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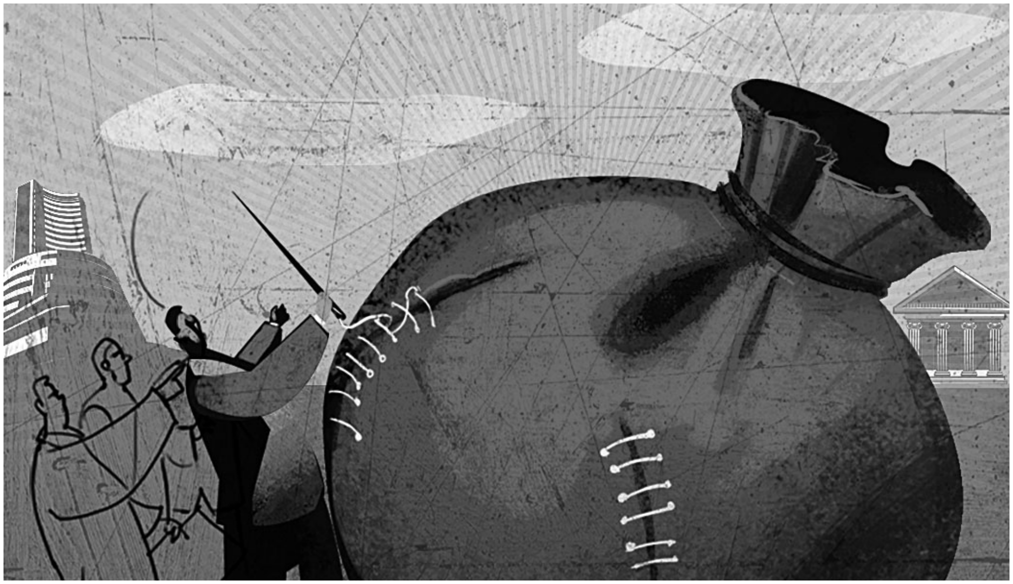

Financial reforms: Mid-term report card

Halfway through the Modi govt's tenure, India has six achievements in financial reform to boast of; a dozen more are needed

Indian finance has deep problems. There is fair clarity on what is needed to be done. When the full picture of the required reforms is shown, it often seems like an audacious goal that will be hard to pull off. Halfway into the Modi administration's tenure, and at the starting point of Urjit Patel's time at the Reserve Bank of India (RBI), the report card shows six wins. Sustained policy work on this scale will achieve the fundamental change in finance that India requires.

Many parts of India were transformed in the period after 1991. The telecom sector did pretty well. Manufacturing was significantly opened up to easier imports, which had far-reaching effects. In finance, only one component was fixed: The equity market. The rest of finance is mostly unchanged (e.g. banking) or has new parts which are as yet small (e.g. the National Pension System).

This has many adverse consequences. We periodically get banking crises and inflation crises, which impose massive costs upon the economy. Consumers are regularly mistreated, cheated, and excluded. More people have mobile phones than bank accounts. Barring the top 1,000 firms, the cost of capital is exorbitant. The government's borrowing is handled badly, and infrastructure financing is hampered as there is no bond market. The system is simultaneously hostile to innovation and competition, and vulnerable to crises. There is a frightening decline of the biggest financial markets (Nifty and rupee), which are exiting from India.

SNAKES & LADDERS

AJAY SHAH

These problems went through the analysis phase of Indian public policy from 2007 to 2011. There is a broad consensus on what is required. The existing laws were built for a different age and need to be reoriented to the needs of the India of the next 20 years. Financial agencies (RBI, Sebi, etc.) need to improve governance procedures in the direction of fairness, transparency and rule of law. Rationalisation of the block diagram of financial agencies and their functions is required. Core objectives, such as consumer protection, price stability and systemic risk regulation need to be stated in the law, and agencies put to work in achieving them.

The full solution is the draft Indian Financial Code (IFC), drafted by Justice Srikrishna's Financial Sector Legislative Reforms Commission from 2011 to 2015. Enacting and implementing the IFC at one shot will require a push comparable to the Bankruptcy Code. This has not happened. But a lot has.

The commodity futures regulator, Forward Markets Commission (FMC), under the Department of Consumer Affairs, made no sense as commodity futures trading is just financial markets trading. In 2013, the subject of commodity futures moved to the Department of Economic Affairs. In February 2015, the Forward Contracts (Regulation) Act was repealed, commodity futures were classified as a "security" under the Securities Contracts (Regulation) Act, and FMC was merged into Sebi. This takes us closer to the convergence of financial markets in the IFC. This ball is (as yet) in Sebi's court, where we are waiting to get big gains in the economy in return for this policy work.

A basic concept of rule of law is that orders of a financial agency should be subject to judicial review. At the outset, there was only the Securities Appellate Tribunal (SAT), where appeals against Sebi could be heard. SAT has performed great service in containing the arbitrary exercise of power at Sebi. In the IFC, the Financial Sector

Appellate Tribunal (FSAT) hears appeals against orders of all financial agencies. After 2015, SAT hears orders against all financial agencies other than RBI. RBI is now the only financial agency where orders are not subject to judicial review.

The Indian system of capital controls has failed. We have thousands of pages of law, profit opportunities for lawyers, irritants for business, controls that are ineffective in practice. The first step towards fixing this was taken in February 2015, where the power to write regulations for non-debt capital flows (both inbound and outbound) shifted from RBI to the finance ministry. Under the IFC, the power to write regulation or debt flows also would lie at the finance ministry. This ball is (as yet) in the finance ministry's court, where we are waiting to get big gains in the economy in return for this policy work.

Two new agencies envisaged in the IFC are the Financial Data Management Centre (FDMC) and the Resolution Corporation (RC). The FDMC will, for the first time, make possible a full view of Indian finance and thus an assessment of systemic risk. The RC is a specialised bankruptcy code for financial firms. In 2014-2015, "task forces" led by M Damodaran and Subir Gokarn worked out implementation plans for RC and FDMC. The 2016 Budget speech has promised that both these institutions will be setup. If high quality laws are enacted, and the implementation plans in hand are pulled off, this will be two big steps in reform.

Inflation targeting and the monetary policy committee (MPC) were once-heretical ideas when they were in committee reports and in the IFC. Conservatives derided the idea that RBI should be accountable, and opposed the shift in power from the Governor to a Committee. But Urjit Patel's report showed modern macroeconomic thinking within RBI, and in February 2015 the Monetary Policy Framework Agreement was signed. In February 2016, for the first time in its history, RBI had an objective (four per cent inflation) and power had shifted from the Governor to the MPC. It is fitting that at the same time, the Preamble of the RBI Act was amended to remove the "temporary" status of RBI.

At this historic moment, Urjit Patel will now refashion RBI as an agency which will consistently deliver on its objective. This is harder than merely announcing the target. There are grounds for optimism that he will be able to get this done.

So at the halfway mark, we have six achievements in financial reform. The finance minister did not give a major speech showing the steps in financial sector reform, but with 12 more actions of this magnitude, we'll be pretty much done.

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