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EVOLVING ECONOMIC AND FINANCIAL SYSTEMS IN INDIA

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The presentation explains that Indian Economy is basically a market-oriented economy with constant rebalancing between state and market. The process of globalization does impact the changing balances in India. These dynamics are best illustrated by the changes in financial system. The outlook for the economy and the financial system in the short-term appears somewhat uncertain, though in terms of fundamentals, the outlook is very positive over the medium to long-term. India's policy-framework is likely to contribute positively to global economic growth and stability.

The presentation is divided into:

i) Economic System: dynamic mix of mixed economy;

ii) Rebalancing in financial system;

iii) Reforms in financial system: a mixed bag;

iv) Outlook for India; and

v) Select Emerging Issues.

(i) Economic System: Dynamic mix in mixed economy

After independence, India adopted a mixed economy model of public and private sector. However, in late sixties and seventies, there was uni-directional expansion of public sector and extensive regulation, partly through a process of nationalization. Since reforms of 1991, there has been considerable deregulation and expansion of private sector in parallel with growth of public sector in some areas. In recent years, the emphasis has been on public-private participation, particularly in infrastructure sector. The public enterprises still dominate banking, insurance and energy sectors, and these are often used as instruments of public policy, though they are subject to market discipline.

Almost half the population is dependent on agriculture, while it accounts for about 15% of GDP. Services account for about half o the GDP, indicating a small manufacturing base. Pervasive poverty and large scale unemployment, especially among the educated youth constitute major challenges for public policy. Inadequacies, both in quantitative and qualitative terms in physical infrastructure and social sector (especially education and public health) continue to daunt the central and state governments. However, stability of political system and self accelerating

growth provide hope for emergence of strong economy. In addition, being an essentially marked based economy, a strong entrepreneurial class has developed with perhaps the lowest cost per unit of innovation in business-processes.

The Indian Corporates have pursued their businesses in other countries in an impressive manner, and are able to adapt to local conditions in an effortless manner. Government plays a passive role in overseas activities of the enterprises from India.

Economy is not excessively dependent on exports and has a sustainable current account deficit. It displays a healthy level of household savings comparable to other Asian economies, while fiscal position continues to be weak both in quantitative and qualitative terms. Financial sector, however, has displayed considerable resilience to shocks.

In brief, the economic system is essentially a market based system, but with a strong and varying presence of public sector in several sectors. There is an effort in public policy to reach out to vulnerable sections through social safety nets like Rural Employment Guarantee and public distribution system in essential commodities. Yet, the rising inequalities and increase in number of super rich has led to a widespread perception of unfairness in public policy, thus undermining effectiveness of governance. The strong presence of media, diversity, democracy and the

argumentative nature of Indians ensure avoidance of extremes in public policy and encourage a process of changing mix between state and market forces. The unbroken tradition of basic market institutions, demographic dividend, and technology-driven entrepreneurial class give the country hope for a sustained growth in GDP over the longer period, though not without vulnerability to shocks, especially in areas of food, fuel, fiscal and external account.

(ii) Rebalancing in Financial System in India

Financial system is characterized by a gradual process of rebalancing between state and market or regulation and market freedom or public and private ownership and between traditional banking and financial innovation. The apex institution in the process of rebalancing since reforms of 1991 has been the Reserve Bank of India (RBI). It is the monetary authority, banker to governments at Centre and states, and debt-manager to the governments. It has also been given responsibility for regulation and supervision of banks; managing external sector, especially capital account and regulation of non-banking financial companies. It is also a regulator of money-markets, government securities market and forex markets. The RBI earned significant credibility among the people and political leadership with its impressive record of maintaining price stability relative to most developing countries and also avoiding a banking crisis. In recent years, there was considerable mobilisation of opinion to divest RBI of non-monetary policy

functions, especially by the financial market participants and advocates of modern finance. The separation of debt office and shifting it to Government of India has been announced, though there is a suspicion that these moves are strongly backed by investment bankers and hence invites some skepticism in accelerated implementation of the proposal.

Internal mechanisms have been devised within RBI to ensure a balance between benefits of coordination and costs of conflicts of interest. Thus, the functions of regulation and supervision are performed under overall guidance of a committee of the Board which meets every month. Similar carve out can be observed in regard to regulation of payment systems.

By standard indicators of independence, RBI is one of the least independent, *de jure*. There are separate regulators for capital markets, insurance and pension funds.

A large part of deregulation was operationalised in RBI by the manner in which the powers and functions were exercised rather than legal amendments that made deregulated financial sector a matter of right to market participants, rather than a means towards efficiency and stability as determined by RBI from time to time. Establishment of new regulatory bodies, no doubt, warranted legal changes. Coordination of regulatory functions was, till recently performed by a High Level Committee, presided over by Governor and with representation from each regulation and from

government. There were pleas for converting the Committee into a statutory one which were not acted upon till recently when the Committee mechanism has been supplanted (as will be described later).

