International competitiveness of the Indian financial system

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Defining international competitiveness

- Service: A customer in a bank branch.
  Being globally competitive is to open up to FDI by foreign banks.
- There are many financial services where it is easy to have global competition – International Financial Services (IFS).
- Globally, most IFS are produced at international financial centres (IFCs).
- Percy Mistry report, 2007: We will fix Indian finance, and then embark on an offensive strategy to compete with London and New York.
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The two biggest Indian financial products

Underlying	Global daily turnover (Billion dollars/day)
INR-USD derivatives	40
Nifty derivatives	23

- The bulk of this activity is cash-settled derivatives: $\implies$ they can be settled in dollars $\implies$ they can trade anywhere.
- **INR-USD**:
  - OTC trading on the 'NDF' or 'non-deliverable forwards' market
  - Exchange traded at DGCX (Dubai), SGX (Singapore)
- **Nifty**:
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How are we doing?

- The size of the available markets in September 2014 are:

	Onshore Exchanges	**Onshore OTC**
INR-USD	\$2.8 billion	\$18.3 billion
Nifty	\$21.6 billion	\$0.6 billion
	Offshore Exchanges	**Offshore OTC**
INR-USD	\$1.4 billion	\$17.6 billion
Nifty	0.85	NA

Source: OTC offshore and onshore, BIS April 2013; Exchanges onshore and offshore from NSE, MCX, USE, DGCX, SGX, Sep 2014

- **INR-USD:**
  Does not include USD 22 billion trading volume on the OTC onshore spot and USD 5 billion on the OTC offshore spot.
- **Nifty derivatives:**
  Does not include USD 32.2 billion in open positions on SEBI registered PNs.

This is international competition

- The FII or FDI firm thinks: Do I send my rupee derivatives business to NSE or to DGCX or the NDF market?
- The global equity investor thinks: Do I send my nifty derivatives business to NSE or to SGX or to the PN market?
- Hundreds of large Indian firms have become MNCs; they operate in the world market and can send their currency hedging work to the global treasury.

Should we care about losing in global competition?

- "The Indian computer hardware industry died; what is wrong if Indian finance dies?" (Shankar Acharya).
- "We will continue to live asif the NDF market does not exist" (RBI).

We should care

- Finance is a labour intensive business; we should be producers and exporters. This is India's natural talent.
  Once we are done with the defensive battle, we should be on the offensive.
- For India-related products, local activity can make liquidity. That is a key selling point which others cannot match.
- Indian exchanges and firms will become capable by fighting for Nifty and the rupee. These improvements will feed back into thousands of smaller products.
- For the top 100 Indian firms, the world market will work, for smaller firms there is no escape from having a local financial system.
- Indian policy tools influence the Indian financial system more. Macro-stabilisation, monetary policy transmission, etc. all require a local financial system.

What has gone wrong?

- *Capital controls and irritants*: If a US customer wants to place an order on SGX or DGCX, it is effortless. India has numerous barriers to doing business.
- *Mistakes in financial regulation*: We have numerous mistakes in domestic financial regulation which are holding back the liquidity and efficiency of our markets.
  E.g. actions taken during the currency defence of 2013 damaged the currency futures market and have not yet been fully undone.
- *Taxation*: A US firm chooses between placing an order in Chicago or London – then London must not charge taxes. Solution: the countries which want to export financial services follow 'residence-based taxation'.

A difficult environment for financial firms

- Like all business, a financial business requires organisational capital.
  Needs long-term investment in people, processes, business development.
- Should you invest in building a rupee business in Bombay or should you put it in Singapore?
- In India, there is considerable legal/regulatory risk.
  - Every now and then, rules change.
  - Every now and then, RBI/SEBI/CBDT do things that damage the economics of the business.
- We need to reduce the regulatory and policy risks for this sector.

How to solve these?

- Rational access controls.
  Match KYC of good emerging markets that are FATF members.
  Rapidly solve the chaos of FII/QFI/FPI.
- Residence-based taxation.
- Improve regulation making:
  - Immediate corrections of regulations – e.g., fully reverse July 2013 interventions in currency derviatives.
  - Deeper progress through Handbook on the Indian Financial Code.
  - Explicitly make international competitiveness a metric of regulatory and market performance.
  - Evaluate policy and regulatory decisions using a quarterly report card.

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Other areas

- Rupee and Nifty are the biggest markets.
  There are other areas:
  - India can be a major player on the global landscape for 10 agricultural commodity futures. E.g. can India be the world's futures market on gold, or channa dal, or milk?
  - Indian firms going abroad for ECB. Why not issue bonds in India?
  - Indian firms going abroad to issue ADR/GDR. Why not make this redundant?
  - Global firms coming to India to issue IDRs.
  - India can be the place for global fund managers: first to invest in India, then to invest in South Asia, then to invest in Asia and East Africa.

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The Capital Account Convertibility problem

- RBI will say: All this is tantamount to capital account convertibility.
- Dozens of other central banks have learned how to deliver on their inflation target while living with convertibility.
- Capital account convertibility addresses India's problems.

The way forward

1. Short-term fixes to address regulatory mistakes, to take back market share.
2. Regulatory certainty by adopting regulation making processes of the Indian Financial Code.
3. Measures of international competitiveness as performance metrics for Ministry of Finance and the financial sector regulators.
4. Rupee internationalisation.

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The policy process

- DEA has setup a ‘Standing Council’ which works on this subject.
- IGIDR FRG is the technical team supporting the work.
- The work going on here is consistent with the main story of financial sector reforms, i.e. FSLRC.

Thank you.

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