

The Mumbai-IFC Report: of Discourse, Garlands and Brickbats!

Percy S Mistry, June 10th 2007.

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Part 1: A Survey of Reactions to the MIFC Report

The HPEC Report on Mumbai as an *international financial centre* (MIFC Report) has been in the public domain for over two months now. It has elicited considerable media attention, thanks to *Business Standard*, *Business World*, *the Indian Express Group*, *DNA*, other national/regional publications, and *CNBC Awaaz*. Such media now provide the main forum for public debate on policies in India. Our culture of dispassionate policy discourse obviously needs strengthening. More public discussion of policy issues is needed in neutral institutional fora. Perhaps we are, as a people, too passionate, politicised, ideological, or complacent about the *status quo*. We prefer arguments to generate heat not light. So we let serious policy discussion take place within confined circles of insiders: the PMO, Planning Commission, MoF, or RBI. But, just as war is too important to be left only to the generals, policy is too important to be left only to policy-makers and politicians.

Before 1991 (and often since), India has suffered from the prolonged pursuit of poor policies partly because the public's voice was not elicited nor sufficiently heard. Policy has been the exclusive domain of dominant policy-makers/politicians, attuned to unsound ideology, populism, and short-term pandering to ever-changing electoral arithmetic. That was to our detriment. An inflexion point was reached in 1991-92. But, having withdrawn from leaping over the edge of our particular abyss by 1995, we have become recidivist. We need to strengthen our infrastructure of applied research institutions (only NCAER, ICRIER, ASCI and IGIDR come immediately to mind) for the wider public exchange of ideas across various vested and other interests on key policy issues that concern us.

Thoughtful leaders in financial and corporate India -- as well as those who comprehend how pension funds that affect everyone work -- acknowledge that the MIFC Report is of strategic import. If that is so, one would have hoped that high-profile neutral fora -- such as IIM in Ahmedabad, ISB in Hyderabad, NCAER, ICRIER -- would by now have hosted symposia (with global media coverage) on MIFC with national and international luminaries who know about international finance and IFCs. That would have been in keeping with the traditions of their counterparts in the US and EU. Fortunately, the CII in Mumbai, and the Administrative Staff College of India (ASCI) in Hyderabad -- with Mr. M. Narasimham as Chair of its Board of Governors, and its dynamic Director-General Dr. S.K. Rao -- did take the initiative in launching public discussion of MIFC. The FT is about to organise a conference on this theme in Dubai in November.

Media focus on the MIFC Report has engendered a policy debate of sorts involving the usual suspects -- i.e. editors and columnists. By and large, it has been favourable. About three-quarters of media commentary has been supportive and constructive. It is gratifying to note the reactions of the Finance Minister and the Deputy Chairman of the Planning Commission. Both have embraced the Report. Both seem concerned about whether

there is political consensus to act on it. The FM has read and annotated it more carefully than most. That he will implement as much of it as he can in his own time, and in his inimitable way, I have no doubt.

The Report has been received enthusiastically by some icons of Indian finance, e.g. M. Narasimham (the father of modern post-1991 financial reform), Vijay Kelkar (whose report on reforming the tax system is a landmark), Savak Tarapore (whose two definitive reports on CAC are the bibles of their age), a number of practitioners, as well as reputed columnists such as Jamal Mecklai, Andy Mukherjee, Deepak Lal, Mobis Philipose, Dev Chatterjee, Stewart Fleming, and many others. Their reactions are invaluable. These individuals know what they are talking about. Some (like Nasser Munji) have asked for the PMO/MoF to set up a high-level unit to monitor implementation of the MIFC-Report's recommendations in real time. That clarion call can only be endorsed.

Knowledgeable stalwarts apart, another tenth of the *cognoscenti*'s reaction to the MIFC Report is of the following kind:

“Yes, the report is remarkable in ambition, comprehensive in coverage, unambiguous in its many sensible recommendations. But, what's the point? No one will do anything about it. This is another report that will be shelved like its predecessors. The politics of the present coalition are not right for the UPA government to implement these bold recommendations. They are more concerned about 'aam aadmi' than about finance, super-rich investment bankers and bonus-obsessed currency-and-options traders. And, in any event, after the recent bout of electoral carnage, the UPA will not be re-elected in 2009. Also, Mumbai's infrastructure will never improve despite much rhetoric; nor will its governance. The Committee is being naïve in articulating fine 'dreams' and believing politicians who say 'give us your best advice and leave us to take care of the politics', etc. etc.”

Such pessimism has been indulged in by a handful of commentators and *ad nauseam* by one particular group of newspapers. It may well be justified by experience. Surprisingly, it is shared by my friend Shankar Acharya. I had taken him, from our earlier days, to be a sunnier sort of chap. Hoping that his acerbic scepticism about Mumbai becoming an IFC is misplaced, I am waiting for his first piano recital with bated breath! But then I am tone deaf. Shankar apart, this line of argument applauds the value of the Report *en passant*. But he goes on to negate that with an overdose of cynicism that does not serve any purpose. One cannot learn anything from it. Nor can one change anything with it. It is simply a frustrated scream at the Indian penchant for hanging on to the *status quo* when it no longer works. In the light of what has happened since 1992, such cynicism is misplaced. It cannot be taken seriously because it is irrelevant to useful debate on the issues that the MIFC-Report raises.

This pessimistic reaction overlooks the reality that, because of Manmohan Singh's reforms under duress, India has come further, faster in the last fifteen years (1992-2007) than in the previous forty-four (1947-91). Sadly, it appears that we sometimes forget that. One can argue whether India has moved five, ten or fifteen times faster since 1992. But that is not of consequence. What is important (cf. Jamal Mecklai) is that India in 2007 is very different from the India of 1992. The India of 1968 does not seem, in retrospect, to have been on the same planet! People below the age of 25 do not quite accept that the India of 1947-68 even existed. They treat that long dark night of failure as a yarn, of exaggerated policy-induced deprivation and economic totalitarianism, spun by elders in their garrulous dotage.

Even to those of us who lived through that era, it seems bizarre to recall in retrospect that, with their adamant insistence on protecting *political and democratic* rights, Indian governments of all complexions in 1947-1991 seemed quite cavalier about depriving everyone of their *economic and property* rights. They did not appreciate that *political* rights and freedoms were meaningless if unaccompanied by symmetric *economic* rights/freedoms. They rejected the view that *real* political freedom axiomatically implied market freedom and individual freedom to exercise economic options. Many academic economists, and too many of those in our civil service whose careers developed under the *ancien regime*, still seem to have a problem with that symmetry. They exaggerate concerns about *market failure* to justify counterproductive state intervention; as if there is no risk or cost of *public policy or governance (i.e. political and administrative) failure* on a larger scale. India's history through 1947-1991 establishes beyond doubt that the risks and costs of public policy and governance failure far outweigh any risks or costs of market or corporate failure.

The much larger, more complex, real economy of India (that makes things and provides services) has changed dramatically in just fifteen years. That took only a few trade and licensing reforms. These removed artificial barriers to entry and increased the scope for industrial competition and innovation. So, why should it be impossible to change the financial sector in the next decade with the kind of reforms we propose?

That is all the MIFC Report asks, and provides evidence to justify that question. India's equity market was transformed beyond recognition through policy decisions of 1992-1994 followed by one big decision of 2001. So, why should it be impossible to do what the Report recommends for CAC, bond, currency and derivatives markets or for transforming financial regulation? Especially if there is consensus on the destination to be reached and action is taken at battle stations? Surely it is more important to exert Herculean efforts at creating such a consensus, and generating a propulsive dynamic for reform, rather than being cleverly cynical and pessimistic about nothing ever happening.

In cooking up an IFC, the Report argues that India has all the ingredients it needs. The recipe is easily borrowed. India lacks in nothing -- not the technology, know-how, human or financial capital needed -- to create an IFC. All it lacks is: (a) proper *governance* of the financial regime and of the city -- which is not that difficult for intelligent, well-intended and capable people to remedy, providing politics permits; (b) the right approach to *financial regulation* -- undertaken by regulators who are not bent on preventing a future in which their draconian, dictatorial powers, are diminished or eliminated -- for the wider public good; and (c) most importantly, *political will and consensus* in an era of unwieldy coalition politics, to get the state out of owning so much of the financial system, and making such a ham-fisted mess of it -- about which more is said in a later piece.

A further tenth of commentary suggests that the Report is broadly on target but misses the bulls-eye. Such critiques suggest that creating an IFC in Mumbai is only a real estate play, and that the Report has a misplaced emphasis on problems of financial sector policy. It is argued that infrastructure is what defines an IFC; it is the only issue. The HPEC does not quite see the Mumbai-IFC that way; although many local politicians and developers of proximate SEZs probably do. The Committee dismissed at the outset the notion that an IFC in Mumbai should be an *offshore* centre (OFC) located in an SEZ, with spanking new infrastructure, dealing only with non-resident clients in foreign currencies that were fully convertible. Proponents of this idea do not appear to have taken fully into account how such an OFC might be regulated. Would Indian regulators would be keen on a bunch of other home country regulators involving themselves in overseeing transactions that involved their currencies and corporations? Would that not overlap irritatingly with Indian regulators overseeing Indian and established foreign firms undertaking such transactions in an OFC?

