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P R O C E E D I N G S

MS. BRAINERD: Well, I think we should go ahead and get started.

I am delighted to welcome you all here today to Brookings to a discussion of the financial reform commission's findings.

I believe the report is being actually issued today; is that right? There was an earlier draft that was released in April. And there's been quite a bit of back and forth and controversy surrounding it since. And so we're delighted I think to have a conversation about both the recommendations in the report, but also some of the areas that have so far proven contentious.

And, of course, we're doing it in the context of both a global financial crisis that both raises the stakes for financial sector reforms in the very vibrant economy of India, but also complicates the environment in which such reforms would be undertaken.

So I'm guessing that this is something that will be hotly debated for some months in India. And if India is anything like the United States, anything that’s tough to do will be postponed as long as possible.

I am delighted to have here both one of the primary -- can I say one of the primary authors of the report? One of the authors -- Eswar Prasad, who is I think you all know him. He is the Tolani Senior Professor of Trade Policy at Cornell, but he is also a Senior Fellow here in the Brookings Global Economy and Development Program; and was previously Chief of the Financial Studies Division in the Research Department of the IMF.

So Eswar will first go through a little bit of the rationale of what led them to make the recommendations that they did, and probably take on some of those controversies and on.

And then Tarun Khanna will give us a view from somebody who has both studied the financial system and who is experiencing it first hand as an entrepreneur in India. But I think his day job is as the Jorge Paulo Lemann Professor at the Harvard Business School. His -- everybody I think is familiar -- has worked on these issues for many, many years.

So we’ve got a great presenter and a great respondent. And then what we'll do is turn it over to discussion.

And I think this is all on the record, so we should have a transcript of it up on the web for anybody that wants to refer to it later.

So with that, Eswar.

MR. PRASAD: Thank you, Lael, although in this political season, I thought it would have been better to start with low expectations, and then build up to them.

Thank you very much for coming. My plan to do is to give you a flavor of the report. This is the report that has been a long time in the making. It was actually commissioned by the Planning Commission in India in conjunction with the Finance Ministry of India. And Urgadam Rajna of the University of Chicago was set up as the Chairman. And the committee members involve many of the high and mighty people in Indian finance.

So I happened to write one of the chapters, but I was not technically a part of the committee, although I was part of the discussions.

But, as Lael said, the draft report that we put out in May did stoke a lot of discussion and commentary. So this final version, which was presented to the Indian prime minister just this morning in Delhi, as a matter of fact, has taken on board some of those reactions, and I think we've arrived at a much more coherent view of what we should be doing.

Now, there are some questions just in terms of the background. India is very good at commissioning reports and producing reports, so a basic question is why another report. One of the objectives of this particular committee was actually to provide a much more holistic perspective on how to approach financial sector issues. There have been committee is looking at very specific aspects of financial system reform -- the banking sector or the corporate bond markets or the government bond markets or specific aspects of banking.

But what this committee was tasked to do was essentially lay out a much more broad blueprint, which would not only provide a broad view of what needs to be done in the financial system, but then hone in on an much more specific steps.

Now India does seem to be doing quite well in a variety of dimensions. The financial system has actually made a significant amount of progress in the last couple of decades, although at a rather slow pace. But if you compare India with China, for instance, the financial system seems to be working quite well.

And the question is whether one really needs another report of this sort to move things along. And I think what has happened in just the last three months has indicated that we do need to be having a much more informed debate, again, not only about these very specific recommendations, but about the much broader context in which these reforms need to be initiated.

Now with impeccable timing, of course, this report is coming out just when things are down the tubes in the U.S., so it has raised some issues about whether the report is likely to be well received.

But in India, again, things do work at their own pace, and it's very important to introduce ideas into the debate. And one of the other things that this report aims to do, although it wasn't a plan initially, is to think a little more about what sort of lessons in should be drawn from the U.S. experience. And there is a great risk, in fact, that some of the wrong lessons might be drawn from the trauma that the U.S. financial system is going through right now.

