

“2nd generation” financial sector reforms
Towards a modern market economy

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Financial markets: the mother of all markets

- India has been converting 23% investment into 6% growth.
- Can we do better?
- The US financial system is legendary for allocating resources well, *and* for being able to support risk-taking.
- A call centre has a COR of just 0.75 – with our labour-intensive pattern of growth, we should be able to do very well in converting investment into growth.
- **To accelerate GDP growth, reform finance.**

What did we get done 1992-2004?

- A “classical banking crisis” with huge NPAs is out of the picture
- A revolution in the securities exchanges
- Nationwide access – not just Bombay --
 - NSE & BSE roughly 15,000 offices in 10 years.
- Enormous growth in personal credit and microfinance
- Pro competitive policies (low entry barriers) in some segments
- Some pockets of very high human capital and institutional capacity

So are we happy?

- Equity derivatives at NSE have volume of \$2 to \$3 billion a day.
- Chicago Mercantile Exchange does daily volume of \$1 trillion.
- And CME is only one amongst several big derivatives exchanges in the US.
- India's inferiority is well beyond that expected based on ratio of GDP.

So, where are we?

- The “functional approach” would ask how well Indian finance is faring in performing the legitimate *functions* of finance.
- An alternative is to compare us against OECD quality financial systems.
- UK – closeness of legal and institutional background.
- And, London is a world centre of finance, so we know that the UK financial system is globally competitive.

UK versus India

- Huge spot and derivatives markets
- Securities dominate financing of big firms.
- 100% globalisation – e.g. German bond futures.
- FSA + Treasury + Bank of England
- Bramha + Mahesh

- Active markets only in equity spot.
- Banks continue to be very important in debt.
- Negligible participation in world finance.
- Very different fin. Architecture.
- Barriers to entry + little death.

Missing markets : UK versus India

- Senior versus subordinated bonds
- Currency futures
- Interest rate futures
- Most options
- Weather derivatives
- Securitisation (mostly)
- Catastrophe futures
- Credit derivatives
- Inflation indexed annuities
- Inflation indexed bonds
- Access to foreign products.

Barriers to innovation

- Missing markets are not because the people in the finance industry are ignorant.
- India fares badly on barriers to innovation
- Example: tradeable depository receipts on gold.
- “If it's not explicitly permitted, it's forbidden”
- At present, innovators have to fight systemic inertia
- Most rational people choose to stay silent.
- To increase investments into innovating, the cost of innovating must go down, and the success probability has to go up.

The access debate (1)

- Many people think the poor have little at stake in financial sector reforms.
- Finance is about how households smooth consumption.
- The poor have highly volatile income!
- The poor need finance
- Doing better in finance is good for the poor!
- Finance sounds fancy, but finance reforms are pro-poor.

The access debate (2)

- When Person X borrows at 36% and Person Y (with the same risk characteristics) pays 9%, this is a violation of market efficiency.
- “Law of one price” : The same good should cost the same everywhere.
- Access concerns sound like social sector policy, but it's equally about efficient use of resources.

The access debate (3)

- Poor people & small firms do a large number of small transactions.
- Traditionally they were “unbankable”
- But with IT systems, we can crash the cost per transaction.
- IT is the key to solving India's access problem.
- NSE, NSDL, ICICI Bank, etc.
- Design of the New Pension System
- IT-centric finance sounds elitist but it's the key to solving access problems

What hobbles the debt market

- “Lazy banking” : Banks that don't like to do credit.
- The corporate bond market is a pale shadow of the corporate equity market.
- Creditor's rights continue to be weak.
- The government bond market itself suffers from non-transparency; lack of derivatives.
- Consequence: we have a strong equity market and one of the world's weakest debt markets.

Questions of financial architecture

- Multiple agencies or one?
- Merge commodity futures & securities?
- Role of RBI:
 1. Central bank
 2. Investment banker to GOI
 3. Banking regulator
 4. Banking supervisor
 5. Bond market infrastructure vendor
 6. Payments system vendor
- India is unique in this regard.
- E.g. China put banking supervision out

The role of the State

- The job of government is to produce the public good of financial regulation.
- PSU finance companies are a serious problem:
 - Moral hazard.
 - Distorted competitive conditions on markets.
 - Conflicts of interest for policy makers
- Privatisation of PSU finance companies should be a central piece of financial sector policy.

How to privatise?

- Strategic sales in finance introduce many problems – particularly with weak supervision.
- India's best bet is to create broad-based ownership through the stock market.
- Public issues, corporate governance, takeover code, contestable control: it is easier for us to walk down this route.

Regulation: a right way

- Don't have regulated PSUs
- Have clear, simple role definitions – don't have a complicated mandate
- Don't trade on the market that you regulate
- Have very high levels of transparency – put draft reports out for discussion, “town hall meetings”, etc.
- Have only “full time” board members
- For all senior staff: have two-way flow between government and the real world.
- Requires commensurate compensation policy

Open capital account but yet closed on trade in financial services

- India has already effectively opened the capital account
- Now let's harness the open capital account to increase competition in finance
- Allow local households & firms to buy finance as they like. Allow foreign producers.
- We know this very story from manufacturing 1992-2004
- Barriers to imports/FDI hinder efficiency
- But this needs to be simultaneously accompanied by better regulation.

Two moves ahead

- When imports & FDI first came into India, local firms were terrified
- Today Indian manufacturing is exporting!
- The same will happen with finance
- India can earn huge export revenues from a more efficient financial sector
- Finance is labour-intensive – like software
- Indian finance firms will fare better than Indian manufacturing did.

Building Indo-Saxon Capitalism

- Finance matters!
- We are far behind
- Clarify the role of the State
- Privatisation
- Reform fin. architecture
- Solve HR problems at the top of regulators
- Exploit globalisation
- IT systems for access
- This is a pro-poor agenda:
 - Better finance is higher GDP growth
 - Empowers the poor through better opportunities