The Report states categorically that Mumbai's crumbling infrastructure is not at all amenable to the emergence of a credible IFC. Yet, even with its obvious dilapidation (i.e. its hopeless transport, worsening power situation, collapsing buildings etc.) a wide range of international financial services (IFS) could still be offered to *Indian* clientele. But, that could only happen if the structure/performance of the financial system and its regulation were reformed. It would not happen if the plethora of unnecessary and counterproductive barriers, prohibiting IFS from being offered in India -- and prohibiting the world's major financial players (and their lawyers and accountants) from operating freely in India -- were not lowered or removed. Obviously, to serve *global* clientele, Mumbai's infrastructure would need to be of a standard similar to Singapore and Dubai. Other IFCs have traffic jams; but they have better buildings, roads, power, water, communications, drainage, flood control, disaster management, etc. The Report could not have been clearer on those key points.

Again, all one can say is that criticism focusing only on infrastructure may make sense to those who have axes to grind and vested property development agendas to pursue. One local commentator observed that only the Shiv Sena could make an IFC in Mumbai a reality! It was the only party that had constructed flyovers. That it had bankrupted the city and state in the process was conveniently ignored. What was also overlooked was the fact that the Sena's ugly militancy, and its politics of: exclusion, communalism, linguistic chauvinism, violence and intimidation to get its way, as well as its role as self-appointed guardian of a peculiarly intolerant and purrulent notion of 'Indian culture', would all do infinite harm to the emergence of an IFC in Mumbai. But that is another story.

The Report alludes to all of these concerns; if more *sotto (notto?) voce* than its chairman would have preferred. But, such commentary notwithstanding, it makes no sense -- in the context of creating an IFC to serve India's needs in the short and medium term, and serve *the world's* needs in the longer term -- to focus on infrastructure as the only issue. It is an important issue; but one less critical than financial system macro-policy, regulation and overall financial regime governance. An OFC meant to attract foreign players to an SEZ providing superb infrastructure proximate to Mumbai, does not make sense for India, even as an initial booster-stage in a multi-stage rocket launch.

Surprisingly, only the remaining 5% of commentary actually takes issue with the Report. The clearest exemplar of this is Shankar Acharya who wrote a clever piece on the *Mystery Report* not so long ago in Business Standard. This type of reaction, especially when put forward with such formidable powers of persuasive erudition, needs to be taken seriously! That is precisely what I attempt to do in the last of this series of six articles.

Finally, it has to be said (ungratefully) that, while media exposure and editorial/columnist commentary has been extremely rewarding and gratifying, it has, with notable exceptions, not been as incisive or deeply substantive as one might have wished. That is perhaps inevitable; because of the medium through which these views have been expressed. In the public media, commentary has to be attuned to what readers want to read and can cope with; replete with polemics that are often falsely grounded. But, in this instance, from the personal discussions I have had with strangers in the corridors of clubs and cinemas, my feeling is that many editors and columnists might have underestimated their readers! I could be wrong, but more in the next instalment.

Part 2: The Urgency of a Second Round of Wide and Deep Financial Reforms

This second instalment on the MIFC Report reiterates that, while reactions to it have been overwhelmingly enthusiastic and supportive, there has so far, not been as much public (or private) policy debate on key aspects of its substance as one had hoped. To encourage such focused debate let me outline (in deliberately provocative fashion) the Report's underlying logic which hinges on *four pivotal constructs*. The first of these is the focus of this piece.

Mumbai's becoming an IFC, is a metaphor for proceeding urgently with the next stage of *deep and wide financial sector reforms* that have been too long delayed. Vijay Kelkar has astutely observed that the real value of this report may lie not in the emergence of an IFC in Mumbai but in the efficiencies that further financial reform would unleash in resource allocation. By lowering India's capital-output ratio (resulting in more output and exports with less investment of financial capital) and improving capital productivity, India's growth rate of 8.5% could be increased to 10%. Even if there were no IFC in the picture, this perspective needs to permeate the core of India's development strategy.

But the MIFC report is not the pioneer in advocating financial reform. It is a second-stage booster. A comprehensive agenda for financial reform was outlined much earlier in the two Narasimhan reports. The first gained traction in 1992-95. Its recommendations were implemented in the immediate aftermath of the 1991 crisis. But the second did not gain as much momentum. Along with the first Tarapore report on CAC, it came at an inauspicious moment. It emerged when the world and India (as well as the IMF and World Bank) were bent on learning all the wrong lessons from the 1997 Asian crisis. Its message was lost in the disagreeable and disoriented cacophony that followed. That unfortunate (and avoidable) regional debacle became an excuse for India's financial authorities to move too slowly on reform in general and on capital account convertibility (CAC) in particular.

The MIFC Report revisits that strategic error of prolonged caution and complacency. It shows that India's *domestic* financial system is becoming, inexorably, a part of the global financial system. The boundary between the two is blurring too rapidly for regulatory comfort. But that kind of integration should be a matter of delight to the producers of financial products and services, and to their Indian consumers, alike. The gradual fusion of Indian finance system with the global system is occurring, in part, as an *unintended consequence* of myopically restrictive policy; that is reacting in an incoherent fashion, in coping with the transition from a closed, command economy to an open, market economy that India is now going through. The efforts of the regulatory authorities (determined to retain command) appear to be aimed at retarding the evolution of the Indian financial system by deferring action on a multifaceted agenda, such as:

1. Proceeding more aggressively and decisively with CAC;
2. Inducing the emergence of a strong corporate bond market along with the government bond market;
3. Encouraging, rather than discouraging, the emergence of a complete derivatives market offering interest-rate, currency, credit-default and political risk derivatives;
4. Breaking down the boundaries between, and strengthening, all types of financial institutions and markets to suit market dynamics; rather than compartmentalising financial market segments too tightly to suit regulatory turf divisions and regulatory domain convenience;
5. Not pressing hard for the overdue privatisation of state-owned banks but instead attempting to prolong their regime of protection; by
6. Slowing down foreign entry by posing absurd macro and micro barriers;
7. Indulging in excessively intrusive regulation and supervision, to the point of regulatory micro-management; and so on.

The Report deals with all these issues in depth. They require wider public discussion and resonance; regardless of how uncomfortable that might make the regulatory authorities. Unfortunately, such discussion has been averted or circumvented for fear of giving gratuitous offence that might result in an unwarranted reaction. In justifying their 'go-slow-for-safety's-sake' approach, the authorities are deploying arguments that are only partly valid (if that) in the short-run, and probably damaging in the long-run, to Indian finance. India's growing share in world *trade* (especially in services) and *cross-border investment* (direct and portfolio) – i.e. its rampant globalisation -- are making hitherto unprecedented *domestic* demands for international financial services. But,

financial policy adaptation and regulation is not keeping pace with that unfolding reality. Instead, and inexplicably, India's financial regulators are adopting a reflexive Canute-like posture, attempting to hold back an unstoppable global tide. Out of sheer force of habit, they are relying on command-economy powers to address market-economy problems.

Whether India's authorities wish it or not, its financial system has, of its own accord, entered the slip-road leading on to the global financial expressway. India no longer has a choice of letting its *domestic* financial system evolve cautiously at bullock-cart speed. India's new non-Hindu, Sardar-induced, annual growth of 8-9% appears to have taken firm hold. It does not permit the authorities, fearful of rapid evolution going out of their control, the luxury of proceeding at a leisurely early 20th century pace in the frenetic 21st century.

Competing on the global frontier in finance, or trade in real goods and services, is like being on a high-speed motorway, rather than the parallel unpaved rural road that Indian financial policy-makers and regulators are travelling along. If everyone else is cruising along at 120 kph, then insisting on driving at 20 kph is neither safe nor prudent, however loudly that instinctive preference may be asserted. In those conditions, the slow-moving Indian financial system becomes a menace to itself, and a danger to others, travelling on that same global financial expressway. Yet, the argument being offered axiomatically and *ex cathedra* by the authorities is that going slow with financial reform and CAC is essential for its own sake; and that going faster runs the risk of destabilising the financial system and the economy. That argument of course ignores the fact that *going much slower than evolving circumstances demand* (simply because the financial authorities do not appear to be sufficiently equipped in terms of their knowledge and grasp of modern quantitative finance, or of principles-based regulation, to cope with the complex new challenges they confront) may run an even greater risk of destabilising the Indian economy and its financial system. This is what the present confusion over monetary and exchange rate policies seems to suggest.

We are experiencing unnecessary difficulty in managing the contradictions of: (1) maintaining a low inflation rate with a competitive exchange rate, in the face of rapid capital *inflows* that are responding to global market signals and opportunities; but (2) artificially impeded capital *outflows* that are not permitted to respond to the same global market signals to the same extent. And we are making life unnecessarily difficult for the Indian corporation and individual by retarding the development of essential markets (such as those for currency, credit, and interest rate derivatives) and institutional capabilities that would enable them to better manage their day-to-day risks (e.g. of unhedged exposure to exchange and interest rate movements) in properly functioning, liquid derivatives markets, rather than stalling on these markets because our relatively inefficient state-owned banks (or SOBs as they are referred to throughout this series -- an acronym more accurate than the sobriquet 'PSU banks' or *zombies*, that caused such an unnecessary disturbance when used for explanatory purposes that were clearly misunderstood) cannot be trusted to use them, without incurring the risk of their own financial destruction.

The contours of the world economy that India is competing in, and the complexity of the new policy-making matrix that confronts our financial authorities, requires reform and opening up to go much faster, in order to adjust to the realities of constantly changing global centripetal and centrifugal forces.