Now, like I said, India has actually not been doing too bad. The stock markets in particular have become a lot deeper. The banking system is doing a lot better than it was a couple of years ago. The reforms to the banking system were set up much earlier than, for instance, in the case of China. And the system has responded to a significant extent, and as the Bank of India constantly reminds us, whatever they may be doing right or wrong, it is true -- and one has to give them credit -- that there have been no major regulatory failures in India in the last two years, even when the global financial system or other Asian countries were being wracked by crises.

But there are issues, still. So if you look at the government bond market, it looks very large, but it turns out much of that stock of bonds is held, in fact, by institutional investors, and it's not really traded.

And if you look at the corporate bond market, it actually turns out to be relatively small. In fact, it doesn't even show on this chart.

So there’s been a lot of action on the stock markets. The bond markets remain relatively small and segmented, and whatever action there is in terms of government bond markets. So the corporate bond markets haven't developed much at all.

Bank financing has been rising. So, like I said, there has been improvement. But if you look at cross-country comparison with a group of emerging market countries and the more industrial advanced economies, India doesn't look very good in terms of where it stands.

So the problem is that the overall level of financial debt in the system still remains low, and its bank lending, a relatively torpid bond market. And the biggest issue is that even though the financial system may be working moderately well, the access that much of the population has to this financial system is really very limited.

So ultimately, we think that this report is important in thinking about the financial system itself as having the capacity to generate employment growth, but there are substantial weaknesses still in the financial system which would have much broader implications not just for growth, but also for macro economic stability, and, more importantly, for inclusiveness, because this has been one of the concerns in terms of the socio-political sustainability of growth, whether, in fact, it is inclusive.

And we think that the financial system has a big role to play in terms of that inclusiveness.

Now given what I said about the report, the objective was to lay out a big grand plan, or a vision, in terms of this blueprint, but, again, it's very difficult to make progress with just a grand plan unless you have markers along the way.

So the report specifically lays out what we call a hundred small steps, and also tries to lay out these priorities in a reasonably realistic manner rather than just suggesting that everything needs to be done.

And it was a very broad consultative process that has resulted in this report. So it's not just a bunch of financial sector people and a couple of academics coming together and thinking deep thoughts. We’ve actually been informed by much of the debate on these issues, and we've talked to a very broad cross-section of people.

So the proposed -- the report goes over five broad areas. As I said, it's a very large report and it should be posted on the Planning Commission Web site sometime later today or tomorrow.

There is an article that is laid out there that basically summarizes the key elements of the report. And the broad areas can be thought of in these five or six dimensions.

Now typically in a sector -- in a report on financial sector reforms, you don't see discussions of macro economic policy issues. But again, it give you a flavor of the fact that we’re trying to lay out this groundwork which includes not just specific parts of the financial system, but things about other parts that feed into the financial system, and, of course, macro economic policies are a very important part of that.

So let’s start with the macro economic policy implications. Now, at one level, it looks like things are going very well in India. It's true that we've had a burst in inflation -- surge in inflation in the last few months for a variety of reasons with the food and energy price shocks. But, by and large, in the four or five years before that, India was bouncing along quite well at a high rate of growth relative to its past, and also a relatively low level of inflation.

But the problem again was that macro economic management was becoming increasingly complicated, because what the Reserve Bank of India was trying to do essentially was manage the capital flows, which were surging in over the last four or five years because many people seem to have bought into the India story, and India has been doing very well justifying that story.

In addition, the Reserve Bank was trying to manage the exchange rate and maintain financial stability and a low and stable level of inflation.

Now these are all ultimately very nice objectives, and I think the Reserve Bank was actually managing this high wire balancing act very well. But the problem was that it was becoming increasingly untenable to manage all these things with the one instrument that ultimately the Reserve Bank has.

So then the question became what should we think about in terms of how to set up monetary policy in order to deal with these challenges, given the constraints of the Reserve Bank; that it can't quite manage all of these things at the same time.

