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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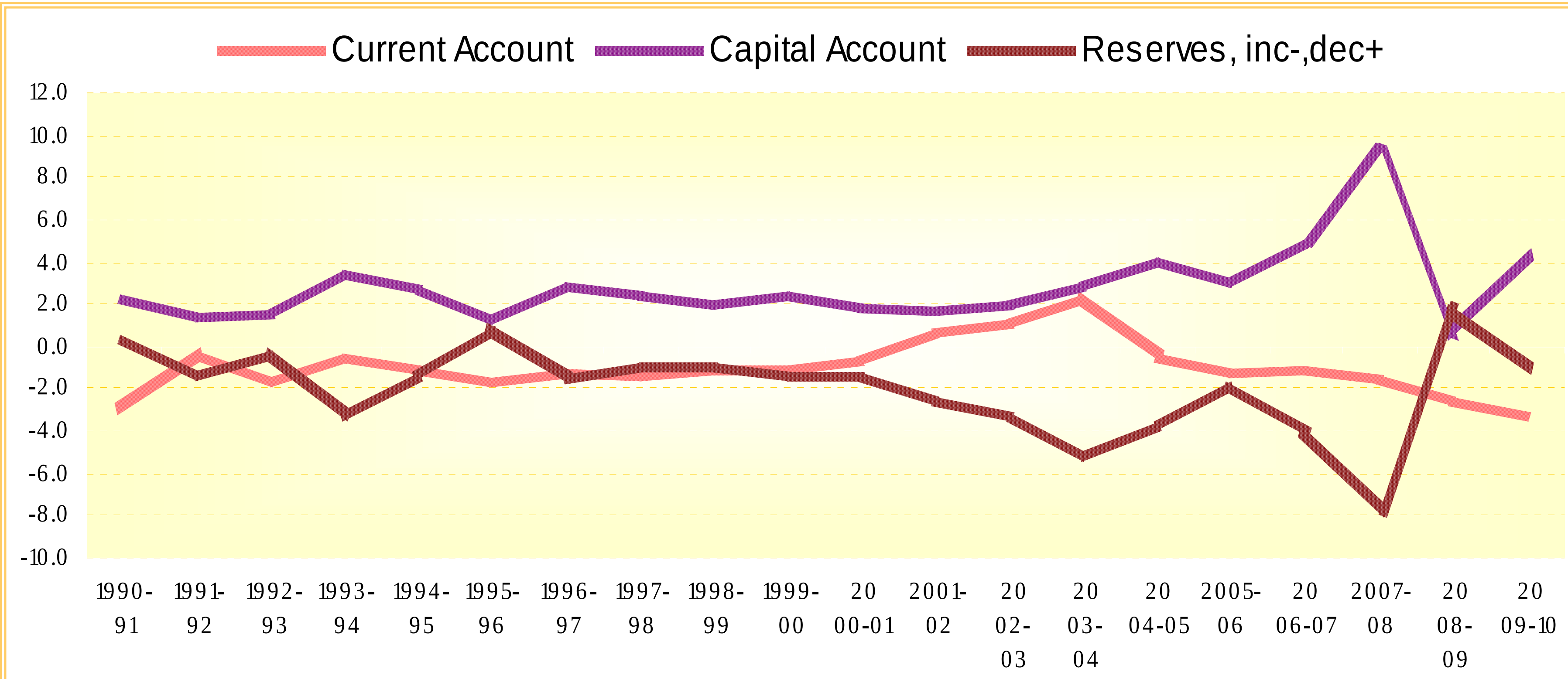
Financial Reform: India's choices

