IIMA's 45th Annual Convocation: March 27, 2010

Address by Chief Guest Dr. C. Rangarajan, Chairman, Economic Advisory Council to the Prime Minister

Chairman and members of the Board of Governors, Director of the Institute, Distinguished faculty, Graduating students, Ladies and Gentlemen

It gives me great pleasure to be in your midst this evening. As I rise to speak to you, my mind goes back to the days I spent on this campus as a faculty member about three decades ago. To be a teacher at IIMA was a great privilege. The students were bright and sharp; they were hard working and sincere. What more could a teacher demand from the students? Since I left IIMA, the Institute has gown both in size and scope. Today, you admit a lot more students than you did thirty years ago. But quantity has not led to an erosion of quality. You still maintain the leadership role among the management schools. May this Institution grow from strength to strength and let the nation benefit from the commitment and skills of the students that pass out of this Institution.

Let me at the outset congratulate all of you who are graduating today. Needless to say, this is a moment of great joy and satisfaction in your life. Your academic efforts have come to fruition. This marks the completion of one stage in your life and another is about to begin. Many of you will be moving out of the sheltered confines of a college and entering the real world with all its ups and downs. The process of transition will pose some problems, but I am sure that with the value system and training that you have acquired at this Institute, you will be able to face the world with confidence. From the country's point of view, we welcome you as our next generation of managers and leaders. May you grow up to provide effective leadership over this century. In a sense, your future is intertwined with the future of this country. You also have an opportunity to shape it. Youth is driven by idealism and ambition. Idealism without ambition may not achieve much but ambition without idealism can be dangerous. May you combine the two in the right proportion?

Management, as it is very often said, is the newest of the sciences but the oldest of the arts. Wherever human endeavour is involved, management is present because the major objective of management is to achieve results. But so long as the organizations to be managed were small and the environment in which they had to operate was uncomplicated, simple "rules of thumb" were adequate to achieve results. However, this is no longer true. Organizations have become large, technologies of production complex and the environment complicated and uncertain. All these changes require appropriate tools of analysis and rigorous training.

We are living in a time of far reaching changes. Modern management must, therefore, be viewed as a dynamic process of seeking constantly to align a firm's internal resources with the external environment. It is this external environment which is undergoing a transformation in this country and abroad and is marked by such challenges as (a) Coping with increasing technological complexity, (b) Responding to an ever faster speed of innovation, (c) Meeting rising quality standards, (d) Satisfying more demanding customers and (e) Conforming to certain codes of conduct demanded by the society at large. It has always been the case that the extent to which a firm was able to achieve its objectives depended critically on its ability to understand the opportunities

presented and constraints imposed by its environment and to respond with appropriate policies at the strategic and functional levels. This is summarized in the well-known strategy of SWOT. Only increasingly, the environment that is relevant is not only domestic but also global.

The world has moved into a new century and a new Millennium with a greater integration of countries and communities. The term 'globalization' means integration of economies and societies through cross country flows of information, ideas, technologies, goods, services, capital, finance and people. Cross border integration can have several dimensions – cultural, social, political and economic. Limiting ourselves to economic integration, one can see this happen through the three channels of (a) trade in goods and services, (b) movement of capital and (c) flow of finance. Besides, there is also the channel through movement of people.

According to the standard theory, international trade leads to allocation of resources that is consistent with comparative advantage. This results in specialization which enhances productivity. It is accepted that international trade, in general, is beneficial and that restrictive trade practices impede growth. That is the reason why many of the emerging economies, which originally depended on a growth model of import substitution, have moved over to a policy of outward orientation. Capital flows across countries have played an important role in enhancing the production base. This was very much true in 19th and 20th centuries. Capital mobility enables the total savings of the world to be distributed among countries which have the highest investment potential. Under these circumstances, one country's growth is not constrained by its own domestic savings.

On the impact of globalization, there are three major concerns. These may be described as even fears. The first major concern is that globalization leads to a more inequitous distribution of income among countries and within countries. The second fear is that globalization leads to loss of national sovereignty and that countries are finding it increasingly difficult to follow independent domestic policies.

The third fear associated with globalization is insecurity and volatility. When countries are inter-related strongly, a small spark can start a large conflagration. Panic and fear spread fast. The East Asian crisis of 1997 and the current international financial crisis are good examples of this phenomenon. The downside to globalization essentially emphasizes the need to create countervailing forces in the form of institutions and policies at the international level. Global governance cannot be pushed to the periphery, as integration gathers speed. That is why the architecture of the international financial system needs a relook.

Nothing is an unmixed blessing. Globalization in its present form, though spurred by far reaching technological changes, is not a pure technological phenomenon. It has many dimensions including ideological. To deal with this phenomenon, we must understand the gains and losses, the risks as well as rewards. To be forewarned, as the saying goes, is to be forearmed. But we should not throw away the baby with bath water. The risks of an open economy are well known. We must not, nevertheless, miss the opportunities that the global system can offer.