Now one other set of policies becomes important when you think about monetary policy, especially independence of monetary policy, and I mean operational independence, not quite full independence of the central bank, but just operational independence in the sense of the central bank being able to use its monetary policy actions, essentially interest-rate actions in order to guide inflation and growth.

The problem is that capital account liberalization has been thought of as a tool to keep capital from flowing in or out freely, and capital controls do give monetary policy a degree of freedom, because if you can stop capital at the border, when you want to, it allows you to use your interest rates much more aggressively.

The problem, of course, is that part of that debate has, in fact, become moot, because India has been opening its capital account over time by relaxing capital controls. But more importantly, the entire capital account has become de facto much more open so that debate and the illusion that one can still maintain capital controls in order to retain monetary policy independence, it seemed to be the Committee was really missing a key part of the debate.

So we felt that what could really be accomplished by monetary policies focusing on one specific element, which is low inflation objective, and this -- misinterpreted by many commentators who have argued that the Committee is suggesting that we should not be concerned about growth, should not be concerned about employment and so on, quite the contrary. But given that the Central Bank is limited in what it can do with one instrument, the Committee felt that the best contribution that, in fact, monetary policy could make to macro and financial stability is, in fact, to have a stable monetary policy focused on one objective, which is the low inflation objective.

And this, again, is not pie-in-the-sky thinking. There is a fair amount of experience from other emerging market countries and a fair body of theoretical and empirical knowledge which suggest that, in fact, having the Central Bank focus on one objective doesn't, in fact, constrain the Central Bank, it actually frees it up to use monetary policy in a much more effective fashion.

But that raises the issue also about capital account liberalization and what should be done. And India, like I said, has become much more open to capital flows.

Now India has taken a somewhat cautious approach to capital account liberalization, where FDI has been let in, but at relatively low levels. That’s the blue bar here. And then its portfolio flows, where actually there's been a lot more opening up.

Now FDI and portfolio flow it turned South from a newly emerging theory about the benefits and risks of financial globalization. These are the right sort of flows that actually conferred a lot of indirect benefits from financial globalization.

Increasingly it's very difficult to find evidence that the standard notion that financial globalization brings in more capital, thereby, allows developing countries to increase investment and grow faster. That doesn't seem to be working very well in the data.

But there is increasing evidence that what financial globalization can do is through that capital catalyze a variety of what I've called collateral benefits in some of my work. These are things like domestic financial market development. And India is a very good case study of this.

In fact, the entry of foreign money has substantially increased both the depth and the overall sophistication of Indian equity markets. So it's had that one positive effect.

And it’s also had the good effect that trying to steer capital inflows away from bank loans has actually made India's capital account liberalization somewhat safer. But again, India's capital account has now become so open that trying to restrict particular types of capital flows just doesn't work that well anymore. So the notion that capital controls really can prevent the tide of capital from flowing in or out in that it provides a degree of freedom to monetary policy I think is simply not tenable anymore.

So in the report, we argue that capital account liberalization should continue at a reasonable pace, and with the ultimate aim of a more open capital account because it is happening, whether the government likes it or not. So managing this process, it seems, is a much better approach.

But in terms of managing and then links between these different aspects of monetary policy start -- monetary and capital account policies start becoming clearer. And the one big elephant in the room again is the fiscal sector because ultimately if you don't have fiscal discipline, it constrains macro economic policies, both monetary policy and other types of policies.

But here is a very good example, and the Committee has tried very hard in the report to bring together these links between policies, and here is a good example of that. Foreign investors are not allowed to participate in the corporate -- and the government bond market.

And what are the concerns there is that a lot of the financing of the government fiscal deficit has been taking place either through the traditional approach of Central Bank financing, through printing money, or by bank financing in the sense that banks are required to hold government bonds three device called the statutory liquidity ratio, which means that something like 25 percent of deposits in the banks have to be held in the form of government bonds, which provides an easy source of financing.

