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BOOK REVIEW

Viral V. Acharya: *Quest for restoring financial stability in India*

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When the editor contacted me last fall to review a book by a former central banker of India, I was very intrigued as to what I would find in the book. In my day-to-day activities as an economic forecaster, I closely follow the speeches, testimonies, and media interviews of the U.S. and, at times, European central bank luminaries. So, would this be a memoir (albeit a highly sanitized one) of his life and time as a central banker—such as those offered by Alan Greenspan, Paul Volcker, and Ben Bernanke? If so, it then would shed some light on the deliberations and machinations of a developing country's central bank whose monetary decisions typically merit only a small blurb in *The Wall Street Journal* or a passing news flash on a Bloomberg terminal? One caveat to that assertion is that these days a blowup by Turkey's or Argentina's central bank, which tends to be quite spectacular, regularly receives front-page news coverage.

Dr. Viral Acharya wasn't the head honcho of the Indian central bank, but one of its four deputy governors. The post is equivalent to being a member of the Board of the Governors in the Federal Reserve System. He served from January 2017 to July 2019 during a tumultuous period in the Indian economy. This period encompassed the aftermath of a haphazard big value banknote demonetization by the Indian authorities, a price of oil that almost doubled at one point, and the Federal Reserve's rate hike regime that caused tremors in emerging markets' currencies. Acharya's book's title clearly indicated that it was to be a policy piece on financial stability, much like Edward Gramlich's prescient 2007 book on subprime mortgage market. Just as Gramlich was a University of Michigan economics professor, Acharya was (and still is) a New York University economics professor, and one of the profession's foremost financial economists, before joining the Indian Reserve Bank. But a question immediately comes to one's mind: What's the relevance of Indian banking experience to a NABE member who is most likely a practicing private-sector business economist based in North America? The answer is, surprisingly, a lot.

Let me elaborate. At the time of writing this review, the Turkish president had just fired his central bank chief of four months for adjusting the benchmark rate up to control inflation. This was the third firing of a Turkish central bank head in two years. That led to a rout, again, in the value of the Turkish lira and the national stock market. Why does the Turkish strongman fire central bank heads so frequently? And why does he believe that raising rates by a central bank causes inflation, rather than curing it, as we know both from theory and experience in the developed world's context? Apart from the fact that he can, legally, remove the head of the central bank, unlike the US president, the answer lies in how the banking system is structured in emerging markets, and how the implementation of monetary policy actions, especially rate hikes, have a clear fiscal implication. To paraphrase the author, it happens when Milton Friedman walks in lockstep with Tom Sargent. Thus, knowing more about this close connection will also solve some of the mystery as to why Argentina is a serial sovereign debt defaulter with periodic bouts of hyperinflation and a currency that has to be birthed anew every few decades.

What we take for granted in a developed economy, a fully developed *private* banking system with well-established *external* interest rate benchmarks for the proper *transmission* of central bank's interest rate changesm is a luxury in the case of emerging nations. Thus, it is straightforward that the absence of a "proper" banking system gums up the effectiveness of a rate cut. But what is not obvious is that the presence of bad loans on bank balance sheets makes the monetary transmission channel ineffective, and when it comes to raising rates, it actually results in a nasty fiscal headwind. This headwind will impact foreign capital flows with the concomitant currency implications, spilling over to economic growth, which then will have political consequences. In the case of Turkey, they summarily fire the central bank chief when they raise rates one too many times.

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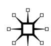


In Argentina, where there is not an effective financial sector (just compare the mortgage loans to GDP ratio of now roughly 75% in the U.S. to that of being less than 1% in Argentina), the federal government (politicians) ends up raiding the central bank's foreign exchange coffers for their fiscal needs. This then destroys both the remaining functioning of the central bank (monetizing government debt) and their national currency. India has been lucky so far that even though the banking sector is dominated by government owned or public sector banks, it never had an occasion where the central bank chief was fired or the coffers raided to support fiscal spending. The foreword of Acharya's book was written by a former Indian Central Bank chief who candidly talks about where the Indian Reserve system stands among its peers and the limitations and challenges it faces. It will give the reader who is not versed with the India's banking sector's evolution since its independence in 1947 a good understanding of the past.

1 The meat of the book

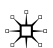
This book has a preface, which is the longest I have ever seen in my career, of 35 pages! And it was a delightful read. It is actually titled "Fiscal Dominance—A Theory of Everything in India" and is based upon a talk the author gave at NYU in January 2020. It spells out his main thesis, as the title itself entails, by telling you about the state of fiscal dominance in India. Fiscal dominance, in a nutshell, is funding of fiscal deficits by the central bank and managing that debt. In the Indian case, according to the author, it also means dominance of *all* financial sector policies and regulations (emphasis author's). How this affects India's financial stability is a very interesting read for anybody who wants to understand the working of an emerging economy's financial system when they sit eight thousand miles away from it. The preface shows how this dominance leads to financial crises and low productivity traps.

