

Fouling Up Finance: Same Old Questions, Wrong Old Answers

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Inevitable and so predictable! We are at it again. Another financial crisis. Another ritual orgy of breast-beating and ululatory lament: What went wrong? Why? Who is to blame? Why is private folly being bailed out at public expense? Don't we need tougher regulation to strangle banks, non-banks, exchanges, brokers, and financial firms? Isn't financial sophistication camouflage for pyramiding? Isn't financial capitalism fundamentally flawed? Should the Glass-Steagal Act separating commercial from investment banking have been repealed? More recently: Aren't financial derivatives dangerous instruments of mass financial destruction? And so on *ad nauseam*! These questions preoccupy journalists and commentators all over the world. But they are not worth answering in the way people seem to think. We've been there before.

Every crisis triggers its litany of retrospective recrimination, implusive introspection, elliptical expatiation, and perambular pontification – indulged in to the n^{th} degree. The current crisis is, alas, no different. These questions have been asked after all the crises of the last half-century. Each time the answers have failed to predict or prevent the next crisis.

Financial crises pre-date *anno dominum* (AD). Finance was not as modern then. There were no CDOs or derivatives. But crises still occurred. Sophistication was not the issue. Failure of human judgement was. Ancient empires (Babylon, Egypt, Greece, Persia, Rome, India, China *et al*) had several such crises. So did European empires, not least, the British. The religious rant against Temples of Mammon had its origins in such crises. Its modern equivalent is peddled in financial journals. Often a crisis was triggered when a new gold or silver mine was found, and used to mint currency. When crises end, as they always do, the causes are forgotten. The financial columnists of the day come up with answers that lead to other problems.

The spectre of 1929-33 still haunts us. That financial crisis became the Great Depression. We want to void repeating that at any cost. But 1929 is now pre-history; as is Keynesianism. The *modern* era of global crises began with the breakdown of Bretton-Woods (BW) in 1971 when the US unilaterally abandoned the fixed redemption price of US\$35 per ounce of gold. Subsequently, the carefully constructed post-war, global fixed exchange rate regime collapsed.

It seems like “*déjà vu* all over again” in 2008. Bretton-Woods cracked because the US overreached in financing the Great Society and the Vietnam War simultaneously. It over-borrowed to cover domestic public over-spending. That crisis was resolved by the US (the world's principal reserve currency issuer) expediently transferring the costs of adjustment to creditors that had accumulated its paper in reserves. It devalued those outstanding obligations at a stroke. Does that precedent ring any bells now? The 2007 crisis has the same macro-origins and roots. China, OPEC, Russia, *et al* are suffering the same loss of value of their USD reserve holdings that Japan and Germany did earlier on. So what - despite the angst and Q&A - is it that have we learnt over the last 40 years? Not much, apparently!

The demise of BW was followed by the oil and commodity price shocks of the 1970s (as is happening now). Global stagflation followed from 1973-87. It may recur now. The chronic incontinence of bad, profligate

governments fuelled global *demand* for syndicated term loans (the complex instrument of its day). Such demand was manifest in developing countries anxious to grow rapidly through socialist, populist, public-spending to finance cradle-to-grave welfare states. *Supply* was provided by global banks. Flush with petrodollar liquidity, banks were more than willing to make inordinate profits by recycling these surpluses at a large spread. Unsurprisingly (though it was a shock at the time) that led to the debt crises of 1982-87. Justifying lending recklessly to *emerging markets* Walt Wriston, head of Citibank in 1975, said: "countries don't go bankrupt!" With equal audacity, thirty-two years later, Chuck Prince (another Citi leader) said: "You gotta keep dancing as long as the music is playing." Neither thought about the systemic costs of their borrowers suddenly becoming illiquid! Must be something in the coffee served at Citi!