So one of the things the Committee recommends, for instance, is freeing up the capital account so that foreign investors can come in and participate in the government market, bond market, which could take away some of the pressure in terms of the financing and thereby free up both the financial system and monetary policy some more.

But again, clearly, fiscal policy is a key component of that. So it's very difficult, you can see already, to disentangle these things and try to push forward very hard in one dimension without the other dimension.

Now even if the financial system was working very well, one of the key issues is whether access to the financial system is easily available. And here there have been very large gaps in terms of actually providing this access. But the Committee took the view that it's not just about provision of credit, but a much broader view of what the financial system should be delivering to the average person on the street, where the average person on the mud road, in the villages.

And it includes not just credit, but also instruments to insure against fluctuations in income and instruments that allow for wealth creation. So it's a much broader notion of financial access.

And here there are two approaches. One is to think small and think big. Slogans are always good when you think about a report of this size.

So on the small side, the idea is to give private small finance banks much more leeway to operate. Now there had been some concerns that these small banks may not be viable, but they have been under a lot of restrictions. And the feeling of the Committee was if adequate safeguards are in place and we're very clear about what those safeguards could be, these small banks could actually play a significant role in providing more access.

But the big banks as well could have more flexible business models where the business correspondent approach could be made less restricted in a regulatory sense. And there also attempts by the government to steer lending towards what are called the priority sectors, like agriculture. So this is trying to mandate in a sense access in a particular way.

So one of the forms that this takes us to have something called priority sector lending, where banks or other deposit taking institutions are required to make a certain amount of their loans to these priority sectors. And, of course, you have a lot of inefficiencies creeping into the system because of that, also because in their wisdom the government has, with noble objectives in mind, of course, also restricted the lending rate at which these priority sector loans can take place.

So the Committee has actually laid a path in which the financial system can be incentivized to actually provide these private sector loans by setting up a secondary market for private sector loans certificates. So it will be sort of like the approach of creating rights to emit pollutants. Secondary markets of this sort can actually lead to much more efficient outcomes.

But in addition, other steps are needed like liberalizing interest rates, again, with the sort of safeguards in mind that the Committee is very explicit about.

But in addition, the overall credit infrastructure needs to be improved, and there are very specific steps that one can take that, independent of everything else, can actually make the functioning of the credit markets work much better in terms of providing access.

The other issue is about leveling the playing field between banks and non-bank institutions, because in India traditionally, there has been this grand bargain whereby the banks essentially are allowed to take deposits at relatively low rates in return for fulfilling some of the social objectives of the government -- priority sector lending and so on.

And at the same time, non-deposit taking institutions of the non-bank finance companies have been given much more free reign. So this is actually making the banks a lot less efficient and creating a lot of regulatory and other inefficiencies in the system.

So the banks still remain a very important player. And the public sector banks are still a dominant player.

There is this notion again that public sector banks are somehow not quite efficient as private sector banks. It turns out that there are banks in India, the public sector banks, that are doing very well. For instance, the SBI, or the State Bank of India Group, has actually had very good profitability rates. They are still constrained in many ways, and in terms of certain objectives, like financial inclusion, they may not be doing that well.

But the banking system again does respond when it has the right incentives. So even though the public sector banks have been profitable, they have been falling behind in a variety of dimensions, and, as I said, their overall business model is going to be -- become increasingly unviable because of these restrictions that they face.

So we don’t advocate a one-shot privatization, which I don't think India is ready for, nor is it absolutely essential. But even the existing private sector banks can be much better governed and some degree of consolidation could actually make them work much better.

But there are other simpler steps that could be taken. The regulator does work with a very heavy hand in India, and ATMs, for instance, are almost treated like bank branches, and there are very significant restrictions on opening up of bank branches or, for that matter, ATMs. So allowing much freer branching, allowing universal banking, and allowing for much more consolidation in the banking system could actually make it work a lot better.

Now the broader issue of making markets, financial markets, much more efficient and liquid is also something that was very important to the Committee, and, again, we think about it as not just the banking system, although India's financial system remains largely bank dominated, even though the stock markets are developing very well.

