Win-win in India

Foreign investors will benefit if the restrictive 'licence raj' is dismantled. If it is not, they will rake in the money offshore, says **Stewart Fleming**

Like much of high-growth Asia, India is enjoying a financial services boom. But inadequately developed domestic markets have prevented the effects from being spread around the Indian economy. Full potential benefits are not being realised.

Unless India moves swiftly, it will lose more domestic financial business to offshore centres and foreign financial institutions such as Goldman Sachs and JPMorgan Chase.

While a weak coalition government – a mix of reformers and anti-reform leftwing diehards – contemplates financial sector reforms, international financial institutions are looking to exploit opportunities in this huge and fast-growing economy.

Earlier this year the limits on foreign investment in stock markets were raised. In no time, several foreign investors grabbed the maximum permissible stakes in India's two dominant stock markets.

The New York Stock Exchange, Goldman Sachs, General Atlantic, and Softbank Asian Infrastructure Fund moved together to each take 5 per cent holdings in the National Stock Exchange and Deutsche Börse bought 5 per cent of the Bombay Stock Exchange.

In Mumbai, foreign investment banks are also restructuring, beefing up their staff and snatching more office space.

Goldman Sachs, JPMorgan Chase, Morgan Stanley and Merrill Lynch have all abandoned the joint ventures with the Indian partners they were originally obliged to "marry" in order to gain entrance to the market. Now they want to go it alone on the sub-continent.

L. Brooks Entwistle, chief executive in India of Goldman Sachs, has said: "We are building a full service Goldman Sachs presence here." As well as thousands of back office staff, Goldman has 75 investment bankers on the ground.

Morgan Stanley is also building a full-service investment bank. JPMorgan has about 275 bankers in India. Credit Suisse plans to reopen its Indian brokerage business and banks such as HSBC and Citigroup, long established in India, are also expanding their investment banking.

The opportunities look appetising, in terms of the overseas expansion of India's nascent multinationals and also, potentially, in domestic markets. According to accountants Grant Thornton, there were $39bn of mergers and acquisitions in India in the first quarter of 2007.

> Will Delhi dare spend political capital on reforms that will see 'more Rolls-Royces around Bombay'?

But there are obstacles. The Mistry committee *(May FW)* points out: "There are still many regulatory restrictions on the entry of foreign banks into [India's] domestic banking market." Of investment banking it adds: "Major areas of financial activity in which [they] excel, for example mergers and acquisitions, risk management, currency trading, interest rate arbitrage, corporate-sovereign, sub-sovereign bond issuance and hedge funds, are artificially proscribed in India."

But for the foreigners, India verges on being a no-lose investment. If the politicians do not dismantle the "licence raj" that is hobbling the domestic market, India's international companies will go offshore for the high-value financial services that domestic banks are ill-equipped to provide. If deregulation comes, they will have the foundations in place to capitalise on it swiftly. Either way they win.

Jennifer Asuncion-Moon, of Deutsche Bank Research (DBR), says that, in contrast to several Asian economies, "India's capital markets are shallow, implying further reforms are needed to make India a world class financial centre".

The depth of the changes required to give India the financial markets it needs were spelt out in the Mistry committee report, sponsored by the Finance Ministry and chaired by Percy Mistry, former World Bank executive.

But, just weeks after the 240-page report's publication, one Indian economist wondered whether, with just two years to go to a general election, the feuding coalition government would be prepared to spend political capital on reforms that "will result in more Rolls-Royces driving around Bombay".

The Mistry report says a revolution is needed in the financial system. "The call for creating an international financial centre in Mumbai is a metaphor for (and synonymous with) deregulating, liberalising and globalising all parts of the Indian financial system at a faster rate." But its recommendations have run headlong into powerful vested interests.

Among its most controversial recommendations is a call to end the suzerainty which the Reserve Bank of India (RBI), the central bank, has exercised over a too tightly regulated financial sector. It has done so through its roles as monetary policy-maker, exchange rate stabiliser, public debt manager, surrogate parent of public sector banks and banking superviser.

