

Next steps in financial sector policy

Ajay Shah
<http://www.mayin.org/ajayshah>

January 2006

Part I

What changed in Indian finance?

Heterogeneity in change

- Indian finance is widely seen as a success story
- But there is actually huge heterogeneity in the progress that's been made.
- Dimensions of quality:
 - Information processing; price discovery
 - Competition policy; Entry barriers
 - Deep and liquid market
 - Exposed to global competition
 - Prevalence of 'license permit raj'
 - Distortions caused by the State.
 - Pace of innovation

A tentative ranking of the components of Indian finance

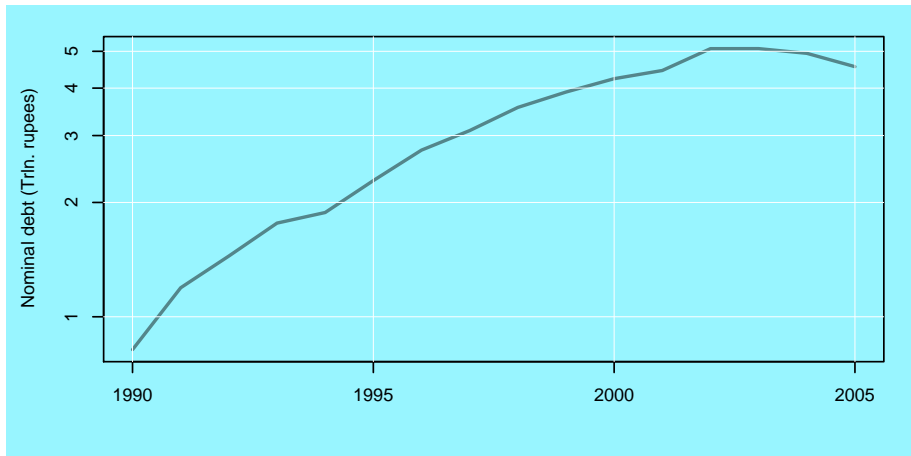
- 1 Equity market
- 2 Mutual funds
- 3 Insurance
- 4 Commodities
- 5 Banking
- 6 Currency
- 7 Bonds
- 8 Pensions

So what?

- 1 Economic agents have shifted their financial intermediation work in response to these differences.
- 2 Public policy needs to learn from the successes and apply the lessons.

Time-series of stock of debt of non-financial firms

Careful! Non-comparable samples! Nominal debt!



Remarkable importance of equity financing

	Stock
“Non-food credit” of all banks	Rs.13 trillion
Market value of 2500 firms	Rs.25 trillion

Equity-market dominated financial system

Leverage of non-financial firms in CMIE database

Year	Debt-equity ratio	
	Accounting-based	Market-value-based
1989-90	1.43	2.19
1992-93	1.82	1.25
1995-96	1.18	0.69
1998-99	1.19	0.88
2001-02	1.21	0.90
2004-05	1.06	0.27

Part II

Why was progress so heterogeneous?

Explanations that don't cut it

SOEs hampered banking? But compare insurance vs. banking.

Knowledge? May be in the early 1990s, but :

The equity market made a huge break with India's legacy;

FMC learned from the equity market;

New ideas in the New Pension System.

Staff quality? GOI staff are all roughly the same (though there are important differences in HR policies).

Interests of incumbents? The incumbent industry always dislikes competition. If anything, the equity market was the hardest.

An explanation: The politics of finance policy

- Overhang of old socialism – control raj
- Mistakes in ‘architecture’ – what regulator should do what.
- Turf battles
DCA/SEBI, SEBI/RBI, SEBI/FMC, RBI/FMC, etc.
- Law drafted in 1934, 1952, 1960s & 1970s is terribly out of touch today.

Remember the Controller of Capital Issues?

- The Controller of Capital Issues (CCI) was not reformed.
- We didn't just ask the CCI staff to now function in a market economy.
- CCI was shut down.
- New legislation came about
- A new regulator, with a new and clean mandate.
- New institutions: NSE, NSDL.

Remember the Controller of Capital Issues?

- The Controller of Capital Issues (CCI) was not reformed.
- We didn't just ask the CCI staff to now function in a market economy.
- CCI was shut down.
- New legislation came about
- A new regulator, with a new and clean mandate.
- New institutions: NSE, NSDL.
- Similar story in Insurance: new and clean law, new regulator
- Achieving these changes was enormously difficult at the time
- These architectural changes unleashed the energy which gave us progress in finance from 1992 till 2001.
- Now those avenues of progress have petered out.

What went wrong with FMC, RBI, EPFO?

- Comparable change has not come for FMC, RBI, EPFO:
 - 1 Agency is intact
 - 2 Staff is intact
 - 3 Law is intact
 - 4 IO structure of regulated industry is intact
 - 5 Conflicts of interest are intact
 - 6 Mistakes in mandate of regulator are intact.
- Ask staff to act like they are in a market economy.
- FMC was faced with oblivion: they made important progress.
- RBI and EPFO didn't.

Get the block diagram right

- Which regulator does what
- What is the mandate of the regulator
- What are the legal foundations of the regulator
- What are the conflicts of interest
- Modern regulators with modern law: only SEBI, IRDA.
- The gaps: FMC, RBI, EPFO.

What is quite feasible by unleashing new energy

Present	Feasible
Equity, Mutual funds	Equity, Mutual Funds, Commodities, Bonds, Currency, Pensions, Insurance, Banking,
Insurance, Commodities	
Banking, Currency, Bonds, Pensions	

Part III

Globalisation

Do for finance what we did for manufacturing

- The Indian economy is quite a captive customer for Indian finance
- Globalisation will induce competition
- Capital controls: distortions, rent-seeking, entrenched bureaucracies, DUP activities.
- Globalisation could help to improve policy making also. (neither necessary nor sufficient).

Summary

- My main claim: Now, progress in finance requires addressing the politics of finance policy
SEBI, IRDA: Now we face second-order questions
RBI, FMC, EPFO, PFRDA Bill: The first order questions.
- Scale down capital controls
- Finance is the 'brain' of the economy.
- Financial sector reforms will improve the allocative efficiency of 28% of GDP.
- Voters don't care about the petty bureaucratic battles of legacy agencies – e.g. no voter was ruffled when CCI was closed down.
- There are few other such low-hanging fruit in Indian economic policy.