The financial system continues to be dominated by commercial banks, though non-banking financial companies are now growing rapidly. Till twenty years ago, 100% owned public sector banks dominated the banking system, and they had virtual monopoly except that smaller banks were allowed to operate. As part of reform, new private sector banks were licensed, and foreign banks presence increased. Private shareholding, including that of foreigners, has been increased up to 49% in public sector banks and their shares are traded actively. They retain the public sector character in terms of governance and ownership. Banks, subject to conditions imposed by RBI, perform non-banking investment like functions. In brief, there was no wholesale privatization or large scale nationalization or bailout since reform era, but there has been gradual rebalancing in favour of market discipline and private ownership. For example, insurance industry which was a monopoly of public sector now has a presence of several private sector players with multi-national collaboration.

The financial repression was all pervasive before reform, with a major part of bank's resources pre-empted for government. Over a period, pre-emptions have been gradually reduced, but they are far from being

eliminated. Administered interests continue to prevail but on a lesser scale than before, both in regard to deposits and advances. Directed lending in terms of prescriptions of priority sector lending continues, with less rigour than in earlier years.

Mutual Fund activity, which was a monopoly of public sector has similarly been opened up to private sector. However, a large part of Equity Funds obtain their funds from corporate and non banking financial companies, as also banks. They have not been able to attract enthusiastic interest of retail investors.

Trading in equity markets is dominated by foreign institutional investors who may also operate on behalf of other clients and through derivatives traded abroad, called Participatory Notes. A large part of flow of funds is through jurisdictions with which there are special tax treaties. There is persisting controversy regarding the integrity of equity market in India due to activities of domestic corporates along with their sponsored non bank financial entities, mutual funds, and insurance companies. Links between foreign banks and their associate FII's have also been matters of controversy.

The debt market is dominated by government securities which are managed and regulated by RBI. Most of corporate debt market is privately placed and seldom traded. In the absence of interest of retail

investor, there is pressure on banks to participate in the corporate debt markets.

Most of trading activity in financial markets is either with foreign flows or with resources from banks. As a result, there is a fear that banks are not adequately discharging traditional lending functions to agriculture, small industry and working capital needs.

Money markets and forex markets are regulated by RBI, and major players are banks, especially foreign banks. Derivatives are permitted but with severe safeguards.

In brief, the financial system of India is not an alternate to western or Angle Saxon model but actually moves towards such a model, cautiously and pragmatically through rebalancing. The process of rebalancing is influenced by two opposing forces, namely, (a) those who believe that deregulating and liberalizing financial markets will improve efficiency and growth, including inducing reform in fiscal and real sectors; and (b) those who believe that there should be harmony in the progress of reform in financial real (non financial) and fiscal sectors, in addition to state of external environment.

(iii) Reform in Financial Sector: A mixed bag

Economic reforms in India since the balance of payments crisis of 1991 have undoubtedly contributed significantly to the accelerated growth of economy with significant resilience to domestic and global shocks. Reforms in financial sector played a critical part in building a strong and resilient external sector also, in addition to facilitating growth and stability.

The balance of payments crisis in 1991 occurred at a time of political instability and change in central government's leadership. The RBI played a leading role in managing the crisis while government was supportive of such a role. The intellectual leadership for the first phase of reforms that followed in financial and external sector management was provided by those who were closely associated with RBI. The two committees on financial sector and banking sector reforms were chaired by former Governor Narasimham, and enjoyed technical support from RBI. The High Level Committee on Balance of Payments which provided the framework for current account convertibility and capital account management was chaired by a central banker of distinction (Dr. C. Rangarajan). A Committee on road map for liberalization of capital account was also chaired by a central banker (Dr. Tarapore); and both the Committees had technical support from RBI. Reforms in insurance sector were initiated on the basis of a Committee chaired by a former Governor (Mr. R.N. Malhotra). In all these Committees, there was representation for several stakeholders, especially the Government. Many of the recommendations

could be implemented since they captured theory, global best practices and domestic macro-economic as well as institutional factors. The credit for successful reforms in financial and external sectors, including the resilience of the economy in the recent global financial crisis, is rightly given to the recommendations.

India entered high growth phase of around nine per cent in 2004-05 which coincided with significant global interest in India's economy, especially from financial conglomerates. This was also the time when RBI expressed discomfort at the origin extent and quality of capital inflows, while government was in favour of accelerated liberalization of capital flows, deregulation of financial sector, and development of bond-currency-derivatives markets. A Committee under the Chairmanship of a former central banker (Dr. Tarapore) was appointed to consider fuller capital account liberalization and most of the recommendations were acted upon.

