India's shackles

'Deregulate, liberalise and globalise' is the bold recommendation for the country's financial system. **Stewart Fleming** looks at the implications

In the latest edition of the US Council on Foreign Relations magazine, Foreign Affairs, Ashutosh Varshney, a professor at Michigan University, says that, looking at what has been achieved since 1991, the common judgment is that India has a "strong consensus on weak reforms". He added that deeper reforms would be needed.

Exactly what these deeper reforms should be is under discussion. In April, a High Powered Expert Committee (HPEC) set up in 2005 by P. Chidambaram, India's finance minister, published a 240-page assessment of the changes needed to transform Mumbai into an international financial centre. The report's conclusions demand changes to India's entire financial system.

The Reserve Bank of India should, it said, be given independence in making monetary policy, like the ECB, Federal Reserve Board and the Bank of England. It should adopt an inflation-targeting monetary policy strategy and, *sotto voce*, it should shed its bank regulatory powers.

India's capital account should be fully liberalised by no later than the end of 2008. To make the most of its financial sectors' national and international potential, gaps should be filled in India's patchy – albeit in some areas highly sophisticated – network of financial markets.

In particular India needs a "properly functioning bond market" rather than one dedicated to satisfying as cheaply as possible the government's demands for funds.

But perhaps the report's most politically divisive aspect is the recommendation it "reduce the extent of public ownership progressively in Indian financial institutions".

This means banks. State-owned banks control 75 per cent of the banking system's deposits, the highest level in a leading economy outside China.

This veiled reference caused a fight. Percy Mistry, the committee chairman and main author of the report who is a former World Bank executive, resigned and said he would stand by the report's recommendations but not by the full report as many of his arguments were deleted in the final version.

The HPEC report says that India's goal should be to create by 2020 not an offshore tax haven or a regional financial centre like Tokyo, Frankfurt or Paris but a truly international financial centre to match London, New York and Singapore.

According to the report, Mumbai should aim to become the main international financial centre in east Asia, outstripping Singapore and Dubai and capitalising on what some see as China's big mistake. This was the attempt to develop both Shanghai and Hong Kong as competing international financial centres rather than make the most of Hong Kong's historic strength.

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Mumbai must now push ahead urgently, "deregulating, liberalising and globalising" a financial system largely untouched by the economic reforms begun in 1991. Regulation and competition policy must be embedded.

For India, financial market and regulatory reform is not just an attractive option. The current box-ticking regulatory regime is going to be overwhelmed by India's progress in global markets. This could throw up a (perhaps systemic) financial crisis unless modernised.

Meanwhile, government regulations and controls, the so-called licence raj, are an obstacle to the development of innovative and flexible financial institutions. "India lacks domestic commercial and investment banks capable of taking on global counterparts without higher levels of capitalisation, global market access… operational expertise and high-level human capital," the report says.

It adds that unless the financial system is modernised not only will many financial services move operations offshore but, by 2015, domestic financial markets will be losing as much as $48bn a year in business to New York, London and Singapore. This would be "more than the output of many Indian industries today".

Sensing opportunities, foreign financial institutions have been stepping up their Indian operations. This year the New York Stock Exchange and Goldman Sachs joined a select group, each of which has bought 5 per cent stakes in the National Stock Exchange of India. Deutsche Bank and the Singapore Exchange have each bought 5 per cent of the Bombay Stock Exchange.

Unless the Indian government is alert to this, foreign financial institutions will cherry-pick the most attractive financial market prospects. Simultaneously, a lack of domestic reform will depress the competitiveness of the wider financial sector.

Some of the HPEC report's proposals are moot. Is inflation-targeting really the best monetary policy strategy for this huge developing country? But, according to one expert, India's politicians cannot duck this test: "I believe that financial reform and political/judicial reform are even more important to sustaining India's growth than the infrastructure bottlenecks that everyone keeps talking about."

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