So we’ve argued that much more of the regulation of trading should come under a single regulator, which is the Securities and Exchange Board of India. But in addition for a system that is developing very fast, there are still many missing markets.

For instance, the regulator -- there is a Bank of India has been very concerned about allowing derivatives products. And, in fact, recently, with the increase in commodity prices, like in many other emerging markets, there are concerns that it's speculation that is driving up prices.

And the government has taken the approach that many of these markets may, in fact, lead to speculative activity that is not good for financial system debt.

So we lay out a very strong case why certain missing markets may actually make the financial system work much better. But there, in fact, there is progress.

In our draft report we push very hard on currency derivatives markets being set up, especially if the exchange rate becomes more flexible, and although we won't take credit for it, just a couple of weeks ago, in fact, currency derivatives have been allowed in a restricted way. But it’s still restricted in the sense that foreign investors are not allowed to participate; non-resident Indians are not allowed to participate easily. So much more can be done even in that sense.

The regulatory environment has actually improved quite significantly over time. And again, one must give credit for the fact that India has managed to get by without crises, but there is a question again whether the regulatory system is up to the task of managing what is becoming a much more complex financial environment.

There is a great degree of very rule-based approach to financial sector regulation and a fair amount of micro management that we could pick up as we talk to financial market participants and look to the regulations themselves.

But more importantly, there are a lot of regulatory gaps because many regulators have a very specific silo-based approach to thinking about regulation, which, as new products and markets are coming online, leave certain gaps in the system.

And, also, as these markets become more enmeshed trying to think about regulators regulating individual parts of the system, it’s just not working very well.

So we’ve laid out a case in the report for a much more systemic approach to regulation that is based on principles rather than rules.

Now again, principles-based regulation is getting a bad name these days, but I think ultimately this is the only way that a regulatory system can actually allow financial innovation to prosper without completely stifling it. So we think that, in fact, an approach where you do have a much broader perspective on regulation, perhaps unified under something like a financial sector oversight agency, which in the report we lay out as a very specific structure and character, could actually make the system work a lot better.

Likewise, bringing the supervision of all deposit taking institutions under the idea could make that part of regulation work well as well.

But ultimately, there is a supply side to this -- and I’m using the words of Tarun Khanna here, in fact -- much of the report focuses on the supply side of finance. But there is a demand-side as well. And in terms of the demand-side, financial literacy is actually something that we think is important as well. We don't spend as much time on it in the report because we were focusing largely on supply-side elements, but I think setting the stage in motion for reforms there is going to be important as well.

And finally, we think of there being a body that could sort of push all of these things together, not only in terms of the broad elements, but also the very specific elements.

Now India is a democracy and a vibrant democracy at that, and, as Lael said, it’s not just India but other countries that try to take important steps that many people agree on, and it's just very difficult to push them through the system. And there are, of course, many steps that are difficult to get consensus on, so the Committee has actually taken the approach that what we need to do is not just think about the next five to 10 years, but also think about the low hanging fruit that we could actually capture.

And here we have a lot of very specific

suggestions. Things would be fairly easy to implement. It just needs a little bit of will. For instance, one simple thing is the fact that many agricultural producers essentially leave a lot of goods at the warehouse, and then the capital sort of gets frozen there. If these warehouse receipts could be made electronic and you could have trading in a secondary market of these warehouse receipts, it would actually make workers collateral and increase the amount of credit available to the agricultural sector with just a very simple setting up of these markets. And clearly, India is able to manage the technical infrastructure of these markets quite well.

So there are many things like that that we think would have a pretty big bang for the buck.

There are other issues that are technically not that hard. For instance, this big macro issue about an inflation objective. Now this is roughly the way the Reserve Bank manages things already, because there is a consensus in India that high inflation is a bad thing. So the Reserve Bank does have room to work on inflation, but, again, the Reserve Bank is being asked to do a variety of things.

So if the Reserve Bank, in fact, had just one objective, we argued that it could actually make things a lot easier for the Reserve Bank to do what it could be good at doing rather than having multiple objectives.