The next (second) phase of what may be called appointment of Committees for reforms commenced with appointment of two committees by Government: one on making Mumbai international financial centre, chaired by Mr. Percy S. Mistry, Chairman, Oxford International Associates Ltd., and the other on next phase of reforms of financial sector, chaired by Professor Raghuram Rajan of Chicago University (formerly of IMF). Their recommendations covered several macro aspects, monetary and regulatory structures, and policies relating to financial sector as a whole.

While details do differ, the underlying logic was broadly on the lines of the then popular Anglo-Saxon Model. The Government had repeatedly expressed interest in implementing the recommendations, but many of them required legislative changes which are complex to bring about. The global financial crisis in September, 2008 resulted in concentration of public policy on crisis management and stimulus rather than reforms in financial and external sector. The formal commitment of public policy to implement the recommendations of both the Committees, remain, and their implementation is formally reviewed. Most of the recommendations remain unimplemented.

Initiatives for reform were resumed in 2010 and these could be described as the third and current phase of reforms. These do take account of the recent global developments, especially deliberations, in regulation of financial sector. It is useful to consider some of them in greater detail to capture the evolving thinking and possibly the forces that are driving the reforms now.

Firstly, a Financial Stability and Development Council (FSDC) has been established under the Chairmanship of the Finance Minister. Its terms of reference include financial stability, financial sector development (including financial literacy and financial inclusion) inter-regulatory coordination; and macro prudential supervision of the economy, including functioning of large financial conglomerates. The council will also

coordinate India's international interface on financial sector. The council can extend jurisdiction to any related matter that the Chairman considers appropriate, thus providing extensive and intrusive jurisdiction. The council is considered to be generally on the lines of oversight council in U.S.A. This body is obviously in lieu of the proposal to give legislative backing to a pre-existing mechanism called High Level Committee on Financial Markets chaired by Governor. In fact, almost all the functions assigned to the Council were being exercised by the erstwhile Committee.

The RBI, in an unprecedented move, expressed reservations on this proposal when it was announced. While the general opinion was that the current incumbent Minister commands trust, there could be occasions when financial stability may occur at times of political turmoil making the functioning of the council complex. Possibly, in response to the general sense of discomfort at the original proposal, the final notification provides for a sub-committee under the chairmanship of Governor. The Minister has also given an assurance that the Council will not dilute the autonomy of regulators. Overall, there is no doubt that the new mechanism is an improvement but for the reservations on the envisaged role in it for Government, and in its extensive jurisdiction.

Second, a law has been enacted, giving to government powers of assigning regulatory jurisdictions in regard to hybrid instruments in financial markets. According to government, this was necessitated by a

dispute between two regulators. In the past, such issues did not arise often; and when they did, they were resolved in the High Level Committee; and in any case, government enforced its views through its representation and formal voice in each of the regulatory bodies, except perhaps RBI.

Many questioned the motives of this law apart from its desirability while all but one regulator expressed misgivings. In view of the fact that there will be overlap between regulators in all cases, emphasis should have been on coordination rather than arbitration. Both RBI and regulator of securities market expressed reservations. In defense, government holds that such formal powers are necessary for clarity on jurisdictions as markets evolve, and innovate products.

Third, constitution of a Financial Sector Legislative Reforms Commission has been announced. The Commission presided over by a former Justice of Supreme Court with membership drawn from academics, central bankers and financial market intermediaries, is expected to study and recommend on the total architecture of legislative regulatory system of the financial sector. The Commission has been accorded a term of twenty four months which should provide opportunity to consider ongoing relevant thinking and developments in global fora.

A longer term view and careful deliberation on rationalization of legislative and regulatory provision, covering over sixty (60) existing pieces of legislation has much to commend for itself. The two year term should provide an opportunity for the commission to consider developments in global thinking and practices. However, there is no clarity on the role of RBI, which more than any other financial institution, has necessary expertise on these matters.

Fourth, amendments to Banking Regulation Act are being proposed, which strengthen the regulatory and supervisory powers of the banking regulator, namely, RBI. These powers relate to prescribing fit and proper criteria appropriate for ownership and control beyond a prescribed level, powers to supersede the Boards, etc. for banking regulator. These proposals were pending with Parliament since five years, but their enactment is being expedited now.

The enhanced regulatory powers will facilitate effective, graded and prompt preventive-corrective actions. This is timely since new licences for banking are being considered.