The same questions were asked and answered *ad nauseam* throughout the 1980s and 1990s. Everyone believed profound lessons had been learnt. By 1993 the world convinced itself that such debt crises could not recur. Then the Tequila crisis erupted in 1994. It was managed by corrective action in 1995-96. But did we learn anything? Not much. Immediately thereafter, inconsonant macro-policies in high-growth Asia (a fixed or appreciating exchange rate with higher domestic interest rates than USD rates – *i.e. India now*) sent conflicting exchange and interest rate signals to global markets. In logical response, global banks took what they thought were 'no-risk' arbitrage bets; leading to the Asian financial crises of 1997-99.

Again, the same banks made large short-term USD loans to dynamic, creditworthy Asian companies and governments from Thailand to Korea. These were not deadbeat Latin American or African dropouts who had disappointed before. Those loans covered domestic financing needs at lower nominal cost than local currency borrowing. People thought (as the RBI seems to now) that "the impossible trinity was not invincible" -- whatever that means! The risk-adjusted cost proved much higher. In between these major tectonic financial market disruptions every decade, a plethora of smaller national financial crises have occurred annually – one after another (e.g. in Argentina twice, Turkey, Russia, Ecuador, etc.)

What is different this time? Well: size, shape, geography and impact. Starting out as a sub-prime crisis in the mortgage market of the US in late 2007, we now have a global financial debacle in 2008, and beyond. We do not know its full dimensions yet. We have no idea how long it will last. Underlying *macro-meso-micro* causes are similar to previous crises. But they are not exactly the same. They include: (a) suspect *governments* overreaching themselves; (b) lax *monetary authorities/regulators* permitting them to; (c) *bankers* operating under *perverse systemic and compensation incentives* (i.e. excessive *risks* being made non-transparent and obscured by *sophisticated instruments*) and (e) sub-prime *risk borrowers* overstressing themselves to procure what they can't afford from their income streams. Sound familiar?

The 2007 crisis is an unholy combination of government failure, regulatory failure, market failure, and induced institutional failure in the financial services industry. It has also been a case of across-the-board *management and risk-management* failure; compounded by a compensation culture in the financial world that generates strong perverse incentives and is now past its sell-by date. Yet the debacle is represented only as a combination of financial market failure, bank failure, and institutional/personal greed; an odd way of interpreting the facts. All these failures have occurred in the world's most sophisticated countries and markets. But because they did, does it mean that modern finance is all wrong and to blame for this mess? That would be an otiose conclusion to reach when there are so many other variables operating.

Failure of personal judgement should not be confused with design faults in checks and balances, systemic paradigmatic flaws, or fundamental structural flaws in regulatory architecture or practice. Of course, the probability of so many judgements, failing simultaneously at so many levels, all at the same time, raises interesting statistical questions. But improbable events do occur. And we err in dismissing the fact that they do. Because a policeman or soldier fails in his duty, does not mean we should immediately redesign the whole concept of a police force or army, or decide to do away with both. And, in times of duress, police and military judgements do fail right through the chain of command. That does not require the whole world to be up-ended! But that is precisely what many pundits seem to be saying now for finance.

Excess dollar liquidity -- created since 2000 by the US Administration (running a large *fiscal deficit* that exacerbated a galloping *current account* deficit) and the Federal Reserve (through monetary accommodation to offset the impact of the technology bubble collapse and that of 9/11 thereafter) -- has inflated global property, asset and commodity prices from 2002 to 2007. The Fed's bubble-blowing capacity raises fundamental questions for the rest of the world. Might we all have been better off if it had only an 'inflation-fighting cum financial stability' mandate like the BoE? If it was not responsible for ensuring growth and employment in the US, would the Fed have primed the pump to this degree? But that key question is being obscured; especially in India, which must ask the same question of the RBI.

The Bush-Greenspan dollar bubble created systemic pressures to increase speculative, risky lending; partly in response to perverse incentives and erroneous signals – *created/sent by governments and regulators* When one maintains a 1-2% prime rate regime for a prolonged period to combat growth and deflation risk,

yet one has pension pay-out obligations, insurance obligations, and asset management obligations, requiring 5-6% returns to meet committed actuarial liabilities, what is the financial system supposed to do? Sit on its hands and keep reserves at the Fed? A financial system that takes no risks is not a financial system at all. It is simply a pass-through utility. Is that what we want? That is the kind of financial system Japan has contrived. The result has been two decades of stagnation and deflation with no end in sight.

