Future of Indian Financial Liberalization

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Opportunities for Global Partnership between India and Japan
-Infrastructure, the Environment, and Finance
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Financial Reform: India’s choices

- Pre reform: Financial repression
  - Administered interest rates
    - Controls; funds for Government
- Post reform: Liberalization
  - Institutional and market development: Banks; BSE, NSE; demat
  - Interest rates market determined: LAF; CCIL; RTGS; money markets
- Financial regulation
  - RBI; SEBI; IRDA; PFRDA; HLCCFM
- Current account convertibility
  - Capital account: Gradual; order: equity over debt; long-term borrowing
  - FDI, FPI, GDRs, ECBs, FIIs limits for G-secs
- Exchange rate: Double devaluation
  - Market determined; managed but flexible; FX markets
  - REER; two-way movement since 2003; FERA to FEMA
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Liberalization: Consequences

- Trend growth rose but so did volatility

- FDI stable
  - Reduces supply-side bottlenecks; learning, better organization
  - Smoothen process, reduce hurdles

- FPI: Volatile, drove equity market volatility
  - Risk sharing (inflows 3 times larger than outflows for equivalent market indices variation)
    - Resumed soon: Indian growth prospects
    - Firms benefited easier fund access; also learning
    - But households exited equity markets

- Reserves
  - Over US200b but CAD; self-insurance but cost

- Sovereign debt held internally
  - Large: 80 percent of GDP; limits on debt inflows; no Greece?


Crises lessons

- Capital flows: Surges and sudden stops
  - Self-insurance, reserves
    - Exchange rate flexibility; FX markets; hedging instruments

- Foreign entry helps but alone does not deepen markets
  - Example retail exit in equity markets
  - New private banks but still large unbanked population

- Transparent sequenced capital account convertibility
  - Distinction between types of flows is useful and must be retained
  - Korea: Reserves security led to high short-term debt, reserves proved inadequate
  - Domestic growth, financial deepening → absorption, FDI ratio; real sector priority

- NIFA; G:20; regional arrangements: to allow faster liberalization?

- Structure of regulation
  - Global convergence; incentives

- Package: CAL, E and M policy, markets: middling through
Future of Financial Liberalization: Critical development imperatives

➤ Inclusion

➤ Infrastructure financing
  ☆ Long-term: Bond markets: Retail, pension funds participation
  ☆ Rollover of ST financing; exit of investors; completing markets

➤ Risk: Derivative markets
  ☆ OTC regulated in India but more transparency, CCP
  ☆ Standardized exchange traded instruments
**Banks**

- Less than 50 percent of the population have bank accounts
  - Expansion of banking services, not just credit

- Use of technology; mobile banking; BCs; MSPs
  - Mobile penetration high; last mile connectivity
  - Requirements: 100m migrants, remittances

- Servicing large corporates (5-7% roi); MSEs (9-11.25%)
  - Entry; mergers but competition, TBTF; loan consortium, LT ECBs
  - Credit bureaus, SARFAESI Act 2002 (used against MSEs)
Markets

Equity markets

- Retail and institutional investor participation
- GDS/GDP crossed 30%: large scope from domestic entry
  - But share of household financial savings in equity dipped from 20% pre-reform to 5%
- 90% trading volume in top 10 cities, and in equity and commodities
  - Only 1.5% of population invested in markets
  - Only 100 large cap stocks liquid
  - AMFs, ETFs, MSEs, single stock options, underperforming

Fixed income markets

- Domestic deepening prior to free foreign entry
  - Banks to push G-secs retail? Allow SLR to fall; more trading
- Corporate bond market
  - Stamp duty; cost of issuing: private placement
  - Pension provident fund guidelines on the basis of rating not issuers category
Debt markets contd.

- Interest rate futures
  - Attempts: 2003, 2009; ZCYC to YTM
  - Globally 81% of exchange traded derivatives, India 1%
  - Physical settlement
  - Corporate repo would provide users
  - Initially only two long-term deliverable G secs; lack of liquidity in underlying

FX markets

- OTC dominates, swaps
- BIS fastest growth rate among world markets but still thin; if no intervention spikes
- Futures, rapid growth
  - Low Open Interest
  - Not settled in hard currency
  - Low contract size: USD 1000
- Continuous devt.: Multiple currencies, options
Creation of electronic markets: Exceeding international standards

- Disclosure: real time price sensitive info; norms; corporate governance; legal issues; shareholder rights

- Volatility: Var + SPAN+ margins +deposits+ circuit breakers +surveillance
  - No stock exchange failed

- Competition: liquidity → network → tipping
  - BSE → NSE
  - Entry: MCX, NSE → predatory pricing? platforms, lock-in
Asian integration

- Regional financial integration low
  - Although intraregional trade more than 50% of total trade
  - Collapse of trade in 2008 partly due to credit freeze
  - Alternatives to Western markets, currencies and institutions; more stable; AMF

- ABMI
  - Large Asian savings to fund Asian infrastructure; stable long-term finance
  - Regional clearing and settlement systems

- CMI
  - Supporting institutions; expansion; review; prevent competitive devaluations

- CSR
  - Environment
  - Commitment to regional development

- Incentives from high expected Asian growth and trade expansion
Post Crisis: Market and Regulatory Failures

Market efficiency implies (no failures):

- Market prices give economic value
- Market discipline constrains harmful risk taking
- Market competition weeds out unproductive innovations
  - Securitised credit: liquidity, diversification
  - Mathematical models: robust measures of trading risk
Market failure

- Monopoly or market power
- Asymmetric or imperfect information
- Externalities or public goods

Financial system: Oversight of operational framework

- Externality—excess volatility: one → others, financial → real
- Information— asymmetric; adverse selection, moral hazard
- Monopoly— network effects; TBTF → risk taking
Government → Markets

Regulation: Principle-based rules
Change incentives of agents
Regional standardization, operational freedom

Basic market failures

⇒ Broad justification for regulation
  ★ Pendulum: neither self-regulation nor regulatory forbearance
  ★ Use incentives not controls: So don’t damp energy and freedom of markets
Future Financial Reform: Stability

- Indian markets → Global norms → Indian regulations
  - Micro-prudential regulation → securitization retention; PCA
  - Macro-prudential regulation → procyclical capital adequacy
    - Reduce under pricing of risk in booms
    - Reduce S-T Funding; excess leverage
    - Size (TBTF) → insurance premium
    - Imposed by host country (domestic cycles)

- Universal standards ⇒ regulatory arbitrage; Competitive risk-taking

- Would allow faster liberalization
Indian regulation

- Crisis—financial sector healthy
  - No road, or good regulation?
  - Eye on market failures, steady market development but innovation slow

- Supervision
  - Post liberalization crises → strengthened
  - Conglomerates → universal regulation

- Counter cyclical incentives - prescient
  - Provisioning
  - Accounting standards—unrealized gains and losses asymmetric
  - PCA

- Low cost of Basel III compliance
  - Banks tier I capital to risk weighted assets 9.3 already
  - Credit GDP to rise structurally; cost of OTC derivatives to rise; SLR not a liquidity buffer?
Financial stability
- Synergy between monetary policy and regulatory responsibilities
- LOLR required by many non-bank entities also

FSDC should be improved HLCCFM
- Improved coordination most important; lacking in govt. agencies

- Chair macroprudential regulator with hands on knowledge
  - Delays: Corporate Repo Market: CCIL; ownership
  - Functional regulation: overlap inevitable; clear responsibility allocation

- Legal structure; development mandated
  - Timelines

Thank you