(iv) Outlook for India

India's financial sector proved resilient and Indian economy has posted impressive and prompt recovery from the crisis. Its contribution to global

economic growth and stability will continue to be positive because of (a) its risk-averse economic and financial system described; (b) its financial sector that is not in need for deleveraging and re-regulating, and (c) its economy that displays no serious economic imbalances that need to be unwound. Yet, India has to guard against two important emerging weaknesses that could induce instability. These are persisting inflationary pressures and mounting current account deficit. No doubt, the deficit is being funded by capital flows but the quality of current inflows as well as the potential volatility of stock of external liabilities makes the country particularly vulnerable in case the global liquidity conditions change significantly. The global spillover of any adverse development in India due to these factors may not be significant in view of the limited extent and diversified nature of India's integration with global economy. Further, the combination of high savings, demography and entrepreneurial talent provide confidence to the long-term investors in India. While policy-mistakes could still derail the growth story of India, the prevalent socio-political systems and the manner of reforming the economic system through checks and balances give room for hope for growing confidence and positive outlook.

The strength of financial sector is essentially in the strong banking sector, and there is a danger that this feature conceals weaknesses in non-banking segment of financial sector. The non banking financial companies or shadow banking which could be a source of instability is growing very

rapidly. There are close links between shadow banking and large corporates, who in turn have sponsored mutual funds. Mutual funds which have been given tax concessions to evoke retail investor's interest are most focused on corporate / bank / insurance companies / NBFC investments, often to the tune of over 70 to 80 per cent. The larger corporates own the insurance companies also. The dealings among these institutions are difficult to monitor or control.

Equity markets are driven by two large segments, namely, Foreign Institutional Investors and domestic Mutual funds with their linkages to other segments of economy. Further, derivatives called Participatory Notes make it difficult to ensure Know Your Investor. These factors may have the effect of diluting the integrity of financial markets and effectiveness of regulation. It is difficult to speculate how these features would affect the growth prospects in the medium to long term. The continued dominance of banking in particular public sector banking, could be a source of comfort for stability.

(v) Select Emerging Issues

In the light of global financial crisis, there has been disclosures about the functioning of financial sector. There have also been disclosures about political economy considerations in conduct of policy in India. These developments warrant exploration of some issues in the Indian context.

First, are there signs of politicization of financial sector? This question is being raised in the light of some of the reforms in financial sector that appear to undermine regulators, and in particular, reduce the importance of RBI. The strong reactions to such initiatives may have diluted the thrust of changes, but the trend could have the potential to further reduce the extremely limited independence that the RBI and regulators possess.

Second, is there a capture of financial sector by big business? There have been several cases of penal actions by the regulator against big businesses. At the same time, the complexity of transactions and the disproportionate (to penalties) benefits that accrue to them does give room for discomfort in some circles. There is a powerful presence of serving officials of government on the governing boards of regulators except in RBI.

Third, are there links between some elements of corruption in the country and global capital inflows, especially private flows? While a few of the capital inflows could be of questionable legality, especially considering the size of inflows from less than fully transparent jurisdictions and instruments such as PN's, there are incentives for non-corruption related inflows into the country on account of residents. The tax regime provides significant incentives to indulge in what has been described as round tripping (A process whereby residents move the money out of the country

to bring it back to take advantage of tax and other regulatory differences in jurisdictions).

Fourth, what is the role of multi-national banks in financial sector? The multi-national banks play an active and positive role in domestic debt and forex markets; and have introduced several innovations. Some of them are active in shadow banking. However, the investment advisory services to "High Net Worth Individuals" and dealings with some high profile Swiss Account Holders by some of them has now come under closer scrutiny. The affiliates of many of these multi-national banks are foreign institutional investors.

Fifth, is the investment climate in India conducive to growth? There is no doubt that India is a very attractive economy for investment. The budget speeches of Finance Minister devote attention to this factor, but the messages relate only to making India attractive to foreign investors. In the recent past, quality of environmental clearances and penal actions against errant entities are, it is alleged, being driven by the need to keep the sensitivities of foreign investors in view. These measures which could amount to greater advantage to foreign investors, may induce some of the funds through round tripping. In brief, public policy should recognize that (a) over ninety per cent of investments have to be funded by domestic sources; (b) the expansion of "unhealthy" flows may crowd out healthy flows; (c) integrity of financial markets and effectiveness of

regulation are critical for longer term growth; and (d) being business-friendly is good but becoming market friendly is better.

In conclusion, there are broader issues in economic and financial sector management than macro economic parameters or financial indicators, and these need to be considered by India to enhance its growth and ensure equity. These issues are worth considering by public policy, though they are not of magnitude or complexity that will have negative spillover on the global economy. In fact, its pragmatism and rebalancing could be appealing to public policy, in general.

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