The Mistry committee suggests that, like the Bank of England, the RBI's supervisory powers should be transferred to a separate banking regulator and it should focus exclusively on setting interest rates and fighting inflation.

The RBI's response has been a stunned silence. It is already struggling to manage the contradictions of containing inflation while steering monetary and

exchange rate policy with what one economist calls "a closed-economy mindset in open economy circumstances".

Alongside regulatory reform, sweeping privatisation, increased foreign competition and the development of more sophisticated currency and derivatives markets, the Mistry report argues that massive investments must be made in both physical and intellectual infrastructure to transform Mumbai, India's financial capital, into a global financial centre to rival New York, London and Singapore.

With Mumbai ranked by international consultants Mercer as 209th out of 215 metropolitan cities for quality of life, it is no wonder that critics of the report say that the committee's recommendations might be hopelessly optimistic.

In February, Standard and Poor's upgraded India's credit rating to investment grade, the highest in 16 years, expecting growth to average 7.5 per cent in the medium term. But this is below the expectations of India's more ambitious technocrats and political leaders.

According to insiders, Manmohan Singh, the prime minister, believes that India's annual growth rate can be sustained at over 9 per cent if reforms are revived.

In their more unguarded moments, the premier and his coterie of ex-World Bank technocrats also believe that, if the political roadblocks to reform can be hurdled, the country might even exceed the 10 per cent rate that has propelled China to fourth place among national economies.

But the threat to the Indian financial sector from abroad is also growing daily.

Ajay Shah, a former finance ministry adviser and an authority on the economy, says Indian companies are moving to evade India's narrow, bureaucratic and tightly-regulated markets.

He says: "Owing to the new phenomenon of outbound foreign direct investment, every significant Indian company now has arms operating elsewhere in the world… It is easy for those foreign arms to place orders on [offshore] currency/interest rate/credit risk markets… hence the international financial services business which could have been transacted in India is being transacted outside."

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Dubai's new financial centre will soon have an Indian rupee/US dollar currency futures market running "at a safe distance from the system of controls that smothers Indian finance," he points out.

The full implications of this trend for India were highlighted by the recent takeover of European steelmaker Corus by India's Tata Industries and the acquisition of Canadian aluminium maker Novelis by the Birla group.

Because of the inadequacy of India's financial markets, substantial international financial services revenues were paid out to companies in Singapore and London.

The Mistry committee estimates that, if India fails to reform and internationalise its financial markets, by 2015 it will be spending $48bn a year on international financial services, much of it from Singapore, and possibly Dubai.

Mumbai's potential to develop, like Singapore, into a global, not just a regional, financial centre, comes in part from India's huge economy. At its current rate of growth, India's nominal gross national income of $1,000bn in 2007 could amount to nearly $2,000bn by 2012.

By 2015, at over $3,000bn, India could become the fifth-largest national economy in the world after the US, China, Japan and Germany. By 2030 it could be the third-largest economy after the US and China.

Although it now lacks the kind of domestic financial system needed to support such growth efficiently, India does have high-quality, low-cost, human capital, with English-speaking ability, experience in accounting and risk-taking and information technology skills.

In terms of time zones, it is well placed geographically to cope with 24-hour trading and it has begun to establish a few high-quality exchanges operating with advanced information technology levels.

The question is whether India's leaders can summon the political will to embark on a transformation of the financial system more radical than the moves launched in the early-1990s. For the central bank, in particular, the challenge is daunting.

The Asian debt crisis of 1997, from which India escaped virtually unscathed – partly because of capital controls but mainly because it was still too far behind east Asia in the growth stakes – demonstrated to the RBI just how vulnerable even large developing economies could be to the ebb and flow of global liquidity. The RBI is well aware of the divisions in Delhi about whether the country should embrace financial globalisation.

It must be conscious, too, of how vulnerable a world economy characterised by massive global trade and financial imbalances might be to new financial crises. It must wonder whether this is the right moment for a leap in the dark.

But what is the alternative? Can an economy the size of India's turn its back on the financial market forces that are shaping the world economy?

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