But again, difficulties exist even at the philosophical level.

And then there are issues that are technically and politically difficult. For instance, thinking about some of these aspects of regulation requires statutory changes, and, there, of course, lots of interests in terms of how one creates regulation in an efficient way and in addition how one sells it to the government and to the public.

But we felt it was important not to take these issues off the table, because ultimately in India, as in many other countries, it's important to introduce ideas into the debate and let these ferment over time and eventually have a payoff.

So let me just sum up by saying that I think and I think the Committee largely felt that India’s financial system really is at a turning point right now, because India has been growing very fast.

But, in addition, it's becoming a much more complex market-oriented economy, and its integration with the world economy, through both trade linkages and financial linkages, has increased very significantly and is going to continue increasing.

So the vulnerabilities in the system are, in a sense, going to increase. So the options as we see it are either to put some of these reforms in place and have a plan for a much broader set of reforms, which would allow the financial system itself to be a source of job creation, and promote these things that we ultimately care about, like growth, stability, and inclusion.

And the risk is that if some of these reforms are not put in place very soon, or if they're taken in a very reactive way, I think with the sophistication and rising openness of India, it's going to become an increasing source of risk.

MR. KHANNA: Okay. Is that it? Good afternoon. And thank you also for coming and thank you, Lael and Eswar, for inviting me to comment on this report.

When I was asked by Eswar to comment, I said it sounds like a useful thing to do, and I was dismayed to find a 260-page report show up. So, in my usual procrastinating style, I didn't do anything about it until just a couple of days ago. And I'll confess that I've had an opportunity to read the -- two or three chapters in some depth, and not a couple of the others.

So I’m going to take the approach of picking a couple of issues that are close to me in the spirit of adding some value, because I think I know much more about some things than others, in particular much more about the microeconomics of the financial sector and the real sector in India and countries like India, and less about inflation, growth trade-offs, and employment trade-offs, and I'm going to stay away from those with your permission.

What I also thought I’d do is I’d tell you a story, because it’s afternoon, and it's Friday afternoon. I think I can accomplish as much through a story as to enunciate it in general principles, and I promise you that this story will have the principles in it. And then I’ll summarize the principles at the end of it.

The story is about really -- it’s not really a story story, but it’s a real ongoing interaction, and I'm afraid since this is a public meeting, I can't name the companies. But I'll identify them roughly.

So these are two companies whose -- that I'm very closely affiliated with, one as a long-term investor, and one is a board member. And one is the real sector, and one is in the financial sector.

So the real company that does something is think of it as Sam’s Club for businesses, all right. So it's a wholesaler. It takes large -- there's some buzzing sound coming out. I hope it's not --

MS. BRAINERD: Your Blackberry is off?

MR. KHANNA: My phone is off, but -- think of it as a Sam’s Club for businesses. In other words, it is not allowed to sell directly to end consumers. It only sells to businesses, small restaurants, roadside stores, things like that.

So it’s a B to B business, business to business business.

And it’s a European corporation, a multibillion dollar corporation. It's one of the biggest companies in the world by sales, and you would recognize it if I mentioned it. Let’s leave it at that.

And it is, of course, tied up in knots, because India does not permit foreign direct investment into retail, but does permit foreign direct investment in certain kinds of wholesale business services. So that's what this company does in several locations in India.

Now this company, which I’ll refer to it as a wholesaler, would like to obviously force their products to rule India, (inaudible) there because some large proportion of people in India -- I always forget the number -- 60, 70 percent still live in villages, and it would be a shame to lock them out of -- I should say this company’s been successful in at least 40 other countries, including many countries that are of the same type conceptually in terms of their developing status as India. So it's very successful.

So the problem is that it doesn’t quite know how to get its goods and services to rural India, because it’s -- it doesn’t have any information on people in rural India, which should not be surprising. There's no infrastructure in rural India to actually accumulate this information and make it publicly available.

