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Too much regulation may lead to danger of shadow banking: Raghuram Rajan

By PTI | Updated: May 07, 2016, 09.42 PM IST

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NEW DELHI: Warning against excessive banking regulation, RBI Governor Raghuram Rajan today said this may lead to activities shifting to shadow financial system and admitted to the lack of "know-how" for such businesses.

The outspoken Governor also appeared to disapprove of the lower interest rates to boost growth, saying low rates actually lead to people saving more rather than spending.

Delivering a lecture here tonight, Rajan also suggested that the "definite slowdown" in branch expansion by foreign banks in India could be due to regulation among other reasons.

"What happens when you put pressure on one side of balloon? It balloons out on the other side. So is there a danger that by regulating the banks so strongly, we have shifted activity -- not just risky activity but human capital -- to shadow banking system," he said at a lecture here.

While shifting risky activity may be good thing, but if smart people are also shifted out into the shadow financial system then "I don't know if a less smart bank is less risky," he said.

Rajan said the central bank knows how to regulate banks and has regulated them.

"But we don't know how to regulate the shadow financial system and we haven't regulated that as much," he said.

It may be argued that it was the smart guys who took the bank down but smart guys also do the risk management as also correct valuations, Rajan said, while asking, "Is a less smart banking system more of a risk or less of a risk that is the question we should ask ourselves?"

Shadow banking system typically refers to the financial intermediaries involved in facilitating the creation of credit across the global financial system, but whose members are not subject to regulatory oversight.

This may include unregulated activities by regulated institutions and has mostly escaped regulation primarily because it did not accept traditional bank deposits.

The Reserve Bank Governor said the idea or intent behind regulation was to reduce complexity and financial engineering while creating risks for the banking system.

"But in that process have you also reduced the ability of the banks to take needed real sector risks anymore. And that is the question we have to ask," he said.

While it is being asked where the real investment was taking place or where the economic growth was, "we have regulations which could again have the potential to pull (away) banks from taking on real risks," he said as he put lending to small and micro enterprise in that category.

Also, there was a definite slowdown in the expansion of branches of foreign banks in India.



Rajan said one of the concerns of monetary policy is that it might encourage depreciation of the exchange rate.

"That has slowed down tremendously since the (2008 financial) crisis. And one could argue that it is a fall out of the global financial crisis and the regulation," he said.

Rajan said, in a global financial crisis, banks have access to central bank window in case of liquidity shortage, but non-banks won't have access to the window to be able to cope.

Stating that if the [global economy](#) hasn't got strong growth even after 7 to 8 years after 2008 meltdown, Rajan said the problem may be that not enough of conventional policy was resorted to.

"Could easy and unconventional monetary policy be increasing be part of the problem? It was part of the solution post financial crisis. Liquidity provision was extremely important. However what was done then has continued... for long," he said.

Asking if an aggressive monetary policy could have run out of steam, he said very low cost and easy capital does not "turf out" inefficient firms.

"Lower the [interest rate](#), the more is the saving... People aren't going out celebrating when interest rates get cut. Rather people are actually saving more because they need [pension](#), they worry about viability of government fund pensions," he said.

If debt levels increase in a country, instead of encouraging more spending, it would start saving knowing the tax burden to pay down the debt.

"You could have perverse effects of very low interest rates, perverse effects of substantial fiscal stimulus, these things eventually run out of steam," he said.

Rajan said it is hard to think in the international economic setting of which assets are free of mis-pricing. "I am not saying they are mispriced, I am saying there is a lot of uncertainty of mispricing given the extremely aggressive monetary policy."

Rajan said one of the concerns of aggressive monetary policy is that it might encourage depreciation of the exchange rate.

"In an [environment](#) of weak global demand, when I depreciate my exchange rate making my goods more attractive to the other countries' citizens, but those citizens in that country, they already have weak demand. So what we are doing is essentially taking their demand from them by depreciating our exchange rate," he said.

He said competitive depreciation is a big concern during the Great Depreciation. "These are called 'beggar thy neighbour' policy, you depreciate in order to take demand from others. No industrial country today, except Switzerland, has directly targeted exchange rate. Sweden is talking of doing it, but no country has done it".

The primary effect of cutting interest rate may be to depreciate currency, rather than to generate domestic demand.

On [inflation](#) targeting, Rajan said when the rate of price rise threatens to fall below the lower band or zero, one of the options before the governments and central banks is 'helicopter drop' of money -- a term used for central banks printing large amount of currencies and giving it directly to the public or through investment in public projects to spur spending and eventually economic growth.

He, however, said there is a probability that people may not spend the money and save it thereby not contributing to growth.

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