My assertion that one can understand firing (or gentle easing out) of central bank chiefs comes from understanding the fact that in order to clean up the shaky balance sheet of publicly-owned banks the government has to issue more debt. This is in addition to making the politically infeasible actions of closing zombie firms (and even public sector enterprises). The government is always loath to do this as it impinges on populist spending needs. As that takes precedence, it kicks the can down the road—unlike the formation of the Resolution Trust Corporation here in early 90's to clean up the savings and loan mess from the prior decade. The country then relies even more on foreign capital inflows to meet these financing needs, as the corporate sector is also a net borrower, and domestic savings are insufficient. Consequently, when the central bank wants to fight inflation arising due to government's ever-rising fiscal spending, fueled by populism, or from an unexpected oil price shock, or a sudden exchange rate weakening when foreign capital inflows reverse as world interest rates (read U.S.) rise, its only option is to hike the policy rate, which further deteriorates the banking sector's papered-over financials. That has an immediate fiscal impact, as more capital now has to be pumped into the system by the government, competing with other spending programs. The end result is fiscal dominance of the central bank as it is now busy monetizing this new debt. Rate hikes are never popular, even in the developed world (if you remember our experience just a few years ago), but are outrightly detested in emerging markets by the powers that be. This then sets the stage for all kinds of negative outcomes for central bankers in emerging economies such as Turkey and Argentina.

2 Flow of chapters

The book is a collection of very thoughtful speeches Acharya gave in his two-year tenure as a deputy governor plus some of his other writings. In the U.S., we follow the speeches of the governors very closely if they are identified as the "whisperer behind the throne". These speeches are typically prosaic but helpful when we are looking for nuggets on the future direction of monetary policy. Acharya's speeches don't deal with this juicy day-to-day aspect of central banking from our perspective, as the title of the book indicates. But his speeches are much more thoughtful and exposited with the help of data and charts on policy issues related to banking and financial stability. These are all very well laid out in six parts. Part 1 lays out the state of the Indian banking system's non-performing asset situation, and on the urgency and challenges of recapitalizing banks. Part 2 examines the dire need for a digitalized registry to capture and store financial information of borrowers in India under the umbrella of the central bank: Public Credit Registry. This type of information exists in the developed world between various government agencies that oversee different facets of the credit market but is usually missing in the emerging markets. The chapters here deal with its role and how to create it in India. An intriguing chapter is number eight, which talks about what lessons the Indian banking system can learn from the shampoo sachet marketing technique, namely big problems have small solutions.

Part 3 deals with unique situations that emerging market central banks face (top of the list is food inflation; that can be crippling) and how to manage the global financial cycle that is instigated mainly by the U.S. Federal Reserve's actions. The taper tantrums at home are nothing compared to what happens to an emerging market's foreign capital flows. In part 4, Acharya details how monetary transmission works



in India and the operational challenges faced. The chapters are very clear, crisp and a good recap of money and banking principles that exposit the operations and challenges of banking in an emerging economy. The readings here will help an economics graduate of a developed country get a better sense of how the nuts and bolts of the banking system work or don't work in emerging economies. In part 5, the author shows his full chops as a leading financial economist by first laying out the interest rate risks at banks from central bank actions in an emerging economy and then an academic style model of global spillovers that matches data with theory. It then very clearly shows how emerging markets are affected by a global financial cycle originating in high-income economies. The last part of the book deals with striking the right balance between central bank autonomy in the face of financial market and economic challenges. One thing I learned was that the Indian version of the FOMC is only 5 years old. The issue of crowding out of private investment by government spending that is being monetized by the central bank is very well exposited. This section draws upon the experience of Japan versus the U.S. and also the haplessness of the Argentine central banker.

3 Net-net

I think I have answered my question as to why a typical NABE member should read this very interesting book by a central banker. It is to learn what constraints an emerging economy's central bank faces in conducting basic monetary policy actions while possessing an incomplete toolset. This *always* results in helping to monetize the fiscal deficits of the government, as it faces the additional challenge of guarding the national currency against sudden gyrations in foreign capital inflows. In this situation of fiscal dominance, the aim of guarding the sanctity of foreign exchange reserves from fiscal appropriation is another challenge that is not a concern of any developed country's central bank (as of yet). Acharya shows his chops as a deep thinker of these intertwined issues in an emerging market's context. However, the money and banking lessons of this book, clearly exposited, are relevant to us here too as our own federal government runs ever bigger deficits to mitigate COVID-19-induced economic damage and to even do some pet spending projects. When even frugal nations like Germany have also ramped up their fiscal spending programs to handle the pandemic's economic fallout, it means there is going to be a shortfall in that "global glut of savings". Consequently, the pressure here will also build up on the central bank to do something when federal debt servicing costs begin to bite the federal budget. The title of the book may have the word India in it, but read between the lines and the train of fiscal dominance has left the station here too.

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