Macro and Micro Drivers of Business Potential of IFSCs in India

Gandhinagar, Gujarat, 11th January 2017

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A. Introduction

1. We are gathered here today to commemorate the establishment and success of GIFT, India's first International Financial Services Centre (IFSC) that brings together world class infrastructure, connectivity, people and technology on a single platform for businesses across the world. An all-inclusive and modern economic zone, it offers global firms competitive access to India's large and burgeoning demand for financial services.
2. International Financial Centres around the world have historically emerged out of the confluence of economic and political developments. In modern times, while major centres adapted their financial institutions and instruments to intermediate international capital flows, they also came to be seen as vehicles for economic growth and development of the host countries.
3. To achieve their objectives, it is necessary that the regulatory frameworks governing IFSC operations are well-thought out, guided by the ease of doing business principle, tempered by prudent risk management, and geared to deliver efficient financial services. The various areas of attention from this standpoint include registration and approval process for new entrants, regulation, supervision and resolution of financial entities, and dispute settlement.
4. IFSC at GIFT City is probably the first such centre to be launched after the 2008 global financial crisis. In some ways, the light-touch regulatory philosophy epitomised by IFSCs came to be questioned in the aftermath of the crisis. However, GIFT City has the advantage of drawing the right lessons in this regard to avoid pitfalls.

5. The RBI has been working closely with all IFSC stakeholders on diverse subjects in recent years to help GIFT develop.

6. Today we see intense competition among the major IFCSs trying to position themselves for various business lines, and increase their business potential, which is the theme of this seminar. In addition to the usual attributes there are two other dimensions, viz., <u>the broader economic environment in tandem with associated policies, and the micro ecosystem specific to the IFSC sector.</u>

<u>B. Macro</u>

7. As we celebrate GIFT today, it is important to recognise that its further growth will, *inter alia*, be predicated on the environment of domestic macro stability that we have achieved along several key areas over the last few years. We need to be ever vigilant to preserve and build upon what we have attained. Our credibility for sound macroeconomic management depends on it. As backdrop, there are two important transitions underway in the two largest economies. One is the realignment of fiscal, monetary and trade policies in the US, which has already imparted considerable financial volatility in the global economy in the last two months. Even NAFTA is not sacrosanct, US trade partners, especially emerging markets, stand forewarned. And all this is even before the new US administration takes office later this month. The other transition, of course, is the rebalancing of China's growth drivers from investment and exports to domestic consumption of goods & services. One of these transitions is welcome, the other not so.

8. For us, in India, good policy housekeeping should be the cornerstone. It is easy and quick to fritter away gains regarding macroeconomic stability. But hard and slow to regain them. What have we learnt about the important policy attributes in this context?

9. Firstly, a monetary policy framework backed by legislation. The RBI now has a notified target for inflation of 4 percent, which a six-member Monetary Policy Committee has been enjoined and tasked to realise. We have to ensure that this objective is secured on a durable basis given the progress already made. In addition to monetary policy, the gain on reducing inflation has been, in no small part, due to supportive policies of the government, especially the proactive management of the food economy since 2014.

10. Low and stable inflation is an essential prerequisite for having a meaningful interest rate structure or regime whereby decisions by savers and investors help to achieve maximal allocative efficiency in an economy whose investment rate has to increase for better growth outcomes. Concomitantly, we have to continue to press ahead for a more fluid, smooth transmission of monetary policy, as also enhance the formulaic linkage between changes in policy rates and other rates, including administered ones. The perception is that some of these adjustments are presently ad hoc. Automaticity will help to impart more predictability and possibly make for better long-term decisions by economic agents.

11. In addition, while some government guarantees and limited subventions can help, steep interest rate subventions and large credit guarantees also impede optimal allocation of financial resources and increases moral hazard. The mandates for these have to be narrow, and thus perforce be deployed judiciously, within a regulatory framework, which RBI has suggested. Guarantees increase government's contingent liabilities, and add to risk premia for its own borrowing. Guarantees *per se* at the end of the day have limited utility in solving important sector issues. For example, for small scale enterprises, perhaps non-pecuniary and transaction costs related to clearances, inspections and the taxation bureaucracy are more important.

12. Second, since 2013, the central government has successfully embarked on a fiscal consolidation path. Even then, our general government deficit (that is borrowing by the centre and states combined) is, according to IMF data, amongst the highest in the group of G-20 countries. In conjunction, the level of our general government debt as a ratio to GDP is cited by some as coming in the way of a credit rating upgrade. We have to take cognisance of these comparisons and facts as we go forward to make progress. Specifically, this will help us to better manage risks for ourselves, and thereby mitigate financial volatility. In the context of an already adverse external environment that I mentioned earlier, this assumes more importance.

13. Borrowing even more and pre-empting resources from future generations by governments cannot be a short cut to long-lasting higher growth. Instead, structural reforms and reorienting government expenditure towards public infrastructure are key for durable gains on the Indian growth front. Investment in public transport, specifically railways and Urban MRTS can lead to reduced costs and productivity gains as also help us to lower our oil import bill, and, as collateral benefit, improve air quality in our cities.

14. Third, the continuing support towards recapitalisation of public sector banks. A well-capitalised domestic banking system enhances the comfort of the various stakeholders to conduct business in the offshore IFSC as well. It is therefore critical that efforts towards developing an attractive offshore financial centre should also include measures for adequate provision of capital to the domestic banking system. We have to ensure that our banks continue to conform to international capital standards as a member of the G-20 and the BCBS. Let me turn to IFSC-related sector issues.

C. Micro ecosystem

15. The other dimension that is critical to GIFT's comparative competitiveness is, as I mentioned earlier, the micro ecosystem within the IFSC. Here, there is the need for a modern complementary legal infrastructure. We need to do a lot in this regard. We have to strengthen the legal framework as applicable to entities operating in the City and their counterparties in the domestic sector. It is possible that many business entities that can potentially relocate to GIFT City are waiting for this framework to be put in place.
16. An IFSC should have a legal structure that is sufficiently supportive of the swift resolution of conflicts and disputes arising from the settlement/enforcement of complex international financial contracts. The contract should be of international standard and enforceable in the court of law and preferably similar to ISDA documentation.
17. The existing laws governing financial contracts in India should be reviewed and gaps addressed. Based on the review, a world class legal framework for financial contracts in GIFT could be enabled, either by appropriately amending the existing laws governing financial contracts or enacting a fresh law. Either way, this should be expedited, may be by constituting a high level working group to address this gap in mission mode.
18. In addition, a unified financial regulatory framework providing for a single regulator for GIFT City could contribute to better regulation and supervision of the financial entities in the City. While individual regulators can supervise the entities initially when the size of the business is small, a unified regulator would be necessary to pay undivided attention to the IFSC. Work on the design of such a framework should begin soon so as to be able to implement this in time.

19. In conclusion, fiscal incentives and other leeway will take GIFT forward only so far, work in areas that I have just suggested is essential for fully harnessing the IFSC's business potential.