been many changes in the financial services industry. Maybe the hopes and aspirations of the people are getting ahead of reality, but a lot of people expect or anticipate that innovation and leadership will come out of India, because the expansion of financial technology in India is almost unprecedented, and the regulatory framework seems very conducive to growth. Do you feel it optimistic?*

YVR: Well, let me begin by saying that, when I was still RBI governor, we wanted to improve the payment system, and we had a payment system board created. It was actually Infosys Chairman, Narayana Murthy, who presided over the board, who said, “These are the global standards [for technology in the financial services industry], how we are going to surpass them?” And we did. In the payment system, today we are definitely top in the world, at least among the top in the world. So definitely, great innovation in this field is possible. But the issues again—technology is one, and regulatory challenges are the other. In terms of regulatory challenges, I still feel that our regulatory system, or rather broader policy framework and macro policy, impose constraints. Constraints on financial institutions by virtue of the policy framework are still high. So both regulatory changes and, more importantly, overall policy changes, require a lot more improvement to mitigate the downside of the technological innovations. But again, as I said, I am not up-to-date; I left the job of governor almost ten years ago.

VG: *Okay, thank you. So there are one or two issues that I should have asked you earlier, which I want to go back and ask you now. One question that I forgot to ask you was about the relationship between yourself as RBI governor and the other people you might have worked with in the political system. Earlier, you talked about your relationship (when you were the RBI governor) with one particular finance minister and the prime minister at that time, but you had worked with multiple finance ministers and multiple prime ministers. Can you reflect a little bit on these different relationships?*

YVR: See, there is no standard prime minister or standard finance minister. Mr. Vajpayee, when he was the prime minister, basically had a very simple message. He said, “Look, you deal with the finance minister, period.” Next, he only asked me the question, “What do we do with all this unemployed youth?” So I gave him an answer, which was unsatisfactory to me and therefore unsatisfactory to him. But in a way, he simply flagged issues in this way. He said, “This is the issue, just keep it in mind, that’s all.” After that, I didn’t have much interaction with him, not much professional interaction.

In contrast to Mr. Vajpayee was Manmohan Singh, his successor as prime minister. Prime Minister Singh previously served as finance minister and RBI governor, so he knew the whole game and his relationship was in two compartments. One, I had worked with him before, so we used to discuss what was happening in the world economy, and it was fun. The second, in business. But in business, he would never deal directly with me. He would keep the finance minister, Mr. Chidambaram, informed. His opinion was often sought out by the finance minister, as well as by myself. He was not hands-on, but he was always there for us.

Now coming to finance ministers. During my time as deputy governor of the RBI, the finance minister was Yashwant Sinha, and he was originally in a left political party, later in the right political party. He was a bureaucrat before joining politics and very solid person. I would say, looking back, that the reforms he brought about were fundamental, but not high profile. The reforms happened quietly, non-controversially—everything was done neatly. He would go into minute detail, but still manage to keep the big picture. And that was the period when Jalan and Sinha were the RBI governor and the finance minister, respectively. That relationship was not news at all. It was one set—they were a good team.

Next came Mr. Jaswant Singh. He was from the army, and he didn't have much interest in finance. He had the whole view of big strategy, his thinking was strategic, he was a gentleman and a statesman, and he decided whether somebody should be trusted or not. And then, he had a simple approach. He said, "Mr. Reddy—Governor Reddy—I trust you. Tell me, I'm concerned with the big picture—when do the reserves reach 100 billion? When does this happen?" And even for annual Fund Bank meetings, he asked me to lead the delegation. I mean, he asked me to deputize for the finance minister, and so I led the delegation.

But Mr. Singh took number of decisions—extraordinary decisions—including opening up the external sector. And the way he used to do this was with just one casual walk along the hotel. He would mention something, I would say, "Oh, that's good, let's go ahead and do that." And that was it. Then I used to call him, and ask, "Sir, should I send a reference to government for approval?" And he would reply, "No need for a reference. Go ahead and inform government." He had an excellent relationship with the prime minister. This was most important, because in order for the finance minister to be effective, he has to have sufficient clout with the prime minister. Jaswant Singh had that. He also had an advantage in the parliament—his relationship with the MPs was very good, so parliament was not a problem. Whether it was own party or the opposition party, he was able to handle parliament. He took care of the parliament. He took care of the prime minister. So for me, I only had to take care of him, and that was it. So that was Jaswant Singh.

Then, came in Mr. P. Chidambaram. He was one of the best technocrats to serve as finance minister. He had an impressive professional knowledge of the institution, he would go deep into the matter at hand, and he was very sharp. He would come back from a foreign tour at 3:30am, and by 8:30amhe would be sitting in the office having already cleared all the files. And he was absolutely, totally hands on. So with him, it was a challenge. Every time I would go and meet with him, I would have to go sufficiently prepared. So in a way, the quality of decision making improved because of this type of interaction. But sometimes, it could be painful. And his relationship with the prime minister was very good. Mr. Chidambaram came from a business background; Mr. Jaswant Singh came from a rural background. So the nature of the relationship between the office of RBI governor and minister of finance depended on the institutions, as well as individuals and ideologies; it is an interplay. I am sorry, I gave a longish answer.

VG: *No, very helpful, thank you, thank you very much! Thank you for participating in this interview for the Creating Emerging Markets project.*