Obviously we do not want national or global financial systems to take excessive risks. What are excessive risks? How do we measure them before they materialise? Are we implying that financial systems should take no risks at all when they intermediate between savers and borrowers? Responding to the perverse incentives created by the excess liquidity generated by the Treasury and Fed, the US financial system started out taking what it thought were *calculated* risks. They proved to be excessive as 20-20 hindsight has revealed. This time, dubious lending was not to developing countries or Asian companies. It was directed to low-income, uncreditworthy US home-buyers. They were persuaded by unscrupulous, poorly regulated intermediaries to buy cheap homes they could not afford through aggressive mortgage pricing made possible by a 1.25% Fed rate regime. But is the Fed blameless for the fiasco that has occurred?

First, the Fed reduced rates to ridiculously low levels between 2000 and 2005. *Second* it jacked them up mechanically to five times the low rate over 21 months. It did not wait to see what the cumulative effect of these monthly/quarterly rises would be. That sharp reversal of tack by the Fed heightened risks across the financial system without banks doing anything. Mortgages that were affordable and sustainable when Fed rates went from 1.25% to 3.5% became unsustainable when they were jacked up too quickly to 5.5%. The sub-prime credit risk taken in 2000-05 was transferred to supposedly professional institutional buyers (like pension funds) that demanded these instruments. They should have known what they were buying. But they blamed the banks instead for opacity; thus absolving themselves of any responsibility. It was done through the sale of bundled CDO and ABSO instruments with high-coupon returns; with the collusion of rating agencies paid by the sellers of such instruments to rate them. How's that for a conflict-of-interest?

Now the sub-prime crisis has unfolded with a vengeance. It is spilling over into prime credits as well. The whole US property market is imploding with devastating implications. Value-loss is now spiralling well beyond limits that any properly functioning market should be signalling. Confidence is collapsing across the board in: (a) the quality, content and probity of *national, regional and global* financial regulation; (b) the monetary and academic judgements of central bankers whose concerns seem to be at odds with what their priorities should be; (c) the reactions of OECD treasuries which seem to be too knee-jerk to be thoughtful; (d) mark-to-market valuations of financial securities, with stressed-out asset markets emitting price signals that are not worth relying on at all for the time being; (e) the credibility and probity of ratings and rating agencies; (f) a seeming inability on the part of financial operators, authorities and commentators, to differentiate *systemic* problems and effects of aggregation, from *firm-level* problems and consequences; and (g) the collective impact this is having on perceptions about the fundamental creditworthiness, solvency and liquidity of all borrowers, especially banks. That is resulting in situations like HSBC not lending to Citibank in national or global interbank markets, because neither knows what the other is worth, or whether it has any free net capital at all! Traders are being asked at a moment's notice not to do business with any outfit about which a rumour is circulating. And now there is financial trade in rumours!

Northern Rock (NR) made good money for years, financing long-term mortgages by sourcing from cheap wholesale short-term interbank credit markets. That is also happening in India; where it would be foolish to assume that 25-year mortgages are financed by 25-year deposits, bonds or loans. No one thought that lending long by borrowing short was odd or risky at the time. Term transformation is the bread-and-butter business of banks and other financial intermediaries. Many (including regulators) thought that the NR business model was fine; it made sense given the way markets were functioning. But the interbank market froze overnight when the sub-prime crisis broke. That compromised the viability of the entire collateralised debt market. The Rock could no longer find the liabilities to fund high-quality assets already on its books. That outcome was unpredictable and unprecedented. Instead of rectifying that short-term market seizure by stepping in boldly and acting sensibly, the Bank of England timorously gave vent to academic concerns about moral hazard, when the stability of the financial system was at stake. Talk about priorities!

