Azadi of the financial sector

Parts of the Indian financial sector have been liberated, and this has fuelled growth. The rest of the sector needs this now

ILLUSTRATION: BINAY SINHA

The 75th anniversary of India's Independence is a good time to look back and dream forward. In the field of financial economic policy, 44 of these 75 years were a period with a highly repressed financial system. As an illustration, the Capital Issues (Control) Act of 1947 was the applicable law for securities markets. Under this law, the government decided which company could raise capital in the public market using which instrument and at which time. It also decided the persons who could buy these securities and at what prices.

All across the financial system, state domination was achieved through a combination of bans and public sector ownership. Banking, insurance and mutual funds were the preserve of public sector banks, Life Insurance Corporation of India/General Insurance Corporation of India and Unit Trust of India, respectively. Most routine activities of financial markets were prohibited by law. Under the then-prevalent philosophy of self-reliance, cross-border engagement was mostly banned. Domestic investment was thus choked to fit within the envelope of domestic savings on questions of both raw magnitudes and risk tolerance. It was a picture of low freedom.

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While in many ways reforms of Indian socialism truly began in 1977, in the case of financial economic policy, *azadi* is dated to the early 1990s. The reformers tried to push in favour of greater economic freedom, reduced central planning, and increased regulatory capacity. These reforms have played an important role in the real sector growth of the last three decades.

In some respects, there are important achievements to show. The rupee magnitudes that are intermediated by finance have grown immensely. New industries like the software industry are financed by a new set of financial players. Activities like a loan against a car or a loan against a house, which were once relatively unusual, have become commonplace. The gap between domestic savings and domestic investment strikes less fear than used to be the case: We are always able to balance the books by tapping into the near-infinite pool of foreign investment.

The biggest achievement was the emergence of the full ecosystem of finance in the equity market. This market has blossomed with the full apparatus of the initial public offering (IPO) market, the equity spot market, derivatives trading, algorithmic trading, *de-facto* convertibility for foreign investors, no entry barriers into trading and intermediation, and the supply chain from angel investing to venture capital to private equity that feeds into the IPO market. The equity market features private persons who take risk in speculative positions, and then large profits/losses are made. Onshore equity market activity interacts with an important derivatives market overseas, which has both exchange-traded and over-the-counter trading elements.

This transformation reveals itself in numerous aspects of the evidence. In the period 1991-92 to 2019-20, equity as a source of capital of large private non-financial firms went up from 24 per cent to 37 per cent: The corporations responded to the supply-side changes by increasing their use of equity as a source of financing. Even more dramatically, the market capitalisation of listed Indian firms rose from about 5 per cent of gross domestic product (GDP) in 1980 to about 20 per cent 10 years later to about 100 per cent of GDP at present. The transformation of the equity market is the poster child for what financial reforms in India can be.

But when we look beyond the equity market at the rest of the landscape, there is much that remains to be done. On the three dimensions of growth, stability and inclusion, Indian finance continues to face difficulties. Notwithstanding some very visible improvements in the payment systems, there are other statistics, like the present access of households and micro, small and medium enterprises to formal finance, insurance penetration and density, pension assets as a percentage of GDP, among others, which unambiguously show that India continues to be underbanked, underinsured and inadequately covered by old age income security measures.

Capital allocation by the markets is at heart about prices being made through forward-looking speculation by free economic agents. In large parts of the financial system this was absent. In the beginning years, this was evident in the form of outright bans on many kinds of financial contracting (derivatives trading of any kind), entry barriers on the private sector (in insurance or in bond market trading) and public sector ownership that is inimical to forward-looking speculative decision-making.

Though the dominance of state-owned companies has receded and sectors with multiple competing private firms have emerged, the long arm of central planning has only grown, where minute details of products and processes are controlled. While a private person may own a financial firm, the work and activity of the financial firm is actually controlled by regulators. In many cases, there are even controls on the persons appointed into leadership roles in these financial firms. This combination of central planning, low rule of law, and potentially high punishment to the extent of the denial of the right to practice the chosen business or profession, has come together to create subservient employees in private firms who work within the written and unwritten wishes of the regulators. When we peel below the private ownership, there is a system of *de-facto* state control.

Financial regulation is one of those wicked public policy problems which require enormous state capacity. Unlike problems like Covid vaccination or a Maha Kumbh Mela, which are a one-time effort, financial economic policy requires sound work every day, with a high number of transactions, where front-line public servants have high discretion. Private persons have a lot at stake and bring energy into reshaping the working of the state in ways that suit them.

It is truly hard to create regulatory capacity to create deep and liquid markets that are not hijacked by special interests, and firms that serve the best interests of financial consumers. The early decades of financial reform kicked off cogitation and the Financial Sector Legislative Reforms Commission (FSLRC). Important elements of FSLRC recommendations were implemented in 2015 and 2016, such as inflation targeting at the Reserve Bank of India and the merger of Forward Markets Commission with the Securities and Exchange Board of India. It needs to go further to implement the balance and unleash financial sector *Azadi* 2.0.

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