The current international financial crisis has brought out in a stark way the impact of globalization. Globalisation spreads both prosperity and distress. The contagion works both ways. The crisis which originated in the sub-prime market in the U.S. has spread to envelop the entire world. Each country is, therefore, trying to decide on the extent of openness with which it is comfortable. However, even in the current crisis,

analysts have been warning against countries adopting protectionist policies. International trade in goods and services will thus continue to expand. However, the coming years may see increasing restrictions being put on financial services. Developing countries may not want to see unfettered freedom in the flow of funds. As in the case of everything, there is need to have a balanced view here.

Apart from the international implications, the current financial crisis has several implications for the functioning of the financial system domestically. I would like to touch on a few of them.

What stands out glaringly in the current episode is the regulatory failure in the advanced countries. The regulatory failure was twofold. First, some parts of the financial system were either loosely regulated or were not regulated at all, a factor which led to "regulatory arbitrage" with funds moving more towards the unregulated segments. Examples of 'soft touch' regulation were investment banks, hedge funds and rating agencies.

The second failure lies in the imperfect understanding of the implications of various derivative products. In one sense, derivative products are a natural corollary of financial development. They meet a felt need. However, if the derivative products become too complex to discern where the risk lies, they become a major source of concern. Rating agencies in the present episode were irresponsible in creating a booming market in suspect derivative products. Quite clearly, there was a mismatch between financial innovation and the ability of the regulators to monitor them. It is ironic that such a regulatory failure should have occurred at a time when intense discussions were being held in Basle and elsewhere to put in place a sound regulatory framework.

There is considerable degree of consensus on how the regulatory framework should be reshaped. Some of the key elements that should be integral to a reformed regulatory structure are:

(1) The regulatory framework should cover all segments of the financial markets. The rigour of regulation must be uniform among all segments to avoid "regulatory arbitrage",

(2) Systemically important financial institutions should receive special attention. Apart from additional regulatory obligations, such institutions may be required to conform to stricter and enhanced prudential norms. Large institutions having operations across countries may require coordinated oversight of regulators of different jurisdictions. In fact, there is a proposal to prevent financial institutions, particularly banks, growing beyond a certain size so that the dilemma of "too big to fail" can be avoided.

(3) Institutions may be required to set up buffers in good times to be drawn down in bad times. This may entail varying capital adequacy and provisioning requirements according to the phase of the business cycle. They may be allowed to rise and fall with the business cycle.

(4) Excessive leverage in banks may be contained through additional supplements to the risk based capital ratio.

Most countries are convinced that the reform of the regulatory structure along these lines is very much needed. However, there is no consensus on measures such as levying a tax on financial transactions. There is also no consensus on whether the financial system should have a single regulator or multiple regulators. The recent experience does not provide an unique answer.

Banking development has taken big strides in the last two decades. The basic motivation for inducting new financial products is to improve customer satisfaction. A question that is being asked increasingly is whether the financial sector today is inherently more volatile and vulnerable than before. The very factors that have contributed to the growth of the financial sector may well have contributed to increase fragility. Close interdependence among markets and market participants have increased the potential for adverse events to spread quickly. They have increased significantly the scope for and speed of contagion. Some question whether the new financial products serve any socially useful purpose. It has been argued that much of the recent innovation in the financial system has sought to increase the short-term profitability of the financial sector rather than to increase the ability of financial markets to better perform their essential functions of managing risks and allocating capital. In addition, it has been pointed out that some of these innovations have engendered financial instability. It would be inappropriate to classify all or even most of the financial innovations introduced in the last few decades as socially useless. Many of the financial products satisfy a felt need. We are living in a world of uncertainty. Customers need to protect themselves from the volatility in exchange rates and interest rates. Appropriate hedging mechanisms are therefore needed. It is the function of an efficiently organized financial system to provide these instruments. It is wrong to argue that the economic growth seen by the industrially advanced countries in the recent period particularly in the last decade and a half has not been helped by the improvements in the financial markets. But excesses in any field have their own dangers. There is no argument that the regulatory regime needs to be restructured to make the banking system more sound. Excessive risk taking and leveraging by banks need to be discouraged by appropriate regulatory measures or controls. Of course, there is the larger question whether the financial sector is growing at a rate disproportionate to the growth of the real sector. But to set the face against financial innovations is not a wise policy. In developing economies like India the structure of the economy is undergoing rapid change. The financial system must be able to meet the diversified needs of a growing economy. In this context, we must actually encourage financial innovations. We need to draw appropriate lessons from the current international financial crisis. Too little regulation may encourage financial instability but too much of it can impede financial innovations which are badly needed. The policy makers must strike an appropriate balance between the need for financial innovations and the need for regulation to ensure stability.

The lesson that we should draw from the Crisis in regard to financial sector reform is that it is not reform or opening-up *per se* that has the potential of destabilising the financial markets, but it is the reckless pursuit of such ends without considering the possible risks and the instruments available to contain such risks, which pose the danger. In a manner, the global crisis offers at one level an experience in the light of which we can learn and unlearn previously held views and positions. This will provide valuable lessons to us in our effort to deepen the financial sector, increase its efficiency, and widen its ability to service the needs of a rapidly growing economy.