The Chancellor of the Exchequer went on TV to reassure depositors of Northern Rock that their funds were safe. But he was non-credible. Brits don't trust someone with eyebrows a different colour to their hair. After his broadcast the public (which had not been bothered before) panicked. Queues formed to remove their funds thus causing a run on the Rock. Had he handled the situation differently, there might have been no run. The crisis could have been resolved with a 30-year multi-currency bond issue to global pension funds. It might have required a temporary public guarantee. But it would have been eminently more sensible. In the US, five months on, Bear Stearns was hair today and Dimoned tomorrow.

With all this happening, a number of commentators (e.g. in the FT) are indulging in heavy-duty, sanctimonious huffing and puffing about how rotten things are in the land of Nod. They are going

overboard with criticisms of financial markets and eliciting applause for striking a chord with Joe-Public. They are attempting erroneously to (again) answer age-old questions definitively, and with finality. These 'legends-in-their-own-mind' are relying on their mighty cerebrums, cerebellums and egos. But they have no experience of finance at any time, nor do they have any practical idea of financial decision-making in firms, banks, central banks or treasuries. Their knowledge of theoretical economics is (hopefully, but I am never sure about this) sound, but their knowledge of finance is suspect. And, like all economists with a PPE tripos (we have too many in India) they are inherently sceptical about finance. They do not understand it. The maths are probably too tough. They believe it is not 'real' and mostly tosh; stuff dreamt up by barrow boys in the City and on Wall Street with the only innovations being nomenclatural rather than substantive.

Such commentators seem sagacious. They write so well that they obscure flaws in what they say. But they can, on occasions like these, be eccentrically off-the-mark: i.e. by proverbially hitting their thumbs, rather than the intended nail on the head, with their verbal sledgehammers. And, because they have a wide audience, they run the risk of destabilising the situation even more, with ill-considered, ill-timed remarks, when everyone who was anyone, is too nervous, stressed and broke (their stock options are now worthless) to think straight, and lacking in confidence in their own judgements. The worst time to kick someone is when they are down; unless your agenda is to make sure they never get up again. But that is what our brave commentators and regulators in India are also now doing, imitating the FT's columnists. The crisis has made clear that the \$100 million dollar a year masters-of-the-universe (Motu's), seem not to be worth 10 cents when the crunch comes. What John Mitchell said was true: "When the going gets tough, the tough get going". He should have added: "And the babblers babble too much". But we knew that from before.

As in the past, when the dust has settled, the cost has been counted, and the global financial system "picks itself up, dusts itself off and starts all over again" all this angst, blame, and recrimination we are over-indulging in now, will recede to the dimmer mists of fading memory. We will learn some lessons to be sure; but not all that can be learnt even from past mistakes.

For example, despite serial crises in its savings and loan system which is regulated at state level, the US has still not found a way to regulate origination quality in a market as elementary as home mortgages. The Fed and SEC failed in not highlighting risks that non-transparently bundled CDOs with hidden sub-prime risk entailed. So did the FSA and BoE. Nor has the US found a way of curbing its own systemic macro-excesses. None of these are financial firm or market failures. They are failures of governments and regulators. They need to be looked at with even greater scrutiny than should the behaviour of financial markets and firms responding to the signals sent. But since governments and regulators are also the investigators, egged on by journalists, they are hardly likely to criticise themselves in the way that they should. And India, which is congratulating itself and RBI for the wrong reasons, is not exempt from that observation.

Worse, the world has not yet found a way of disciplining the economic behaviour of the US in the same way as the US has, in the past, disciplined other countries (including the UK and Italy in the late 1970s); bilaterally and through multilateral institutions. Instead, since 1945, the US has always portrayed itself, and been regarded by the world, as being above and beyond economic law. But circumstances have changed dramatically sixty years on. The US has escaped harsh scrutiny from the international community although it has twice brought the world to the edge of financial Armageddon since 1970. Three times would be one too many. The US must now be brought into the same ambit of collective multilateral surveillance that other countries have accepted. Yet, the world is reacting in the opposite way. It is now extending the same courtesy of according 'untouchable' status (not in the Indian caste sense but in the Elliot Ness sense) to China which, through its intransigently inflexible (until too late) exchange regime, has contributed to the current debacle. Can adjustments occur, in correcting large imbalances automatically through markets, if we perpetuate the loaded asymmetry of having *free and open* global markets for goods and services but *managed and closed markets* for some of the currencies in which they are valued?