The 'go-slow-at-any-cost' strategy has had the unintended consequence of India's financial system now lagging too far behind the real economy. It is not meeting India's needs for efficient, cost-effective domestic or global financial intermediation. That is why corporate India and high-net-worth individuals look abroad for their financial needs. That will eventually become an ingrained habit, with India and Indian finance losing out permanently. In the infelicitous phrase of the British Home Minister, the Indian financial system is "not fit for purpose". One would have liked to have a more pungent debate on that proposition in response to the Report's various contentions in support of it.

Part 3. Dealing with Lacunae, Weaknesses and the Problems caused by State-Ownership in India's Financial System

The previous two articles in this six-part series focused on: (i) media reactions to the MIFC Report and (ii) the first pillar of its underlying logic – i.e. the *need for a second stage of deep and wide financial sector reforms* to support an IFC in Mumbai. In this article, I focus on the second logical construct on which the MIFC report stands, in the hope that much more public discussion, aimed at building a wide, all-inclusive consensus for change, will be focused on this critical issue. The second strut of the Report's logic contends that a major impediment to Mumbai's becoming an IFC is *India's financial system being too state-dominated and consequently under-developed. It has too many critical missing markets. It has insufficiently large/strong institutions. It is too inefficient in the banking sector, which contaminates other areas of finance. In an overall sense, India's financial system is altogether ineffectual in meeting the rapidly growing needs of its burgeoning economy.*

The Report argues that, if this financial system is not quickly transformed, Mumbai's chances of becoming an IFC are between nil and zero. To be sure our financial system is much better than it was in 1991. That is thanks to (a) the venerable Mr. M. Narasimhan; (b) the actions taken by the RBI in developing the money, forward currency, and G-Sec markets; and (c) the Capital Markets Division in MoF – which has had the good fortune to be led by a series of exceptional people – along with the NSE, NSDL and SEBI in developing the equity spot trading and (limited) derivatives markets.

But, that defensive but repetitive argument -- about major financial sector improvements having occurred (often portrayed as being broader than they really are) -- keeps being made in every public speech made in every city by every senior financial official. What that argument intentionally obscures however is that, even with these limited reforms, our financial system is, nevertheless, more dysfunctional than it needs to be, to meet India's needs in the 21st century. Contrary to public pronouncements by officials of apex agencies, India's financial system is *artificially* (i.e. as a matter of legislative and regulatory policy, rather than because of any inherent weakness in the availability of financial or human capital, or management know-how) debilitated by being:

- a) Too *fragmented* across the major segments of banking, insurance, securities issuance and trading (i.e. bonds, equities and derivatives), asset management, long-term involuntary savings such as pension funds, and *commodity* derivatives (which are *financial* contracts)
- b) Too *protected, rigid and relatively closed* to foreign (and domestic private corporate) entry resulting in a lack of real competition and a lack of innovation resulting in the kind of egregious inefficiencies reflected in some of the largest intermediation spreads (e.g. between deposit and prime lending rates of banks) in the world;
- c) Too *tightly compartmentalised* within individual segments without the kind of operational and financial permeability across segment boundaries that enhances the width, depth and liquidity of the financial market as a whole
- d) Substantially *incomplete in terms of market architecture* -- i.e. it has large lacunae with 'missing markets' for bonds, interest rate derivatives, currency trading and currency derivatives (which are the lifeblood of an IFC), credit default derivatives, weather risk derivatives, political risk and catastrophic risk insurance and derivatives
- e) Deficient in the *capacity and size of institutional players* in all segments of the financial system. They are too small, too undercapitalised, too unsophisticated in terms of risk management, too technologically backward (except for our stock exchanges and depositories), and too overstaffed to be competitive on a global scale; and, finally,
- f) Too *state-dominated* in ownership (and in policy/regulatory intrusion to the point of micro-management) -- the principal reason for many of the deficiencies outlined.

The first five of these adumbrations are too obvious to require further elaboration. If elaboration is needed, readers are referred to the MIFC Report which deals with each of them in mind-numbing detail. But the last of these points has not been dealt with adequately in the MIFC Report. The politics played in the HPEC did not permit it.

So I shall elaborate my own views now on this vexing issue. It needs to be confronted more transparently without umbrage being taken on grounds of political correctness. What I offer is a *personal* view. It is not an HPEC view that was wrongly suppressed. I suspect that many of the HPEC members shared that view, but felt that there was little to be gained by having it expressed as forcefully in the report as I would have wished.

State-ownership (along with prolonged regulatory strangulation) has diminished the quality of Indian financial intermediation. It is responsible for the large institutional and market deformities that the Indian financial system now possesses. Areas of the financial system in which the State is predominant as owner (e.g. banking) are the areas in which financial firms and markets are least efficient, most poorly managed, most bureaucratic, most overstaffed, and least-well compensated, creating too much room for petty malfeasance. They are also the areas in which Indian financial firms are the most technologically backward, least customer-orientated, least imaginative, least competitive, least innovative, and least prone to proper risk-management of their brands, human resources, financial capital, as well as their assets and liabilities.

A proper cost-benefit analysis of the impact of state-ownership in banking between 1968 and 2007 would probably conclude that the nationalisation of banks on ‘developmental’ grounds was perhaps one of the worst strategic errors made by any Indian government. It compromised and retarded India’s development for a quarter-century. It contaminated the brain, bloodstream, and oxygen supply that allocates resources and sends signals through the body of the real economy. The SOBs, as a system, made it possible for GoI to finance too large a consolidated fiscal deficit for too long, resulting in excessive internal (and, up to 1991, external) public indebtedness being built up too rapidly. In part, their dysfunctional instrumentality accelerated India’s headlong rush to the edge of the economic precipice in 1991. That level of public indebtedness (reflecting a long period of fiscal incontinence) has now effectively paralysed GoI from acting as it should, in dealing with: (a) the problems of reviving agricultural output growth to 5-6%; (b) financing critically essential public infrastructure, especially in rural areas; (c) India’s messy transition to large-scale and rapid urbanisation; and (d) tackling the core issues of rural and urban poverty.

A huge proportion of cumulative public resources (several trillions of rupees at current market prices) are locked up unnecessarily in the ownership of SOBs and other PSUs. All these PSUs would be more useful to India, and better off as functional institutions in their own right, if they were privatised. One only has to look at peer comparators in every industry to arrive at that obvious conclusion. Under our present binding fiscal constraints, it stands to reason that an exit of state ownership from SOBs and PSUs would release the resources that GoI needs to tackle more pressing social and political issues. Obviously, the proceeds of privatisation (of assets) would need to be used first to reduce commensurately India’s public debt burdens (liabilities) rather than financing recurrent expenditures. But that would create headroom for greater budget flexibility by enabling pre-emptive debt service obligations to be diverted to finance priority social expenditures instead.

Yet, GoI is immobilised (politically) from doing what it should to address urgent electoral priorities by divesting its stakes in SOBs and PSUs. Reason is a rare attribute in the Indian political universe. It is applied only accidentally. Or it is a compromise of convenience, or a matter of pure chance rather than deliberate intent. So, what needs to be done urgently, will probably not be done (or done too slowly) for the worst of reasons – i.e. the inability of ideologues and political opponents to come to terms with reality for the common good. This is an issue on which a ‘coming together’ of the core Congress Party and the BJP (whose more reasonable members agree on this issue) would outflank their more difficult allies on the extreme left and right. By joining hands for this one purpose the two genuinely national parties would accomplish an outcome of immense long-run benefit to India. But what is the chance of that happening? Your guess is as good as mine.

What have SOBs achieved since 1968? They have sucked up deposits from the rural poor, to lend more than was prudent to the government and to the licensed rich (often with very poor outcomes). They have contributed to sustained resource misallocation through directed lending (not entirely their fault, but it couldn’t have happened without them), resulting in a waste of scarce capital over three decades and yielding a low growth rate. That low growth has resulted in prolonging India’s underdevelopment, as well as its inability to tackle the national shame of endemic poverty. The SOBs have resulted in an entrenched system of politicised (rather than *market*) finance that has become impossible to ‘de-rigidify’ and to make more competitive, innovative, flexible and adaptable. Moreover, the governance of SOBs, while perhaps the most elaborately prescriptive in terms of procedural requirements, is also the least transparent or accountable to other stakeholders and to the public that supposedly ‘owns’ them. Their Boards are stuffed with “political hacks” (in Shankar Acharya’s damningly accurate phrase), who know or care very little about management, banking, finance, economics or resource allocation.

Unlike Singapore (which is always held up for comparative argument to justify state-intervention in India), the state-ownership of financial and other types of institutions in India has created space for exercising political influence (petty and full-blown) in the economy through the financial system. Unlike India, the state in Singapore subscribes to a different political ethos, a different concept of democracy (of course disputable), different ideas about the importance of ensuring economic efficiency at all times, and a different set of ethical standards in corporate and public governance. The comparative Indian vulnerability to political malfeasance and influence makes itself felt in: selecting unsuitable leaders and top managers of state-owned financial institutions, with really good leaders (like N. Vaghul from the Bank of India) being the exception rather than the rule; hiring staff and promoting middle managers with political connections rather than ability; applying absurd reservations policies that compromise capability; hyper-active unionisation; and excessive interference in the day-to-day decision-making of SOBs, e.g. lending unwisely to shaky borrowers (e.g. sugar mills or property development companies) owned by or linked to politicians or their relatives.