So it turns to this other company, which is a very prominent microfinance company, I think one of the best -- certainly the best in India, probably one of the best in the world, very, very rapidly growing, including the ones in Latin America by operating metrics. And these guys know a great deal about their customers. Their customers are all rural women, and micro-finance I'm sure is familiar in Washington circles, but the idea is you make very small loans to very poor people, typically women, and they use it for all sorts of consumption or investment purposes to finance a very small business or to buy livestock or buy agricultural equipment, et cetera.

Now this micro-finance company would like very much to provide more and more good things to their customers. But they're basically a financial institution, and don't want to get into the business of providing wholesale goods and services.

So the wholesaler turns to the financial institution to say you know your customers. Tell us about them. And the financial institution turns to the wholesaler and says, well, gee, you have all these goods and services. You have the relationships with the global multinationals and local companies. Why don't you make baskets of goods and services available so we can get them to the poor women, and really radically change their standard of living. And I mean radically change their standard of living with the provision of a vast basket of goods and services that you and I would take as elementary, but are vastly under provided in rural India.

So it sounds like a match-make in heaven. Alas, there is all sorts of regulatory morass and barriers that prevent this.

So let me list some of the more prominent ones, and that only scratches the surface. The wholesaler discovers that because of restrictions on being a wholesaler -- it's not allowed to do retail -- it cannot go directly to the customers. It's not allowed to. It would be in violation of Indian law.

So it says to the micro-finance company what if you take the goods and deliver it to the customers. Well, the micro-finance company is technically any non-bank financial company, NBFC, which Eswar just alluded to, and NBFCs have all sorts of rules and regulations around them, one of which is that they're not allowed to take deposits.

So this particular financial institution is entirely funded in the capital markets; right -- and through bond issuance and so on and so forth -- all through banks.

So the financial institution says we'd like to, but we'd be -- our legal counsel informs us that we would be in violation of our NBFC license, because we'll have to deliver this basket and they'll have to pay us for it, and that payment will be construed as a deposit. And so, we can't take it.

So one can’t take the money, and one can’t return the goods. So now, we’re in this horrible conundrum in real time where we’re trying to figure out how to induce yet another private sector entity to enter into this morass to run this experiment, which ultimately is an experiment in, say, 10 villages in one state in India to deliver these goods and services.

So here we are sort of mucking through this and I’m taking my calls and trying to figure out if there's any other poor hapless corporation that I can drag into this experiment and impose this crazy idea I had on them.

And then comes another legal counsel saying, wait a second. It’s actually worse, because we just discovered that this micro-finance company, which is a quintessentially grassroots Indian formerly NGO, right, is actually classified as a foreign institution.

I said hang on a second. This entity which came out a village India is a foreign institution. While, it turns out that because it's operating metrics are so good, it's the first micro-finance company certainly in India, possibly in the world, to attract a large corpus of investment from a major Silicon Valley venture capital fund, private equity fund, and, therefore, under Indian rules, even though it's not a large majority chunk or anything like that, it's suddenly become a financial institution.

And financial institutions, lo and behold, of foreign provenance are not allowed to do pretty much of anything. So here we are technically in violation of many different things with this experiment, and I'm confident, since this is India, that we will muddle through and find a way to actually deliver goods and services, but it will take an extraordinary period of time and a lot of hemming and hawing and bending around the rules and having different people issue different kinds of missives on our behalf and exceptions and so on.

So that's the story, and it's a real thing. And here are the principles that I think it enunciates.

First, why are -- why are these -- the micro-finance company and the wholesaler engaging in these contortions? Competition is a simple reason.

The first -- the micro-finance institutions faces enormous competition from other financial institutions, including large banks that are getting into micro-financing in India, and feel that it must distinguish itself from other financial institutions. And its way of doing it is to try to lock its customer base to itself. The customer base currently is not very sticky. If somebody else comes along and offers better terms than its own, it will switch.