That is simply not a tenable argument to sustain for any length of time. India and China now risk reversing the benefits of globalisation they have gained so much from. They risk triggering a global backlash, if they insist on adhering to fundamentally misconceived philosophies and a heterodox stance on capital account convertibility and managed exchange rates. Their posture is self-serving in the short-term but self-defeating in the medium and long term. It defies theory and logic. Those are the real issues that need to be addressed as the 21st century unfolds. If we cannot resolve them, but focus attention on the supposed failures and risks of modern finance, we risk deluding ourselves and lynching the wrong mob.

But, coming back to the current crisis: The problem arose with the lack of regulation of the base mortgage market to prevent its criminal abuse. Why did that happen? The sub-prime problem was one of origination through NINJA loans i.e. loans being made by unscrupulous realtors, mortgage brokers and local mortgage institutions and small banks to people with No Incomes, No Jobs or Assets. Immigrant gardeners were classified as landscape architects. They were induced to borrow 120%-of-value to buy four properties at a time and rent them out with mortgages that involved virtually no costs for the first three years. Mortgage

originators were incentivised to churn out as many of these mortgages as they could so that the bundlers and packagers of these dubious assets had grist for their mill.

But though all that happened, the sub-prime problem was not simply a case of unscrupulous investment banks, and bonus-obsessed operators stripping, re-packaging, and selling mixed bulk assets with unsound risk profiles, to unwitting innocent buyers of synthetic debt obligations. Institutional investors who bought CDOs by the barrel are not widows and orphans. Also, let's not forget that regulators at several levels failed to identify or express concern about the transparency-deficit in bundling these CDO packages; nor the failure of rating agencies that rated many of them AAA.

There is nothing wrong with the basic principle or mechanism of collateralised debt obligations (CDO) or asset-backed securitisation and the sale of repackaged debt stocks. In fact the reverse is true. The principles and mechanisms of packaging different strips of debt stocks are sound. They can be incredibly useful devices for transforming maturities and durations. They help to liquefy otherwise stagnant but productive assets. Constructed and used properly, the risks of firm-level, and systemic, illiquidity can be reduced by CDOs and ABSOs. The same is true of maligned derivatives both simple/traded and complex/tailored.

Yet both are now condemned (especially in India) as inherently flawed and evil; in particular, derivatives. Constructed and traded without proper knowledge and transparency, the risks they are intended to ameliorate can be amplified by uncertainty and ignorance. Credit risks can be managed through credit default derivatives; but the counterparties have to remain viable. Interest rate risk, currency risk, political risk can be managed with derivatives as well; but these instruments can be abused if the objective is to speculate without knowledge rather than hedge within limits.

In India such mindless vilification is reaching insane proportions with the losses recently suffered on currency derivative transactions. Witness the loud screams of Indian corporates who made the wrong bets on currency hedges incurring collective losses alleged to be INR 200 billion (or USD 5 billion). They are now crying foul and blaming their bankers for tailoring these hedges to their specified needs. They are pleading ignorance and lack of understanding. The RBI is joining in the chorus. But is it blameless for not having permitted a market to develop in exchange traded currency derivatives in the first place? Had such a market been permitted to develop, corporates could have traded on that market directly, using their own treasury judgements and not gone to their banks.

Talk of these instruments being inherently deadly and dangerous is just plain wrong. Even my wise friend T.N. Ninan has been infected by the retroactive 'modern finance-is-wrong-RBI-is right' strain of virus. It is being propagated by the Indian media (abetted by FT commentators) and by a Left that hates capitalism. Such criticism is often motivated by superficial interpretation of the evidence, by ignorance, and by a failure (or unwillingness to make the effort) to understand the mathematics involved. Since no one (especially a senior central banker) wants to admit to being slow on the uptake, it's so much easier to cast aspersions and make the case that these instruments are too dangerous for public use. Properly used, with broad, deep and liquid markets in them, derivatives and synthetics are indispensable in a modern financial system. They are its traffic signals, its price discovery mechanisms, as well as its trading nuts and bolts; grist for the financial mill that would otherwise be confined to only four plain vanilla functions: i.e. buy, sell, borrow, lend. And if that was all finance could offer we would be back in pre-historic times.

