Subir Gokarn: Financing the future - II

Subir Gokarn | New Delhi **May 05, 2008** Last Updated at 00:00 IST

This column continues my assessments of the recommendations of the Committee on Financial Sector Reforms (CFSR), chaired by Prof. Raghuram Rajan. In the previous one I had discussed the proposals relating to monetary and exchange rate management, financial inclusion and bank restructuring.

Broadly, I had little to disagree with as far as the technical aspects of the major proposals of the report were concerned. However, I did see the need to differentiate between them on the basis of how critical and efficient they might be in addressing major problems that the country's financial system faces today. I believe that several proposals fall into that category, while others are more of a "nice-to-have" variety, but need to be examined further to see whether they are the most efficient way to do things and what challenges implementing them may pose.

In this column, I explore recommendations relating to market development, credit infrastructure and, with a little more attention, a new regulatory architecture. There are several proposals to improve market liquidity and efficiency, covering the range from a unified regulatory framework for markets to specialised exchanges, which would allow for new products and sophisticated investors to come together and spur financial innovation. There is also an important recommendation to open up government and corporate debt markets to foreigners, a move consistent with the recommended transition in the exchange rate regime. If the rupee is to float, the quantum of capital inflows should be of no concern.

More so, domestic and foreign investors must have access to relatively low-cost hedging opportunities to mitigate exchange rate risk. Of course, many of the recommendations for market development are of long standing in the reforms debate, but the macroeconomic underpinning of a floating rupee provides them with greater significance and relevance. Risk management is not the only reason why markets emerge, but it is an important one. In the same vein, the report recommends that market bans be abandoned as a means of controlling undesirable price movements. This issue has proved to be a great source of divergence in the Abhijit Sen Committee, which, when it submitted its report a few days ago, took no collective view on the issue of banning trade in agricultural commodity futures, but also did not explicitly recommend that the existing bans be revoked. A stalemate on the issue is clearly in sight!

There are important recommendations on credit infrastructure, starting with a universal smartcard identification system. This will, of course, facilitate access to formal credit mechanisms, which is why the committee wants it, but it will have enormous implications for the more efficient delivery of public services as well. It has always seemed a shame that the country's formidable IT capabilities are helping other countries manage their universal identification systems, while we have to make do with six or seven pieces of paper to prove ours. The report builds on this fundamental requirement of proof of identity to make a series of proposals relating to both access to credit and the creation and dissemination of credit information. All of these will contribute to the equally important, but often contradictory, objectives of efficiency and inclusion.

Compared to these relatively small steps, the proposals on the regulatory framework seem quite radical. The committee lays a strong foundation for a universal regulator by emphasising the direction that financial services are moving in. The emergence of financial holding companies, which the committee is in favour of, allows a single entity to offer the entire range of financial services, from banking to housing finance to the gamut of investment services. Universal banking offers huge opportunities for efficiency gains from both scale and scope economies, but because of the complex ways in which assets and liabilities are structured, can increase systemic risk. The danger increases when different components of a universal bank's balance sheet are regulated by

different entities. A universal regulatory agency, the committee suggests, is the most efficient way to derive the full efficiency gains from universal banking while managing the risks.

However, conceding that the transition to such a structure will be difficult, it opts for a less onerous requirement