This has happened *not* because state-owned banks are under-regulated or under-supervised. Quite the contrary. They are over-regulated to the point of being micro-managed by the RBI. But political sensitivity and malfeasance have permeated the system to the point of rendering its entire fabric dysfunctional. The SOBs now serve political interests for the exertion of subterranean political power and influence over economic activity, rather than serving the interests of economic efficiency and effectiveness in the mobilisation and allocation of resources. Even when they are not transmitting this debility, SOBs are prevented by a plethora of petty restrictions from being efficient and competitive.

Until quite recently, when it actually owned the majority stake in the State Bank of India (SBI), the RBI acted as much as the owner-manager-guardian of the state-owned banking system, as it did as monetary authority and banking regulator-cum-supervisor. That created a colossal conflict of interest in governance that no one in India seemed too bothered about. It resulted in explicit and implicit protectionism and market retardation of a kind that we have not begun to realise the hidden cost of.

But despite (or perhaps because of) such micro-management from outside, our SOBs -- while being among the largest financial firms -- remain the least capable. In saying this, I am not comparing them with the *penny ante* private co-operative and other banks which we have far too many of. The comparison is with their large private (ICICI, HDFC) and foreign (HSBC, Citibank, Standard Chartered, etc.) counterparts. That would not matter if SOBs accounted for only 10-20% of deposits and banking assets. But they account for nearly 75% of the banking system. In their present form the SOBs are not suitable channels for the intelligent allocation of resources for corporate or public investment through prudent banking. They are the most resistant institutions to being reformed. They will not change in the way they should, at the speed they should, without recourse to full privatisation. Without a strategy for the withdrawal of the state from ownership and intrusion (apart from legitimate arms-length regulation with a light touch) in the financial system, any prospect of real reform is elusive and futile. For all those reasons, SOBs are perhaps one of the greatest obstacles to Mumbai becoming a credible IFC.

This line of argument (which was removed from, or diluted to becoming meaningless, in the published version of the MIFC report) needs wide public discussion. Without that, the groundswell of opinion and the political consensus that is needed for inducing the exit of the state from the ownership of any financial institution -- will simply not materialise. As a result, any prospect of creating an IFC in Mumbai will be jeopardised. But, even more importantly, the state-dominated financial system will continue to act as a *deadweight drag* on the more rapid, efficient development and growth of the Indian economy (rather than catalysing such growth) by impeding genuine market forces from playing a greater role in resource allocation. That will retard efforts aimed at poverty alleviation.

The unfortunate legacy of SOBs dominating the Indian banking system, and of state ownership dominating the insurance and asset management industries for too long, has had detrimental ripple effects across the rest of Indian finance. The use of SOBs to pre-empt national private savings and divert them into low-yield government bonds (earlier untradable and held to maturity) resulted in impeding the emergence of a properly functioning bond market for over three decades. Today, that legacy is being fixed with a better functioning G-Sec market. But it is being fixed in a manner that is impeding the concomitant development of the corporate

bond market in a symmetrical, holistic fashion. In India, the G-Sec market and the corporate bond market (which is conspicuous by its absence) are seen as two distinct and separate markets; whereas, around the world, government and corporate bonds are part of one seamless debt market. The G-Sec trading platform is, amazingly, owned and operated by the central bank (which was, until the last Budget, also the public debt manager), rather than by a securities trading exchange. Limiting the development of the bond market to the G-Sec segment does not permit the market for fixed-income debt instruments to display the full range of credit risk (and associated reward) characteristics across the normal spectrum from riskless bell-weather issues (G-Secs) to much lower credit risks (with higher coupon returns) issued at the sub-prime end of the market.

Similarly, remaining restrictions on CAC – which prevent convertibility and therefore inhibit the emergence of a free currency trading market that is a mainstay in most IFCs -- is being deferred indefinitely, because of the weakness and relative incapability of SOBs. That key constraint was identified by both Tarapore reports as a key justification for delaying CAC. Worse still, the development of stronger derivatives markets has been deliberately suppressed by the regulatory authorities -- with the prohibition of interest rate, currency and credit default derivatives – because of fears that the SOBs could not operate competently in these essential risk management markets. It was also felt that if the weak SOBs could not be permitted to play in such derivatives markets, neither should any other more capable financial firm, because that might give them a further operating advantage over the SOBs and thus drive business away from them.

Because the SOBs have been over-protected by regulation, the Indian banking sector (and its wider financial system) has been denied the opportunity to grow, diversify and evolve in India in the same way that it has in the rest of the developed and middle-income world (apart from China and the former East Bloc economies). As a result, the Indian financial system has been fragmented into a number of separate pieces that are now too rigidly compartmentalised. They are prohibited from interacting through permeable boundary membranes in the way that they should. That has impeded the emergence of large complex financial institutions (LCFIs) – i.e. global financial conglomerates which straddle activities across the entire financial universe (e.g. like Citigroup or HSBC).

LCFIs are able to deploy their risk capital in more intelligent and optimal ways than is the case with deliberately proscribed, artificially stunted financial firms in India. Consequently, while the 10 largest financial firms in the world now all have balance sheets exceeding US\$1 trillion, India's largest financial firm – SBI – has a book of only about \$170 billion.

Thus the SOB legacy, that has been the direct consequence of ill-conceived nationalisation policies in the late 1960s, has not just made our *banking* system anaemic and infirm; it has contaminated our *entire financial system*. Our domestic *investment* banks are also, as a result, too weak, too lacking in essential know-how (because markets in which such knowledge is developed have not been permitted to incubate), too undiversified by activity and revenue-source, and too under-capitalised by international standards, as are our insurance companies, asset managers, securities brokerages and trading firms. By contrast our securities exchanges, electronic trading systems and depositories are of global standard. Such an unbalanced financial system -- which is under-developed, under-capitalised and under-resourced in too many aspects, while being globally competent in one or two -- is inconducive to the emergence of an IFC in Mumbai, without a considerable amount of remedial repair and construction work being done on a war footing.

Part 4: The New Challenges of Financial Regulation.

This fourth article, in the six-part series on the MIFC Report, focuses on the third logical construct on which the report rests: i.e. the need for a *fundamental change in financial regulation*. The MIFC report's logic contends that India's approach to financial regulation is now antediluvian and counterproductive. It needs to be transformed radically by shifting from highly prescriptive *rules-based regulation* (RBR) to more open and broad *principles based regulation* (PBR). The report elaborates on this crucial idea at length to explain why it recommends what it does. But, to avoid boring readers with unnecessary detail on this technical issue, suffice it to convey the difference between these two different types of regulation by reproducing below a box (self-explanatory) that appears in the MIFC Report to explain the core differences.

Principle Based vs. Rules Based Regulations (PBR vs. RBR)

1. Principles Based Regulation (**PBR**) is outcome oriented
2. It differs from Rule Based Regulation (**RBR**) which is process driven.
3. PBR is based on the premise that the regulator is not always best or better placed than market participants, to judge what is best or what is right or wrong in terms of products, instruments, services, practices or market functioning.
4. PBR is based on the premise that competition and innovation in rapidly evolving markets driven by technology should not be inhibited by over-prescriptive regulation.
5. PBR allows for greater flexibility in devising internal corporate business and compliance processes to cope with changes in rapidly evolving markets
6. RBR invariably prescribes permissible business processes in micro-detail and changes too slowly in response to market changes.
7. The overall effectiveness of PBR is critically dependent on the ethical and governance standards that prevail in the financial and corporate worlds in any country.
8. The higher such standards are in a given operating environment, the better is compliance with PBR and the better its overall outcome.
9. In an environment accustomed to RBR, regulators see PBR as posing high regulatory risks
10. They fear that the operating flexibility PBR permits could be misused in environments with insufficiently high standards of internal corporate ethics, compliance and governance.
11. With RBR, market participants leave it to regulators to specify what those standards should be through detailed rules.
12. But experience suggests that RBR does not necessarily or automatically instil or encourage high standards of ethics or governances to be applied in any particular environment.
13. What RBR appears to encourage is the development of capabilities aimed at evading rules through technicalities and loopholes. This weakens incentives for better self-regulation within the regulated industry and induces a tendency for market competition to be driven by a propensity for cleverly evading rules faster than the competitor.
14. The key to determining the regulatory tone in a particular environment, and deciding whether PBR is more suitable than RBR in a particular country circumstance, depends on the standards applied by the regulated industry in: monitoring itself, ensuring that all players in the industry conform to rules that protect the reputation and integrity of that industry; and ensuring that the best global standards of corporate ethics and governance are applied by all players.
15. PBR is particularly well suited to the regulation of securities markets which regulators that are RBR driven (such as those in the US) have now explicitly recognized.
16. Compliance under PBR depends as much on the spirit as the letter of the law.
17. For that reason enforcement of PBR is different and more difficult than the enforcement of RBR.
18. Violation of rigid but specific rules is much easier to establish than broader 'standards' that are more open to subjective interpretation.
19. PBR requires greater knowledge on the part of regulators, an obligation to remain up to date with changes in rapidly evolving markets, as well as more accountability and responsibility to be exercised by supervisors in exercising judgments than RBR which focuses too much on the use of detailed checklists for compliance assessment.

The bullets in the box above suggest clearly the kind of change implied in shifting from RBR to PBR and why the MIFC Report advocates it. But that change will be resisted by India's regulators precisely because of the attitudinal adaptation it requires. They will argue that PBR requires such high standards of corporate governance that it will be a long time before India can even think about applying it. Higher levels of skills and

discretion need to be exercised by regulators and supervisors under PBR. Contrary to the RBR system of compliance box-ticking and using long laundry lists (that monitor adherence to detailed regulations) PBR requires the application of thought and independent exercise of discretion at the supervisor-financial firm interface on a much broader canvas of issues. It requires supervisors, and the managements of supervised institutions, to have an entirely different type of relationship; i.e. mutually supportive and co-operative, rather than adversarial and confrontational. It requires supervision to be exercised at a much higher level.

