Subir Gokarn: Financing the future - I

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The draft report of the Committee on Financial Sector Reforms (CFSR), chaired by Prof. Raghuram Rajan, was placed in the public domain a couple of weeks ago, with the intention of getting feedback prior to final submission by the end of June. As the introduction to the report points out, the need for another report when so many were already in circulation, with a slew of unimplemented recommendations, is questionable. If the CFSR report had to add any value, it would largely be in terms of integrating the more narrowly focused recommendations from previous reports to create a comprehensive and internally consistent roadmap for the sector.

Going beyond comprehensiveness and consistency, a reasonable set of standards by which to judge a financial system would comprise the following four attributes: stability, both of the system itself and its contribution to macroeconomic management; allocative efficiency, the ability to price financial resources consistent with returns and risks; intermediation efficiency, the ability to bring sources and uses of funds together at minimum cost; and, inclusion, the ability to provide resources and services that do not meet strict commercial criteria.

The 35 major proposals made by the Committee broadly meet both sets of standards. They are comprehensive and broadly consistent, while doing well by the four criteria listed above. In this sense, it is difficult to disagree with most of them on pure technicality. There may be some quibbles with the specifics of individual proposals but they will be minor enough to move beyond the content and into the practicalities of implementation. This transition will require some thought about how to prioritise the proposals into a sequence that ensures that the baby will not be thrown out with the bathwater. In other words, a distinction needs to be made between those that are absolutely necessary to enable the financial sector to deal with challenges that are already visible as well as those which are likely to emerge in the years ahead.

This article, the first in a two-part series, assesses the proposals from this perspective. The first set of two proposals, which addresses the macroeconomic policy regime, in my view, contain one which is necessary and another which could be subject to further debate. The argument in favour of transiting from a tightly managed exchange rate regime to a predominantly market-determined one is strong. Such an arrangement is entirely consistent with both the stability and the allocative efficiency criteria. The explicit consideration of exchange rate risks into all financial calculations, whether the exposures are direct or indirect, is critical to the efficiency of the system.

The report underlines this argument with a description of the costs that a managed exchange rate regime imposes on the Chinese economy. The operational issue is essentially one of transition; China embarked on a transition strategy in 2005 and, to be pragmatic about it, we are unlikely to see an overnight transition. The report would benefit from a more explicit specification of a transition path with timeframe and milestones.

The second proposal, having the single objective of monetary policy to control inflation, is, to my mind, less important. The varied nature of shocks to the macroeconomy, the current scenario being a good example, supports an argument in favour of flexibility, both in terms of objectives and in the use of policy instruments. I would be much more comfortable with a somewhat broader objective of stabilising the business cycle, a term that has been used in the report, with a reasonably explicit statement of what that entails. I would also argue that the broader definition of objectives does not come into conflict with the stability and efficiency criteria.

The four proposals relating to increasing financial inclusion are probably the most critical of the lot and operationalising them should be on the top of the must-do list. Importantly, the notion of inclusion is not

confined to expanding rural exposure, a misconception that has proved to be rather limiting in the past. Letting smaller financial institutions expand their lending and other services to small enterprises and enlarging the eligibility criteria for correspondent relationships promise to strengthen the last mile of the links between the organised financial sector and the mass of enterprises and households which are currently excluded from access to it.

The proposal for Priority Sector Loan Certificates which introduce tradability into these exposures backs up the entry expanding proposals by encouraging the most efficient service providers to take the largest exposures in the priority sector, while others can make resources available by buying the certificates in a secondary market. Of course, similar proposals have been around for a long time; given the importance of the objective and the huge contribution to efficiency that it will make, an understanding of why it has been resisted for so long will be helpful in dealing with the barriers. Finally, the mounting evidence that interest rate distortions do not in any way enhance inclusion supports the proposal for freedom in pricing of loans to the priority sector. This is necessary to exploit the full potential of the tradability of the loan certificates.

The six proposals for banking sector reforms are a mix of must-do and nice-to-have. Attempting to sell underperforming banks pushes the agenda into the black hole of disinvestment/privatisation, which is, in my opinion, a battle not worth fighting at the moment. Facilitating mergers and consolidation, a strong recommendation of the second Tarapore Committee two years ago, falls into the same category.

To a significant extent, a differentiation has already taken place within public sector banks, with the ones having private shareholding being governed and managed more like their private sector counterparts. This differentiation needs to be sharpened and reinforced without necessarily formulating a comprehensive policy towards all public sector banks. One critical element of a differentiation strategy is autonomy in setting compensation. Finding a way to let the proportion of private shareholding, the strength and sophistication of the governance mechanisms and the compensation paid to employees, particularly senior management, move in tandem is something that should take priority. The weaker banks, like a lot of weak public enterprises in other sectors, can be left to fade away without much risk to the system.

I will explore the proposals relating to market development, regulatory design and credit information systems in my next column two Mondays from today.

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