A kitchen knife can be used to murder someone. It is more usually used to cut onions, vegetables, bread and meat. Murders often involve kitchen knives. Does that mean knives are inherently dangerous and should be banned? Or should their possession be restricted only to certain types of consenting adults with Ph.Ds and an intensive 4-year training course in knife-use? The same is true of cars, planes, trains, ships and buses. Accidents happen. They are part of the game of life. Should we ban all transport and traffic to avoid any accident happening at any time? Should we stop issuing driving licenses altogether? Should we introduce bicycle-riding tests that take a day or car driving tests that take a week? And yet this is what command-control freak regulators, and supposedly wise commentators, seem to be suggesting when it comes to correcting all that ails finance. It is at times like these that common sense, especially on the part of supposedly intelligent people, escapes and becomes unusually uncommon.

What went wrong with the *sub-prime* crisis is a question that has multiple answers at different levels: *macro*, *meso* and *micro*. Some of them we will always disagree about and never get to the bottom of. We have to accept that reality. Views of public choice economists, who always want to put sand in the wheels of finance at one end, and market-friendly, tax-unfriendly economists at the other, will never be reconciled. Their philosophical and technical differences are too profound.

But let's make an attempt at a plausible explanation. At the *macro-level* as explained above, Bush and Greenspan printed about US\$10-12 trillion more in 2000-05 than was needed to finance US or world growth. Where did that excess liquidity go? It's estimated that about \$4-5 trillion was absorbed in unusual

property price increases in the US property market. Of that about US\$1-2 trillion has already been written down over the last year or so. It may be that a similar amount will be written down in the coming year.

Another US\$2-3 trillion went in inflating commodity prices, especially oil, gold and precious metals. That is now reflected in the ballooning reserves of hydrocarbon and commodity producing countries. Much of the remainder has gone into inflating the price of financial assets, especially in emerging markets, where valuations at the end of 2007 reached stratospheric levels based on fantasies about future growth prospects. These valuations too have seen sharp corrections in recent months. They have returned to more sensible levels that can be justified by a reasonable discounted value of future earnings based on more realistic growth trajectories. But, some selective overvaluation of particular assets in these markets (like India's property market) continues and requires further correction.

At the *meso level* the financial industry's traditional herd instincts (that Avinash Persaud has so eloquently and persuasively written about several moons ago) took over. The Motu's of Wall Street (joined rapidly by their brothers in the City) decided to jump on the bandwagon of packaging and aggressively selling CDOs. These contained mixed mortgage debt obligations that ranged from sub-prime to super-prime (which has now also become sub-prime). The buyers of these instruments (who run your pension and mutual funds and mine) obliged by demonstrating an unusual appetite for them. Wouldn't you buy paper (however complicated in its construction) that gave you a yield of 5-7% and was rated AAA, when the alternative was to park your funds at returns of 0-2%? That sell-buy tendency was difficult to restrain in a property market where prices were rising by 5% a month for a considerable number of months, thus increasing the underlying collateral value of the debt obligation it supported. And then the Fed reversed itself!

At the *micro-level* the unusual pressure on Motu's to keep flashing extraordinary quarterly profits, in order to justify even more extraordinary personal bonuses, actually increased. That perverse incentive launched trading markets -- for sophisticated CDOs and a range of affiliated derivatives -- into overdrive. Almost everyone with a sense of history knew from mid-2006 onwards that valuations and trading volumes were going haywire. Many (including *me*) expressed grave concern in our writings about another bout of market access and the certainty of another crisis. But none of us were aware of how large and debilitating or contagious it might be. It was openly discussed in official and private circles. But the 'Prince Principle' -- *continue dancing while the music plays* -- ruled with a vengeance. No one wanted to stop dancing though the band was running out of puff. Is that a systemic flaw or human nature?