That fundamental change is daunting for any regulator used to RBR to contemplate. It involves a difficult transition to be made from the comfortably precise specifications of RBR to broader, less precise specifications under PBR leaving scope for considerable judgement that may be criticised later. But it also requires regulators to relinquish their draconian punitive powers for petty infractions, in favour of broader, more powerful remedies (including the revocation of licenses) in the event of infractions that involve not merely the letter, but also the spirit, intended behind the laws, rules and regulations that are framed.

Eventually, despite an enormous amount of resistance likely to be offered by the Indian regulators, PBR will come about inexorably and inevitably, as it becomes the global regulatory standard. That is simply because it will prove to be more efficacious and productive in achieving the ultimate goal of all regulation – i.e. to assure sound behaviour and compliance on a voluntary basis, through positive incentives, rather than have compliance ensured through petty bureaucratic wrangling and constant surveillance of an unacceptable sort that often results in unintended outcomes and consequences.

Apart from the approach to regulation, the MIFC Report also alludes to problems with our heritage of financial regulatory architecture and the division of regulatory responsibilities in different financial segments. Overall, the present approaches and arrangements in India no longer make sense in the kind of financial world that is evolving domestically and globally. The trend worldwide is toward unified regulation of all financial institutions and services for a number of reasons – not the least of which is the blinding speed at which new products and services are being innovated and applied, and the continued blurring of boundaries between what can be considered a pure banking product versus an insurance product or a market product. Bank loans can now so easily be transformed into tradable security equivalents and listed on the exchanges. Derivatives are often just a form of insurance. But worldwide trends do not by themselves justify what might be appropriate in the Indian context given its historical legacy and transitional challenges.

For that reason, while the MIFC Report suggests what is happening by way of ‘best practice’ on the financial regulatory frontier around the world, it withholds (on grounds of prematurity) making a definitive recommendation on immediate unified regulation. Nevertheless, it has to be said that if India does wish to have a credible IFC operating in Mumbai, its regulatory architecture and arrangements must reflect the best industry standards that apply around the world, and particularly in other leading IFCs. We cannot make the mistake we have made on the domestic scene – i.e. compartmentalising and artificially re-arranging financial market segments to suit regulatory turf and convenience. Instead we have to follow the global practice of adapting our regulatory approaches, practices and arrangements to suit rapidly evolving markets – both Indian and global.

For those reasons, the MIFC Report suggests unambiguously that the RBI now be divested of its multiple roles and the many conflicts of interests that such roles create. Global practice that has been evolving over the years suggests that central banks perform best, and are most useful, when they focus on the single target of controlling inflation through monetary (interest rate) policy. This precludes central banks from regulating and supervising all banks. That function is seen as being better performed by a unified financial services regulatory authority or a dedicated banking regulator. Some central banks (e.g. the US) are mandated with controlling inflation, along with encouraging stable growth, and high employment. But these other targets (growth and employment) are coming into question as goals that central banks should *not* be concerned with, as they may deflect from the attention they need to give to containing inflation. Goals other than containing inflation are now seen as objectives and targets for other arms of government to achieve; not the central bank.

In India we have an omnipresent, omnipotent, and omniscient, central bank. It has straddled (many would allege *suffocated*) the Indian financial system like a Colossus. By and large, my view is (though many disagree) that it has played a remarkably useful role; even if that role has been more variegated, more demanding, more

‘developmental’ and challenging than the role played by most central banks. Over time, RBI has proven itself to be one of India’s great public institutions; as yet untainted to the same degree, or unaffected by the damage to its reputation for competence and probity, that other Indian institutions (such as the legislature and judiciary) have recently suffered. It has had some extraordinary governors (and deputy governors) of unimpeachable intellectual stature and great personal character; not the least among which rank Dr. I.G. Patel, Dr. Manmohan Singh, Dr. C. Rangarajan, Dr. Bimal Jalan, and the current governor Dr. Y. V. Reddy.

In India, RBI has been made responsible for an incredible array of activities and goals: (a) the creation and maintenance of a delivery infrastructure for rural credit through its child NABARD; (b) parenting and managing, on behalf of GoI, the SOBs; (c) managing the issuance of debt by GoI, until just a few months ago; (d) designing, developing and operating the bond trading platform for G-Secs, something which is done in any other country by a securities exchange; (e) managing and stabilising the INR exchange rate by continuing regular interventions in currency markets; (f) regulating and supervising banks even when they operate in domains that fall clearly under other regulatory purviews such as investment banking, capital markets or insurance; (g) applying gradually diminishing controls over the convertibility of the INR; and (h) operating the incipient currency trading market and the forwards market as well as insisting on regulating trading and transactions in interest rate and currency derivatives that are more likely to be used by banks.

Given this plethora of functions and objectives, it should not be surprising if containment of inflation slips from the RBI’s grasp as the primary goal for it to attain; or if achieving an inflation target is compromised by the simultaneous need to achieve balance with all the other goals as well. The impossibility of the RBI trying to juggle all these balls, keep them in the air, and hit multiple targets (such as low inflation, a stable nominal exchange rate, a high growth rate, a high flow of agricultural credit, etc.) is becoming more apparent by the day, if recent public concern and column inches of media commentary are any guide.

For all these reasons, the MIFC Report suggests that responsibility for financial regulation be more clearly divided, defined and respected by domain. It suggests that the RBI be made responsible solely for containing inflation in India; providing of course that we can agree on what a good single measure of inflation might be and can manage to measure it properly. For the RBI to undertake risk-free inflation targeting, the government must stop interfering in subsidising or setting prices of major commodities (like oil, wheat, rice, sugar, etc.), and interrupting abruptly normal market supply-demand relationships through ill-advised actions like exigently banning commodity futures trading or banning commodity imports and exports on an expedient basis for political showmanship reasons. GoI should also refrain from expressing views on the right level of interest rates at any particular time. That should be the exclusive prerogative of the RBI. The MIFC Report goes further. It suggests that a revamped RBI should be constitutionally independent (with its governor having the same status/remit for monetary policy as the finance minister has for fiscal policy). It should not be accountable to the government of the day through the MoF. It should pursue a monetary policy that is good for India regardless of the political compunctions and priorities of any government. That is what international best practice now amounts to. And India would be ignoring such practice at its peril if it wanted to have its own IFC in Mumbai.

In my view, the current spread within which inflation in a rapidly growing, middle-income country like India should be targeted is a range of 2-5%. The floor of 2% is set in order to avoid any risk of disinflation (which cannot be as finely tuned in India as in developed economies that are able to risk a 1% floor). The ceiling of 5% provides sufficient headroom for monetary expansion that can support an 8-10% growth target. The growth target should be achieved by the MoF and the Planning Commission, not the RBI. In the UK, the task of the BoE is to achieve inflation in the 1-2% target range. Other central banks have target ranges of 1 to 2.5 or even 3%. The target range for India can be reduced to a 2-4% range and eventually a 1-3% range as evolving circumstances and adjustments in the public’s inflation tolerance limits might demand. Of course inflation has to be contained by RBI in a way that engenders confidence in the global financial system about the strength and solidity of the INR as an emerging reserve currency. That is what the INR will inevitably become eventually, as India takes its place as one of the world’s three largest economies by mid-century and, toward the end of the century, probably the world’s largest.

But the MIFC Report also suggests that RBI be divested of all other functions and roles other than the management of an inflation targeting monetary policy. It recommends that the role of banking supervision be transferred to a separate and dedicated banking regulator. It also suggests that SEBI be made responsible for all regulation that concerns transactions in capital and derivatives markets (which includes all bond trading, including G-Secs, and all derivatives trading including futures/option contracts other than equity derivatives i.e. for interest rates, currencies, credit default, political risk and commodities).

For the time being, it accepts the necessity of having four separate regulators for: (a) insurance (IRDA); (b) pensions (PFRDA); (c) banking (a new BRDA?) and (d) organised financial markets (SEBI). But the MIFC Report makes clear that regulation of pensions and insurance should be separate only for the consumer-protection related part of insurance and pensions. All the asset management activities of pension funds and insurance companies should be regulated by SEBI; as should *commodity derivatives* contracts, which are essentially financial derivatives that should be traded on securities exchanges.

The Report has been criticised by some (like Shankar) as going over the top in making these recommendations and, in particular, overloading SEBI – which compared to the RBI is the new kid on the block -- and making it much too important in comparison with other financial regulators. Having looked at those arguments closely, I come to the conclusion that they warrant little merit and continue to argue for what the MIFC Report suggests. Reform proposals should be judged for their logical strength, without any bias in favour of protecting the *status quo*.

Part 5: The Challenges of City Development and Management in Mumbai.

This fifth (and penultimate) article in the series on the MIFC Report deals with the need for *improved infrastructure and governance in Mumbai*. These are obvious concerns. If India is to have an IFC, it will emerge in a city that is already India's domestic financial fulcrum; despite its many glaring deficiencies. In looking at infrastructure and governance the MIFC Report leans towards the city's *governance* deficit as being the more critical. If Mumbai had good governance it would not have the infrastructure deficit it has today. And, the new investments in infrastructure being planned (if they materialise) would be wasted if the problem of the city's governance deficit were not fixed first.