- 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



Current Account
Capital Account
Reserves, inc-,dec+
12.0
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
-6.0
-8.0
-10.0
1990-91
1991-92
1992-93
1993-94
1994-95
1995-96
1996-97
1997-98
1998-99
1999-00
2000-01
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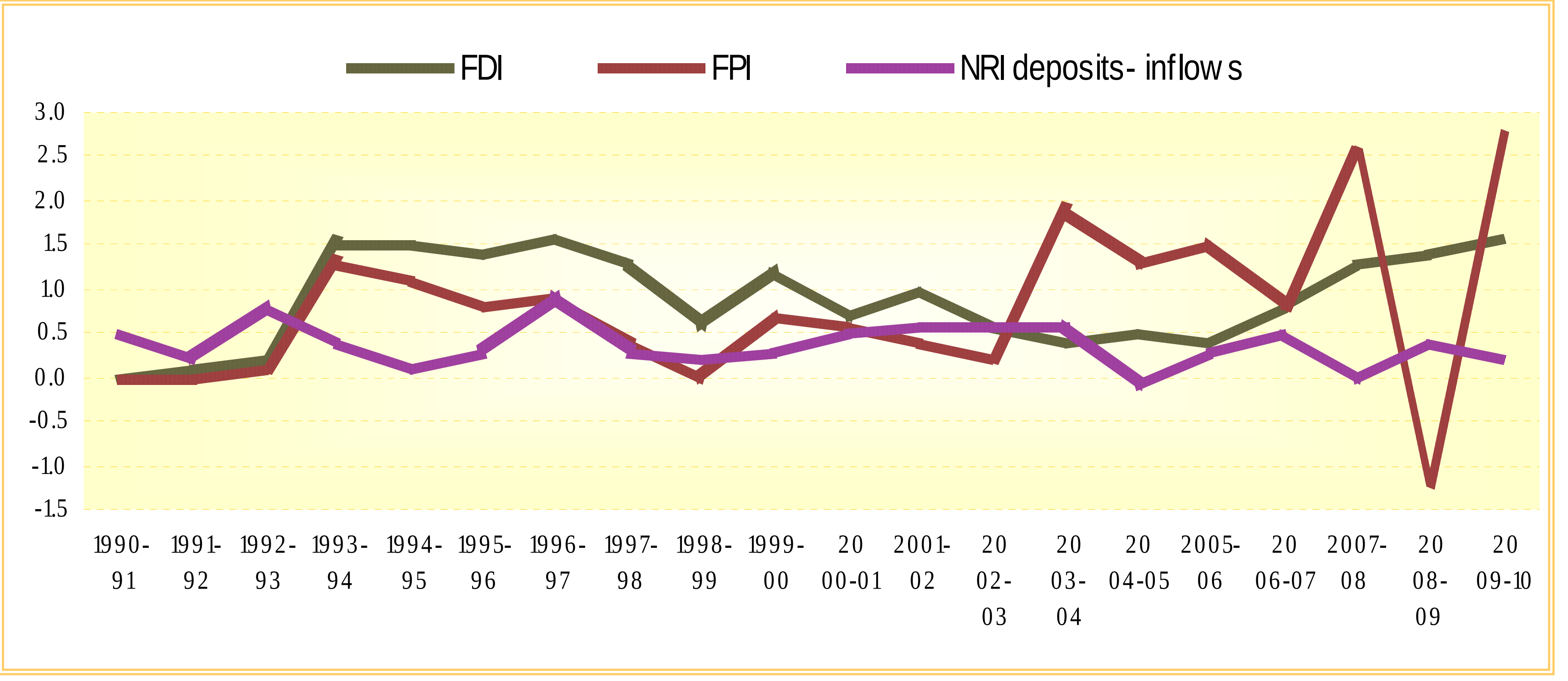
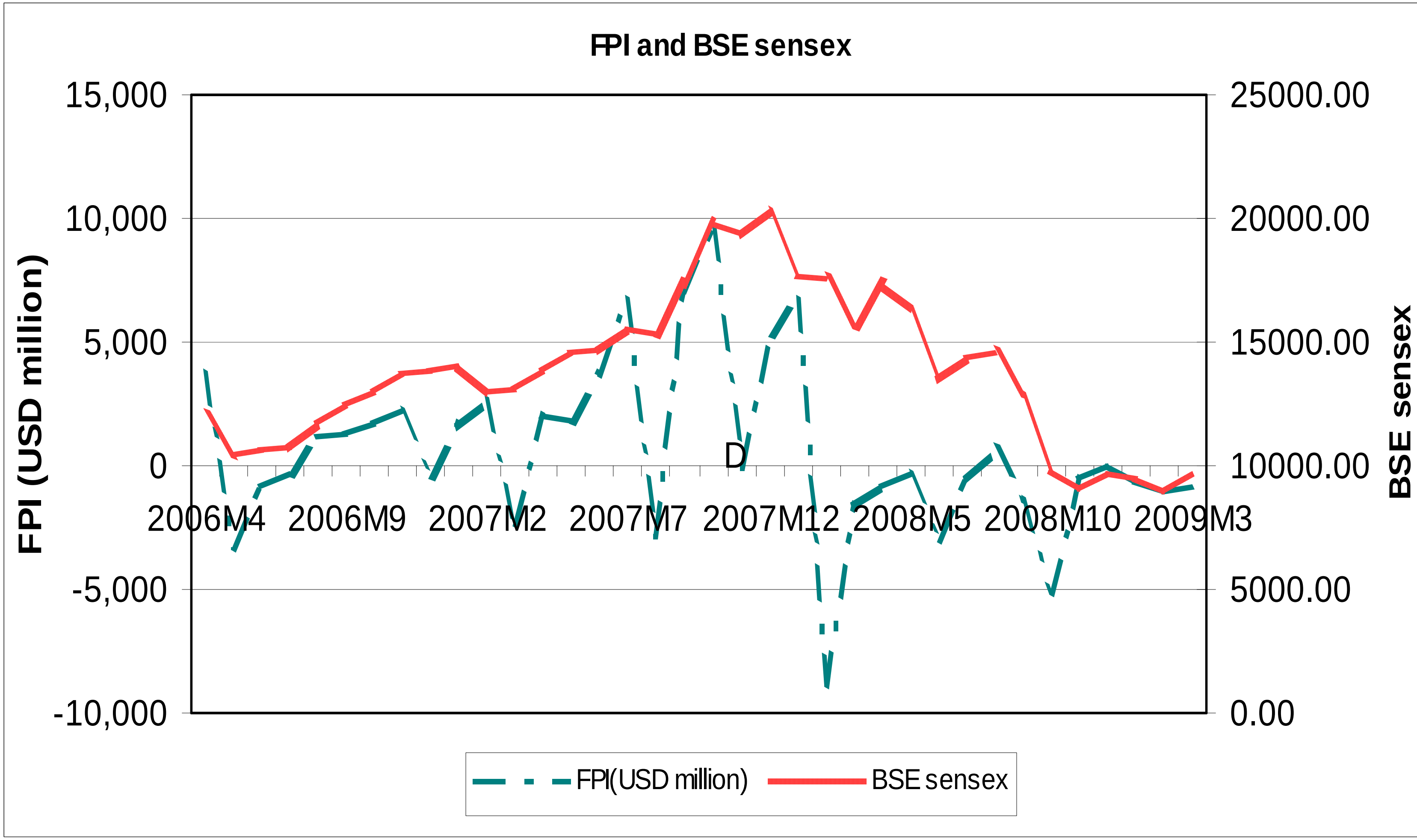


FDI
FPI
NRI deposits- inflow s
3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
-1.0
-1.5
1990-91
1991-92
1992-93
1993-94
1994-95
1995-96
1996-97
1997-98
1998-99
1999-00
2000-01
2001-02
2002-03
2003-04
2004-05
2005-06
2006-07
2007-08
2008-09
2009-10



FPI and BSE sensex
15,000
10,000
5,000
0
-5,000
-10,000
25000.00
20000.00
15000.00
10000.00
5000.00
0.00
FPI (USD million)
BSE sensex
2006M4 2006M9 2007M2 2007M7 2007M12 2008M5 2008M10 2009M3
D
FPI(USD million)
BSE sensex

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**

Markets contd.

- 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