Perspectives on Financial Sector Strategy

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I welcome this initiative by the Asia-Europe Business Forum to organize a discussion on opportunities and challenges for financial services in our respective regions. Virtually all significant debate that is taking place today on financial sector regulation and development, whether in advanced or emerging economies, is placed in the context of the crisis and the role that the financial sector played in it. However, there is a significant asymmetry in that debate, as is evidenced, for example, in the discussions on post-crisis financial regulatory strategies in the G-20 process. It is by now fairly clear that significant differences in regulatory frameworks across countries contributed to very different outcomes in terms of both the role of national financial sectors in the crisis and, in turn, the impact of the crisis on the financial sectors themselves. Within the G-20 process, this has resulted in concerns about a "one-size-fits-all" regulatory response to the crisis. However, on a more constructive note, it has also contributed to the emergence of a collective view on balancing the role of the financial sector in the development process with the need for global co-ordination on regulation in the face of increasing global integration of both financial systems and economies as a whole. This "emerging market perspective" was the subject of a seminar organized in Seoul as a prelude to the recent G-20 Finance Deputies meeting in Gwangju, Korea, earlier this month. I believe that this perspective provides an important foundation for sustaining a meaningful dialogue between advanced and emerging economies, of which this forum is an example.

In this brief keynote address, I would like to put forward some thoughts on the broad principles that guide our thinking on financial sector development and which have shaped our contributions to the "emerging market perspective" that I referred to earlier. On previous occasions, I have articulated four basic principles: efficiency, stability, transparency and

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inclusion. An effective strategy would need to balance the objectives implicit in the four principles by, first, exploiting the complementarities between them and second, recognizing the tradeoffs and, wherever they arise, prioritizing between objectives. Let me elaborate on the "opportunities" and "challenges" provided by each set of objectives.

As regards efficiency, there is little doubt that the financial system needs to meet the expanding and increasingly complex requirements of a rapidly growing economy; more so, it needs to meet them in as cost-effective a manner as possible. Given the imperatives of speed, a number of factors can be brought to bear on this. New capacity combined with greater competition is clearly one way to achieve this objective. New ways of addressing specific needs, for example, through the development of new markets and new products is another. However, it is important to recognize that the efficiency of the financial system cannot be viewed in isolation. There must be a concrete link between the development of the economy and the capacity and the capability of the financial system.

Clearly, as we think about rapid increases in both capacity and capability, the role of foreign institutions needs to be considered with reference to their ability to bring both capital and knowledge to the table. However, the benefits that greater foreign participation may generate have to be balanced against their potential to increase risks. This brings us directly to the second principle, stability. Financial stability, explicitly or implicitly, has always been an objective of both governments and central banks and this was quite vividly demonstrated in the response to the crisis on 2008. Since then, what was perhaps more implicit than explicit is now sought to be formalized and institutionalized in many countries, including India. The mechanisms needed to both pre-empt and deal with systemic risks and their materialization are being seriously debated. From a broad emerging market perspective, the question of how the significant presence of large foreign players contributes to systemic risk is a critical one as regulatory and prudential strategies are designed in the post-crisis environment. How do we exploit the benefits that they offer with respect to the broad developmental objectives without making our own systems vulnerable to shocks that emanate outside and over whose transmission we have little or no control? A balance needs to be maintained between ownership, governance and prudential norms that satisfy reasonable systemic safety requirements and commercial viability, which will make it worthwhile for these institutions to expand or set up business.

I would like to emphasize that the stability principle is not confined exclusively to foreign presence. Systemic risks can originate in domestic financial players as well. An effective safeguard mechanism must identify all possible sources of such risks and put in place appropriate measures.

Transparency is a critical requirement of a globally integrating financial system. Standardizing and harmonizing reporting norms will help to bring about global comparability, which, in turn, will help national regulators identify the vulnerabilities of their systems and take necessary steps to prevent the precipitation of a crisis. However, while this is a desirable objective, the process of convergence is itself resource and knowledge intensive. Cross-border comparability will remain a problem as different countries converge gradually to the global standards. Even after it happens, mechanisms that ensure the full dissemination of information need to be instituted or strengthened to derive the full benefits of comparability.

Finally, on the issue of inclusion, this is clearly an objective at the core of the larger development agenda. It is not easy, even for people within the system, to appreciate the sheer scale of the challenge. It is not just a question of numbers. The imperative is to provide financial access to several hundred million people in widely differing local environments in terms of levels of affluence, economic structures and means of livelihood, risks emanating from both natural and man-made sources and infrastructure conditions. This requires a deep understanding of the local terrain and the organizational ability to find cost-effective ways to cater to the requirements of financial services in each terrain.

There are, of course, some universal or replicable components, which are either already in play or will become so shortly. Saturation coverage by the telecommunication network allows the use of low-cost wireless handheld devices to actually play the role of a bank branch, significantly reducing the cost of expansion. The impending introduction of the Unique Identification Number will significantly improve the efficiency of the KYC process as well as allowing full mobility across the networks of individual banks. But, given the overall scale of the challenge, as well as its regional diversity, properly visualizing the role of different participants and coordinating their activities will be of critical importance. And all this will have to be done with full consideration of cost-effectiveness, commercial viability and, of course, the implications of any strategy for financial stability. In short, robust development of our financial sector in a manner consistent with the larger goals of economic development needs to balance these four principles. It needs to exploit complementarities and manage tradeoffs. Let me list three current areas of activity, which reflect this overall approach.

First, the process of issuing new banking licenses has begun, with the articulation of core issues and the pros and cons associated with ownership and capital criteria. A public debate and consultation process is now under way. Second, an effort to co-ordinate action on the remaining barriers to the development of the bond market is in motion. A very important motivation for this is the sharp rise in infrastructure spending and the need to ensure that this is not hindered by financial constraints. Third, a process of consultation with individual banks with the objective of developing realistic financial inclusion plans is going on.

I will conclude by highlighting three balancing acts that our financial sector development strategy needs to perform:

1. Between the drivers of financial sector growth and the requirements of the larger growth and development agenda

2. Between the benefits and risks of greater global integration

3. Between the advantages of scale and the compulsions of diversity

I trust that these thoughts will be a useful input into the discussions that follow and I thank the organizers of this Panel for the opportunity to share them with you.