Mumbai's becoming a successful IFC will require concerted efforts by the central, state and city levels of government. All three will need to dovetail efforts to transform Mumbai into a city that offers infrastructure, amenities and a quality of civic governance similar to other IFCs. Many commentators and critics see this as 'dreaming' on the part of the HPEC. My response is simple. If Mumbai cannot offer those standards, then the *globile* (globally mobile) community of professionals, that make IFCs what they are, will choose not to locate in it. Mumbai will not become an IFC or a GFC. That is not a matter of the HPEC's having dreams or nightmares. A failure to reform Mumbai's governance will simply betray India's national interests.

If what needs to be done cannot be done, then Mumbai will (at most) be a more limited IFC, serving India's IFS needs on a partial rather than total basis. It will not succeed as a financial centre serving the global community. In making its recommendations, the HPEC however, chose not to accept defeat before battle was joined.

It is up to the citizens of Mumbai, its municipal government, the state government, and the centre, to decide how much effort and money they want to put into making Mumbai an IFC. The HPEC suggests, quite sensibly, that such efforts should focus on developing an IFC that is capable of serving Indian clientele in its first phase of its development (2008-15) before graduating seamlessly thereafter into serving the world. With the right approach and effort, the HPEC sees no reason why those goals cannot be achieved. They certainly will not be achieved if defeatist cynicism – based on the primitive nature of local politics -- takes hold and destroys any prospect of an IFC being successful before we even begin.

It is not easy to create and govern a first world global city in a third world environment. Nor is it impossible. Malaysia has managed to do that with Kuala Lumpur. China has Hong Kong, Beijing and Shanghai. South Africa has Johannesburg and Cape Town. Brazil has Rio de Janeiro and Sao Paulo. Chile has managed to do that with Santiago and so on. The problems faced in Mumbai are not new. They have been solved by dozens of cities; many in the third world. In offering this observation (and here I quote the MIFC Report), the HPEC realises the challenge that it poses to all levels of government in India, Maharashtra and Mumbai. It may well be that the human talent needed to manage and run a world class city may have to be sourced from wherever it exists to upgrade dramatically the quality of local city administration. If that is the case, then the myopia of local politicians unwilling to accept that reality should not be permitted to block progress.

To accomplish the difficult, but by no means impossible, task of making Mumbai a *global city*, policy-makers may have to consider the short-term perpetration of an inequity quite deliberately, as an investment in the future; not just of Mumbai but of India. What needs to be done is to recreate Mumbai, within the next fifteen years, as a forerunner at the city level of what India should become in the next forty years – i.e. a developed country. Focusing on making Mumbai a credible IFC involves actions that are elitist. But then international finance is elitist in nature. That is a politically incorrect admission to be candid about in the Indian socialist ethos and in traditional political discourse. But whitewashing that issue risks missing the point. Going for an IFC in Mumbai is a policy choice that will invoke social reactions in the city and require astute political management. Those reactions may be difficult to cope with. But it would be remiss to obscure this reality for that reason; or attempt to deal with it through a rhetorical compromise that distorts reality and compromises the achievement of the IFC outcome.

Mumbai's infrastructure deficiencies are well catalogued. They require no elaboration. The city now has a fractured geography with two financial centres located in the Bandra-Kurla Complex and Nariman Point/Fort. Intra-city drive times have become critical. Innovative strategies need to be applied to reduce transport times, utilising public transport and high speed intra-city expressways. It is urgent to build a Metro to augment the suburban railways, along with intra-city and coastal expressways linking the islands to the mainland. A host of PPP solutions, based on user charges, can be rapidly rolled out in order to alleviate infrastructure constraints

such as transport, power, water, sewage, drainage, railway stations, etc. These could be put together by the Indian IFS industry, global PPP players, and multilateral institutions if the overall policy framework permitted.

The exorbitant cost of real estate in Mumbai could inhibit its emergence as an IFC. Solving this problem involves repealing the Urban Land Ceiling Act and new thinking on FSI. It will require bringing to closure the long-standing, but as yet unresolved, issue of rent control, especially for pre-1940 buildings. An economic historian observed: “*There are two ways of destroying a city completely. One is carpet bombing. The other is rent control. And, of the two, rent control is more effective*”. That statement must have been made after visiting Mumbai. A number of the city’s pre-1940 buildings have been acquired recently by city and state politicians. That has been done at undisclosed prices in improperly recorded transactions, under circumstances that would be questionable in law, in the hope of reaping windfall gains when rent control is finally removed. It would be unfair, and electorally suicidal if, in removing rent controls, the long-established ‘acquired’ property rights of tenants -- who have lived in these buildings much longer than their present landlords have owned them -- were not fully respected and protected. That could be done through one-time devices like statutory transfers of premise ownership at an appropriate rent multiple in order to deal with a problem that has eluded resolution since it the mid-1950s.

Mumbai has chronic fiscal problems that persist because of revenue under-collection with unsustainable tariff structures and non-transparent subsidies for services. Its property tax system requires restructuring and modernisation. Financial allocations for Mumbai from central and state governments are too low in comparison with: (a) the tax revenues it generates and (b) its legitimate needs for infrastructure maintenance as well as urban growth and development. That results in the city becoming subservient and hostage to the majority rural electoral interests that presently dominate state politics.

Unlike Delhi, the other metropolitan centres in India are handicapped by not having their own revenue base or autonomous status within our three-tiered structure of governance. Thus they become step-children of state governments that rely on the rural majority vote rather than the urban minority vote. It is a recipe that has brewed the paradox of key Indian cities decaying rapidly in the face of rapid population growth. That will change with the rate of urbanisation that is now taking place across India. But such change may occur too late to matter in making a difference when it comes to Mumbai becoming an IFC.

Fresh thinking is called for revamping the city’s administrative structure. In China, the four largest cities have been given provincial status; like Delhi. But the sensitivity of state and local politics need to be taken into account in considering such an option for Mumbai; even if, theoretically, it might ensure better city governance and greater accountability of the city’s policy-makers to the urban electorate. If this solution is out of the question, the most critical priority is to transform the city’s administrative structure in a way that creates a fully empowered if not elected ‘manager’ for the city, who can be held accountable for everything that goes right or wrong in Mumbai (without being able to pass the buck to the state government) and who is not required to be concerned about anything else.

The notion of a “*city bandh*” -- which has become a regular feature of Mumbai’s life and the bane of its citizens -- is not a familiar feature in any other established or emergent IFC. In any other IFC a city wide shut-down, for any reason, would not be tolerated by its governing authorities because of the large economic, financial and reputation losses that the IFC would incur. If it was tolerated, that would result in the swift migration of the city’s IFC to a more amenable location. Ways need to be found to ensure that in the future, Mumbai is not vulnerable to *bandhs*. If that is not done, the implication is clear: the city will have no realistic prospect of emerging as an IFC. For that reason, an understanding on this critical issue needs to be reached by all concerned. The MIFC report is not dreaming when it thinks about a Mumbai without *bandhs*. It is only pointing out -- with cold objectivity - that until a Mumbai without *bandhs* comes about, Mumbai cannot be an IFC.

The sheer size and rapid but disorderly uncontrolled growth of Mumbai presents an unprecedented challenge in inducing sound institutions for urban governance. The provision of urban infrastructure is linked to decentralisation of economic and political powers to sub-national tiers of government flowing from the 74th Amendment to the Constitution. There is a need in Mumbai to create fully empowered city government to manage urbanisation with political and financial accountability. International experience suggests that without reforms in the institutional framework for urban governance, central or state level funds directed into urban infrastructure will not have the expected economic and social returns. Nor will they be appropriately directed for priority use.

Mumbai's administration needs a radical overhaul. Urban governance needs to be put on a sound administrative and financial footing with full accountability. Municipal governance needs to coalesce under an urban development authority properly accountable to the city's electorate. At present, decision-making on financial and governance matters concerning the city is split across the Centre, State and City. This diffused responsibility results in lack of coordination, disjointed planning and a loss of financial independence.

Municipal services in Mumbai are fragmented across many different corporations, agencies, and local government bodies with conflicting lines of accountability. Existing agencies for delivery are structured functionally with poor accountability, limited incentive for innovation, and limited use of private sector capacity to manage and finance essential civic services. There is no effective interface and almost no accountability connecting the city's administrative systems to its decentralised wards. In particular, poor communities have almost no voice over city policies except through extreme forms of public resistance when their interests are compromised beyond their limited abilities to cope. In Mumbai, low income households are at the regressive end of the fiscal system. At the same time, improvements in tax revenues and user charges are likely to be most acceptable if concurrent improvements were to occur in service delivery. This is perhaps analogous to the acceptance of tolling highways *after* high quality highways came about.

At present Mumbai has limited creditworthiness with opaque financial systems and primitive treasury management. A corrupt nexus between city councillors and contractors on a variety of public works contracts has emerged because of a lack of proper controls; coupled with individual discretion over budgets of a kind that generates perverse incentives inclined toward malfeasance. These need to be rectified before Mumbai can access capital markets, and make the needed institutional and fiscal reforms. Transforming urban infrastructure in Mumbai therefore has dimensions of institutional, fiscal, financial and regulatory reform to ensure good governance. Sector-focused reforms in service delivery -- e.g. focusing only on water and sanitation and solid waste -- need to incorporate such institutional, fiscal, financial and regulatory dimensions in the reform package.

