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Lord Adair Turner, Chairman, Financial Services Authority, UK delivers the 14th C.D. Deshmukh Memorial Lecture on 'After the Crises: Assessing the Costs and Benefits of Financial Liberalisation'

The Reserve Bank of India organized the 14th C.D. Deshmukh Memorial Lecture on February 15, 2010 at the Y.B. Chavan Centre, Mumbai. The Lecture was delivered by Lord Adair Turner, Chairman, Financial Services Authority, UK on 'After the Crises: Assessing the Costs and Benefits of Financial Liberalisation'.

This year's Lecture assumes special significance as it is a part of the Reserve Bank of India's Platinum Jubilee Celebrations. It may be recalled that Shri Chintaman Dwarakanath Deshmukh was the first Indian Governor of the Reserve Bank of India. He later became the Union Finance Minister. In recognition of his meritorious services to the Reserve Bank and the nation and in order to perpetuate his memory, the Reserve Bank of India has instituted in 1984 an annual lecture series entitled 'Chintaman Deshmukh Memorial Lectures'. It may also be mentioned that Lord Turner is the second Chairman, Financial Services Authority, UK to deliver the C.D. Deshmukh Memorial Lecture the first occasion being the tenth C.D. Deshmukh Memorial Lecture where Mr. Howard Davies, the then Chairman, Financial Services Authority, UK who had delivered the lecture on 'International Financial Regulation: The Quiet Revolution' on February 7, 2000.

Following is the brief abstract of the lecture:

Twice in the last 15 year the world economy has been hit by financial crises which have imposed huge economic harm – first the Asian financial turmoil of 1997 and then the developed world financial crisis of 2007-09. The precise nature of these crises differed, but there were underlying common features which need to be understood if we are to learn lessons and build a safer global financial system for the future.

Both crises were preceded by a rapid growth in the scale of financial activity relative to the real economy. The Asian crisis followed a period of rapidly increasing short-term capital flows and related foreign exchange trading. The crisis of 2007-09 followed an explosion of financial innovation and trading in credit securities and credit derivatives. And across the last three decades throughout the whole world the scale of increased financial activity relative to the real economy has been striking.

A dominant conventional wisdom of economy theory and policy – the Washington Consensus as it was labelled – has assumed and asserted that this increase in the financial intensity of the economy is beneficial, driving a more efficient allocation of capital, imposing discipline on inappropriate policies and enabling investors and users of funds to hedge risk better. But this theory has shown to be severely deficient, failing to take account of the inherent potential of financial

markets to be subject to self-reinforcing herd and momentum effects, with periods of irrational exuberance followed by sudden and contagious panics. Short-term capital flows can under some circumstances be harmful: and complex financial innovation in developed countries has produced few demonstrable benefits and resulted in an increased risk of financial instability. John Maynard Keynes's insight that increased market liquidity can bring disadvantages as well as benefits needs to be rediscovered.

In the aftermath of these crises it is therefore essential for economists and policy-makers carefully to assess the benefits and disadvantages of different categories of financial liberalisation, rejecting the over simplistic ideology which asserted that limitless liberalisation in all financial markets is always beneficial. The challenge for policy makers is that a more thoughtful analysis provides no simple and universally applicable answers - liberalisation and increased market liquidity may well be beneficial in some markets but harmful in others. But as Lord Turner says: "*It is much easier to proceed in life with a clear and simple set of beliefs which provides immediate answers to all specific answers. But we are more likely to achieve good economic results if we live the real world of complex trade-offs and of economic relationships which are true up to a point and in some circumstances but not in others*".

Given this analysis, policy makers should openly consider policy options which were rejected by the dominant conventional wisdom of the last two decades:

- While it is very difficult in a globalised economy to impose comprehensive controls on short-term capital flows, and while some categories of capital flow are beneficial, policy instruments (such as taxes) which place constraints on short-term speculative inflows may have an important role to play in some emerging economies.
- A variety of policy levers focused on 'putting sand in the wheels' of short-term speculative trading should be openly considered. Financial transaction taxes have theoretical attractions which need to be balanced against practical implementation challenges. Increases in capital requirements against trading activity are a key priority, and leverage constraints need to be applicable to non-bank as well as bank trading activities. Reductions in trading activity in markets of uncertain economic value (such as carry trade foreign exchange speculation on credit derivatives trading unrelated to underlying credit extension) would be acceptable consequences.
- Developed countries should consider macro-prudential tools which directly address the level and pattern of credit extension as key economic variables, constraining credit extension in the upswing, particularly where credit extension can drive asset price bubbles such as in commercial real estate. This constraint may be achieved via discretionary countercyclical variation in capital or liquidity requirements. This implies moving away from a sole reliance on the interest rate lever to steer the economy.

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