Of course, in the domestic context, with India having (for the third time since 1982) avoided global contagion (have we really?) another question has been highlighted implicitly and explicitly: Hasn't the RBI been wise in **deliberately retarding** : financial system liberalisation; innovation and competition to protect antediluvian state-owned banks (SOBs); development of the derivatives, corporate bond and currency markets; and employing draconian regulatory practices over congenitally non-compliant banks and financial operators? In other words, hasn't India been fortunate in having financial authorities who operate with the conviction that modern finance is quintessentially un-Indian, thus emphasising primitivism over modernity, simply to continue exercising familiar command-control options with greater facility?

These questions of course obscure the reality that, irrespective of what has happened globally, India has had its own series of home-grown financial scams, scandals and failures. They have involved massive losses in value. And they have recurred with alarming regularity, despite our supposedly terrific regulation! But, in India, the peculiar view has taken hold that regulators are always right. They are naturally cautious and conservative. And they have the public's interest at heart. Conversely operators are always wrong. They are thieves who take risks with other people's money and create crises which then require public bailouts.

No one pays enough attention to the perverse incentives and the contradictory macroeconomic, monetary and exchange rate signals that are emitted by the authorities in ways that often heighten uncertainty and risk before a crisis erupts? When people like Ajay Shah and Ila Patnaik do that, they are branded either as heretics or as people who have temporarily lost control of their senses or as people simply against the RBI.

No one believes that strangulating financial systems artificially in the name of conservatism, caution and (false) security, also involves massive costs. If the financial sector were permitted to breathe naturally, if currency markets were opened and freed, India's financial sector would generate additional value added and export revenues amounting to 1-2% of GDP. The efficiency gains of further financial liberalisation and financial market development would result in another 1-2% of GDP growth.

Non-pre-emption by the fiscus of scarce resources (always unproductively deployed by government), and privatisation of SOBs/SOEs, would dramatically reduce India's public debt and its annual debt service obligations. That would result in further growth gains of another 2-3% of GDP. So we are implicitly

surrendering potential gains of 4-7% of GDP *annually* just to maintain command-control in the name of financial safety (which has often proven illusory).

If we chose the alternative path of financial liberalisation and sophistication, we could afford a financial crisis every decade that costs us 3% of GDP, and still come out well ahead. That may be seen as an excessively cynical view. It is not. It is in the nature of markets to work well most of the time, overreach egregiously at the end of cycles, and fail occasionally with disruptive effects, followed by cleansing that is entirely healthy and natural. If we believe in market economics, we have to accept the intrinsic nature and cycles of market functioning. We should do everything we can to learn more about stretching out period of proper market functioning and to anticipate/mitigate the effects of potential failures. But we cannot make markets socialist and planned to behave in ways we like and not behave in ways we don't.

What is also obscured in the Indian debate is an awkward but very real asymmetry. No one complains when they are making easy money in stock or property markets quickly (because they are brilliant) but wail, ululate, and demand revenge and redress when they lose it (because it is someone else's fault). It goes unnoticed that a financial system is in distress when asset prices are rising too rapidly; and is actually emitting sound corrective signals when such prices correct downwards sharply. But *aam aadmi* never sees it that way. In fact he sees it in exactly the opposite way: i.e. that the financial market is great and healthy when his portfolio is increasing in value at 10% a month, but that all financial operators are thieves and crooks, and regulators are corrupt and stupid, when that momentum reverses.

Of all the screams heard, the loudest are those of empty wallets: just go to the racecourse and talk to a losing punter! It's never the punter who was stupid and made the wrong choice: it is always the fault of the owner, trainer, jockey or syce, who hooked the horse, or of stewards who are ignorant and blind.

And that is the way it is with financial systems and the periodic crises they generate! So let's stop pointless breast-beating and making the wrong arguments for the wrong reasons. Let's not give credit where it is not due (i.e. to the RBI) and let's not thank the authorities for keeping our financial system unsophisticated and primitive. That does not suit the image of India of the 21st century – an image we are trying to convey of being at the cutting edge, and not at the thicker end, of human intelligence and progress.