Finally, becoming an IFC requires a city to exude genuine cultural tolerance and pluralism. A healthy and hospitable city environment that can attract expatriates requires open-mindedness, good residential facilities, office space, leisure, and entertainment facilities catering to international tastes, smooth enrolment processes at good schools, hospitals, colleges, universities, and sports clubs accessible to expatriates. Mumbai as a global city will have to focus on continuing the efforts underway to revert to using English as its *lingua franca*. Expatriates (and people from other parts of India) working in an IFC that purports to be global, should not have to face local government interfaces in other local languages when it comes to dealing with simple everyday requirements for form filling or communicating with state or city officials or its law enforcement officials.

The foregoing suggests a daunting list of challenges (many of them political) that have been laid down in the MIFC Report. But its authors believe they can be met. We have little patience for cynical carping that they will never be met. The gauntlet has been thrown; the challenge made. It is now up to the central, state and civic authorities to pick up the glove and take up the challenge. We can succumb to the cynicism that ensures nothing will happen. Or we can make it happen. The choice is ours to make and pursue.

Part 6: Shankar Acharya on MIFC: Off-Target-- but not completely!

This article in a six-part series on the MIFC Report is the final *piece de resistance*. It suggests why, in his column on the Mystery Report (*BS, May 24, 2007*), Shankar may have gotten hold of the wrong end of the stick. That is not to suggest his critique is unwelcome. On the contrary, it is a rare privilege to have elicited such comments – especially from someone with Shankar’s knowledge and experience of the Indian macro-picture. Such views are essential pre-requisites for improving on what the MIFC Report has come up with. And room for improvement, there certainly must be! But to be useful, commentary has to be based on accurate portrayal of what has been said rather than misconstrued perceptions. It must also be constructive; not just entertainingly misleading!

Shankar’s problems with the MIFC (Mystery) Report appear to boil down to: (1) *indulgence in blatant ‘financial sector boosterism’* – whatever that phrase might mean, other than resentment on the part of macroeconomists who do not quite appreciate the importance of finance and financial services (as a *real* productive sector in its own right) in the economy; (2) *significant diagnostic weaknesses*, which I am sure the Report has, but are not the ones Shankar brings up; and (3) *a daunting list of recommendations* (policy prescriptions) – I assume he means too long a list – some of which he thinks are sensible and others bizarre. Let me deal with each of these issues (and his elaboration of detailed specific charges under these respective headings) in turn.

1. The ‘boosterism’ issue. Shankar alleges that the MIFC Report makes sweeping recommendations for creating an IFC in Mumbai without making “*a clear and compelling case*”. In his view the Report simply *asserts* that India has no choice but to produce and export IFS and capture a share of the global IFS market. It does this without the benefit of a reasoned argument. He also thinks it’s the wrong assertion; citing the examples of the successful economies of East Asia and Southern Europe not having an IFC as a ‘must’ for economic success. To all this, I have three carefully considered reactions.

First, the HPEC was not asked to suggest how Mumbai could be ‘nurtured’ into becoming an IFC. It was asked to recommend what needed to be done on a number of fronts (policy reform, infrastructure investment, financial regime governance *et al*) to ensure that Mumbai could operate credibly as one. That is a fine but critical distinction. Perhaps the question was put by MoF to the HPEC prematurely, without sufficient understanding of how far behind Mumbai was, and how high the mountain was it had to climb. Personally, I do not think that was the case. The “*What needs to be done for Mumbai to become an IFC?*” question was asked: (a) to explore what the opportunity was for India in global markets for IFS; and (b) more subtly, to trigger debate/action on long delayed financial reforms. But I do not want to hide behind any technicality of what our terms of reference were.

Second, contrary to what Shankar asserts, almost every other commentator has remarked that the Report makes a very powerful case for why Mumbai should and could become an IFC. It rests on: (a) India’s quasi-continental hinterland market for IFS which presently have to be procured quite unnecessarily from abroad; (b) possession of every ingredient needed for a successful IFC – i.e. well-endowed human capital (but not in an inexhaustible supply as commonly believed), innate aptitude for quantitative finance, technological prowess of the right kind, excellent trading infrastructure, etc.; (c) being in a propitious time zone; (d) having the know-how for exporting IT services which provides a platform of experience for exporting IFS as well; (e) proximate regional/global clientele; (f) Mumbai’s established capability as India’s national financial centre; and so on.

The Report notes that having an IFC would: (a) increase India’s growth rate by an incremental percentage point or two by increasing resource allocation efficiency through further financial reform and expanding financial services output/exports, with (b) less effort and investment than any other area of business opportunity. It provides convincing quantifiable evidence to substantiate its conclusions on: (c) the significant balance-of-payments savings and the potential revenues that could be generated from IFS. Such exports could amount to an estimated \$10 billion by 2015 and more than \$50 billion by 2025. That would have a net positive impact on the B-o-P account of \$100+ billion by the mid-2020s. Moreover, an IFC in Mumbai would generate: (d) between 40-50,000 high-level, high-income professional jobs (in finance, as well as in the legal, accounting, IT and consulting professions) with a vast array of indirect lower-level jobs being created in a ratio of 10:1 relative

to direct jobs. The prospect of a new industry generating over half a million white-collar jobs is hardly chicken-feed. What else needs to be said to make the case?

Also, it might be useful to remind ourselves (on a different wavelength but in the same context) that, when India started exporting IT services, no clear and compelling *ex ante* case was made. TCS, Infosys *et al* just went and did it. In this instance, the case for IFS is obvious. Sufficient evidence to support it has been provided. *If India decided to eschew producing and exporting IFS via an IFC in Mumbai, that would be akin to a diffident idler stumbling accidentally across a pile of gold bricks that belonged to no one, and walking right past them, because the effort of picking them up would have been too much to make!*

To be fair, the Report also delves into all the *negatives* that plague Mumbai/India: e.g. poor governance, appalling infrastructure, inappropriate regulation, missing markets, weak institutions, poor legal and judicial support systems, etc. But it had to be balanced. Some commentators (and some HPEC members) felt the Report was too transparent about these blemishes and warts. They showed India up in a poor light. They cast doubt on whether Mumbai could become a viable, successful IFC. As Chairman, I was dismissive of that reaction from my colleagues. Suppression of pertinent reality has no place in a report of this kind. One could not, in fairness, accentuate only the positive and ignore the negative. The MIFC Report is not ‘selling’ anything to anyone as Shankar implies. Quite the opposite! It is saying what needs to be said and leaving the choice of having an IFC or not to policy-makers and the financial services industry to make. It is not our business as an advisory group to exhort or proselytise. It is to provide an expert opinion; which we did.

So, contrary to the allegation that the Report simply asserts without reasoning, the polar opposite is true. One leaves it to any reader with a modicum of intelligence (and proper reading glasses) to judge for him-or-herself whether Shankar is right on this score. As far as I am concerned, that particular criticism of his is out of the ballpark. But Shankar is correct in the Report suggesting that India does not have a choice but to produce/export IFS and gain increasing global IFS market share. It says that on the basis of careful reasoning (a full chapter). Of course, in a literal sense, India does have a choice. It could choose not to have an IFC; i.e. if it wanted to cut off its nose to spite its face. So the MIFC Report does not say that ‘India has no choice’ in quite the way Shankar portrays to suit his argument. Nor does it say India has no choice *because* India needs IFS, and therefore the HPEC believes that India must produce them. India needs hydrocarbons. It cannot produce them in the quantity it needs. That is true for a vast array of things that India needs as well. The same is true with IFS for now. Nowhere do we make an argument for self-sufficiency or autarky (as Shankar suggests) for producing and exporting IFS simply because India needs them. In fact, the Report specifically states the opposite: i.e. that there is no case for an autarkic approach. It actually makes a quite different argument.

India ‘has no choice’ but to produce/export IFS and gain global market share *because* it can do that more easily and more competitively than most other countries; including those with established IFCs. It can start (as it did with IT service exports) by dominating the low-value, back-office service spectrum. It is already doing that. But the revenue is showing up as IT service revenue not IFS revenue. The production of IFS in India can focus initially on Indian clientele simply because they happen to be proximate and within the ambit of Indian firms to serve. That gives IFS production (and exports) an edge that IT service exports did not have. IFS activity can graduate quickly up the value-chain to capture the high-end spectrum, and the global market, without too much incremental effort/cost.

So, what the MIFC Reports says is different from what Shankar thinks. It says that we have the technology, capital, human ability, know-how and many other ingredients, as well as a platform and hinterland advantage, to produce IFS efficiently and competitively for the world market, *if* we can fix the policy, governance, and infrastructure deficits that we are saddled with. The fact that we need IFS in such large amounts for our own use is simply icing on the cake. It gives the IFS industry a head start, offering operational economies of scale in its home market that would work to India’s advantage in the global market. That is not an unusual conclusion. Nor is it an unreasoned assertion.

Third, Shankar observes that many other countries in East Asia and Southern Europe have not needed an IFC in order to develop and grow; therefore it is odd for the MIFC Report to assert that India needs one. In making this argument, Shankar has gone off the deep end and got his intellectual knickers knotted the wrong way

round. No one is saying that India needs an IFC in Mumbai because it is a pre-requisite for its development and growth. Without evoking the experience of successful economies elsewhere, India itself has grown at an average 6-7% between 1992-2007 (over 8% between 2002-07) without an IFC; so obviously it is not a necessary precondition for growth. China (*sans* Hong Kong) has grown at 10%+ for three decades without relying on an IFC or producing/exporting IFS.

But that is not the point. Of all the economies Shankar mentions China's is the most similar to ours in size. He was mischievous in mentioning the others. He knows too well the fundamental differences accounting for their growth trajectories versus ours. China has grown rapidly without an indigenous IFC. But China has emulated the manufacturing export success of the East Asian tigers by offering an almost inexhaustible supply of even cheaper labour, land and capital for the foreseeable future. It also has the ability of a totalitarian state to tailor policies to suit individual foreign investors and exempting vast areas from inconvenient laws, rules and regulations. The success of *Korea, Malaysia, and Thailand* has been due to one set of reasons: i.e. manufacturing export success (as well as healthy tourism exports) with a progressive climb up the value scale.

The economic success of *Portugal, Greece and Spain* has been for other reasons: i.e. large transfers of EU structural funds for regional development and infrastructure; open access to the EU labour market with large ensuing remittances; disproportionately large capital flows to their property markets by northern Europeans; accompanied by a mass annual migration of retired and self-employed northern Europeans to southern Europe, which has boosted demand for services in these economies in unanticipated ways. That is happening with the newly acceding countries to the EU as well. But there is no reasonable comparison that can be made between their experience and India's. They can rely on London (and to a lesser extent) on Paris, Amsterdam, Frankfurt and Milan for their IFS needs. They do not need to develop Lisbon, Madrid (which once were IFCs) and Athens for that purpose.

The six smaller economies that Shankar mentions are not of continental size and scale. None of them are likely to become the third or second largest economies in the world within the span of a single generation or the largest within the span of two. None is likely to need IFS on the same scale as India or China. Those two giants now need IFS on the scale similar to that of the US and EU in the mid-20th century. And where would those continental economies have been without New York and London to globally intermediate their IFS needs? For that matter where would the Asean economy be without Singapore?

India has grown differently to all the smaller economies that Shankar mentions and even to China. Part of its post-1992 growth is accounted for by unshackling the chains that impeded domestic growth for five previous decades. On the external frontier, India has developed special competence in service exports, labour exports and remittances. It is a late-comer to manufactured exports; but it is catching up. It is because of its successful history with IT service exports (the one arena in which state intervention was least debilitating) that diversifying into IFS for the global market is likely to prove easier and more fruitful than other activities to keep export revenues growing commensurately with India's even faster-growing import financing needs. IFS provide the next natural service export frontier for India to conquer successfully. India has the endowments, attributes and aptitude for doing so; even if it presently lacks the policies, governance and infrastructure. These deficits can be fixed if India's policy-makers have a mind to fix them. After that India may develop greater acuity in exporting entertainment, media, education, and healthcare services as well. In short, the argument that Shankar puts forward by using the examples he has to suggest that an IFC is unnecessary for India is misdirected and disorientated.

2. Diagnostic Shortcomings: On this specific charge, by alluding to the unwarranted dilution of the MIFC Report -- on the matter of SOBs and the pervasive problems caused by state-ownership of so much of the financial system -- Shankar is clearly right. He knows I was opposed to such dilution and resigned for that reason. The HPEC must plead "*guilty as charged, my lord*". It was not that the problem was undiagnosed. Some HPEC members (from the SOBs) opposed disclosing the diagnoses, warts and all. The proper alternative for them would have been to recuse themselves from the Report on this particular issue; or express a personal dissent, as they were invited to. But they chose instead to create an artificial crisis in the Committee, and damaged the integrity of the Report in the process, by weakening its internal logic and the linkage of its analysis to particular recommendations.

In fairness, many of my senior colleagues (for whom I retain personal regard) felt that being too forthright about the problems of state ownership/domination of the Indian financial system would raise political hackles that would obscure the other messages of the report and sink it. They may well have been right. Time will tell. But, the damage, in terms of diagnostic obfuscation and deliberately otiose omission of a vital issue, has been done. It can be partly undone by bringing that issue into the open in public debate despite the Report soft-peddalling it. And Shankar has earned my gratitude by doing precisely that!

Shankar raises pertinent questions about the MIFC Report not having dealt openly and forthrightly with: (a) the way in which regulatory integrity is compromised by state ownership; (b) compromising the governance of SOBs by appointing 'political hacks' to their boards; and (c) tackling the 800 lb. gorilla in India's financial living room – I loved that one, albeit more accurate imagery might have been evoked with the metaphor of a 20-tonne beached flatulent whale, contaminating by its presence and relative lack of utility an otherwise attractive vista. I could not agree more with Shankar that unless this carcinogenic growth in the financial system is surgically treated it will continue to compromise the healthy development of the rest of India's financial corpus. The issue is much too important to be buried or evaded. It has to be recognised and tackled head-on.

But having excelled himself on that crucial point, Shankar then wanders off taking pot-shots with no aim on the charge of poor diagnosis. He points to two particular recommendations of the HPEC as seriously flawed or bizarre:

- A. **The need for radical reform of India's regulatory system:** Shankar is sceptical about transferring too much responsibility to SEBI regardless of how appropriate that might be on other grounds. *First*, he feels that SEBI is too young to regulate trading in currency, interest-rate and commodity derivatives.

That misses the point. Such derivatives are financial contracts traded on a daily basis like shares or bonds. If SEBI is responsible for regulating trades in capital markets then it defies logic and common sense to NOT make it responsible for these contracts as well. It would cause immense regulatory confusion for one part of capital market activity (equities and equity derivatives) to be regulated by SEBI and all other capital market activity (bonds, currency trading and non-equity derivatives) to be regulated by RBI. That is a compromise that seriously damages every concept of sound regulation. *Second*, he goes on to say something that makes no sense, except as a defence of the indefensible: “Given the RBI’s much longer regulatory history, and (unlike SEBI) trained cadres, a more pluralistic approach to regulatory architecture seems safer for the foreseeable future. Indeed HPEC displays surprising insensitivity to the historical and contextual contours of financial regulation in India”. The language in which this thought is put is exotic. But it means nothing. The elegant reference to “historical and contextual contours” is absurd. More time was spent within HPEC debating issues of regulation than any other issue. The HPEC recommended what it did after the most careful deliberation. We asked RBI to participate in these deliberations. It chose not to. I have already elaborated on why the HPEC recommends what it does on regulation in the third part of this six-part series. The Report itself could not be plainer or more elaborate in its reasoning on that issue. It would be tedious to repeat all that again. But Shankar’s argument amounts to saying that, to respect history, chauffeurs of modern cars can only be relied on to handle them if they’ve had a century of experience with bullock-carts or *ghoda-gadis*. In these respects Shankar is guilty of what he accuses the HPEC of: making *ex cathedra* assertions without any foundations of logic or reason; just an oddly idiosyncratic attachment to history and, possibly, misplaced loyalty to the RBI.

- B. ***The need for more Rapid transition to CAC***: Here again I’ve explained the HPEC’s position at length previously. It would be repetitive to the point of boredom to do so again. The fact is that, even with *partial* CAC, India has already lost autonomy in managing its exchange rate. That should by now be blindingly obvious. It can always have autonomy in managing its monetary policy if it chooses not to mess that up by targeting other unattainables simultaneously. In fact that’s the only autonomy that really matters. The RBI’s balance sheet and India’s reserves should not be exposed to needless risks of currency fluctuations caused by global capital movements and futile exchange rate stabilising intervention. Nor should all of India be exposed to the risks of unnecessary inflationary pressures due to the monetary accommodation of capital inflows when sterilisation has reached its limits. Those risks should be borne by owners and users of domestic and global capital. But we must allow them to have and use the markets and instruments that permit them to manage such risk. Worse still, Shankar goes on to insult the intelligence of the HPEC by asserting (without any foundation) that it shows “little understanding of the nuances and benefits of an intermediate exchange rate regime of the kind that has served India well for 15 years.” Regardless of whether we were long on finance chiefs and short on economists (for which I am eternally grateful to Rakesh Mohan in composing the Committee), the issue is not whether HPEC appreciated the rather nebulous and fictitious nuances and benefits that Shankar alludes to. It is whether Shankar really understands what needs to happen in finance with irreversible opening of the Indian economy being driven by markets at a faster pace than economists and policy-makers, wedded to a command-control approach, can cope with.

3. *Daunting Recommendations*: Finally let me come to Shankar’s comments on the long list of recommendations that the MIFC Report makes, while sympathising with his lament that he ran out of space and time. I agree with his point that the list is daunting and comprehensive. But I would suggest that this is *necessarily* so rather than over-indulgence for its own sake on our part. The HPEC would not have fulfilled its Terms of Reference if it had been less diligent in its coverage of issues. I am much happier pleading guilty to a charge of undue diligence than confess to a charge of negligence.

Of course I disagree with most of the telegraphic comments in Shankar’s rather cute little table. He and I can discuss that another day. Its not important enough to dwell on here and now. But I am obliged to agree with his pessimism about Mumbai’s and Maharashtra’s infrastructure, the worsening power situation. Mumbai would indeed blow any chance of becoming an IFC in the foreseeable future if it resorted to brown-outs and black-outs.

To end on a lighter note, I am not persuaded by Shankar’s cynicism about the chances of Mumbai becoming an IFC being less than his chances of becoming a concert pianist. I had never imagined that option as a suitable

sunset career alternative for a retired, but still suave and erudite grey-hair like Shankar. After absorbing his piece I now realise that it would be wise for him (as it is for me) to consider every option in that regard!