And one way of locking it in -- I had

suggested to the micro-finance company -- was why don't we build a relationship with the clientele by bundling your provision of financial instruments -- loans and increasingly other financial securities, simple financial securities -- with some real assets as well.

So it is entirely motivated by the specter, a credible specter of very real competition nipping at his heels. So that’s the first thing; that absent competition, it's very unlikely that financial institutions of any stripe -- and I'm using a micro-finance example to make the point -- absent that competition, you're not likely to see anything.

In fact, many of the successes that Eswar put up in his presentation I think can be traced back to competitive impulse. The most -- perhaps the most celebrated example in India is the National Stock Exchange, which has out competed, I think it's fair to say, a much more incumbent Bombay Stock Exchange and forced both of them to raise their game with the result that the equity markets are actually reasonably well functioning, or even the state-owned banks, the State Bank of India that was referred to in the presentation, is a I believe a much better running institution today because of the rise of other private or pseudo-private entities like ICICI Bank and others coming in.

So you see the imprint, the constructive imprint in this case, of competition pretty much across the length and breadth of the financial sector where for competition is allowed to breathe a little and do its thing, work its magic.

The third point I'd make, so there's competition in both the real sector, which is a -- I'm sorry. I made a point of the competition in the financial sector.

There's also competition in the real sector, which is why the wholesaler is busy trying to do this complicated experiment for the financial institution to get something done.

Further, there's complementarity between the real and the financial sectors, which is the point that I wouldn't expect the report to go into, but I think is worth noting that absent -- that none of this financial experiment would occur -- that the financial system is ultimately a lubricant to the real economy, conceptually and practically, and absent the experimentation in the real economy, there really isn't a need for experimentation in the financial sector, and there really isn't a need for development of the financial sector.

It’s kind of like the old stories of the chip and the software, you know, in a standard PC. Until the chip gets more powerful, you can't put complicated graphics on it, and you can't put complicated graphics if the chip is more powerful. I think the analogy is more or less exact.

So the complementarity is a point that I wanted to highlight.

A fourth point is that -- is to consider the role of the regulator. And, you know, here's my sense -- and I don't think that the financial regulator is any different from the median regulator in India. The regulator generally is a very high caliber individual, a laboring under some, to my eyes, strange incentives.

And I suppose a constructive way to think of it is that it used to be that an experiment of the sort that I just described between a micro-finance company and the global tens of billions of dollars wholesaler would never have happened historically. If it had happened, the regulator would surely have shut it down immediately, saying that the foreign company with billions of dollars in its balance sheet is out to squeeze poor Indian women in rural India. And they would have shut it down immediately; right.

So that fact that it isn’t happening is actually hugely positive. And I'm not being cynical. I do believe that it's a sea change in mentality that's happened in the last decade; that we shifted from a regulatory process that's forced things out through the regulatory process that indulges experimentation. It has failed to abet experimentation, but I hope that we'll eventually get there.

And I think the way we might get there is over another 10, 15 years, but through a new generation of bureaucrats who will be trained in different ways and will see the world slightly differently from previous generations.

Currently, the regulator really has no upside with encouraging experimentation, absolutely no upside. And, you know, I believe that, on average, most people do respond to incentives, so it's not a question about motives. And their incentives really on the -- to do something positive and to take a risk, because the experiment that I described is usually risky, but the fact that both companies, the micro-finance company in India and a globally leading wholesaler of goods and services are willing to put enormous amount of time and energy into it suggest that they’re willing to take the risk; that it’s a risk that’s appropriately priced in the market in some complicated sense.

But the regulator has no incentive because he or she keeps none of the upside, but certainly keeps a lot of the downside. If something goes wrong, then they will be -- they will be visited upon by the full wrath of the so-called -- what is it called -- Vigilance Commission or something like that, which is a policing entity by the government, a well-intentioned policing entity to make sure that there’s no fraud and so on and so forth, but incredibly draconian. And the last thing you want to hear is a bureaucrat in the Vigilance Commission is looking into you, because this is a Kafkaesque process that might take, goodness, I don't know, a year or certainly, if not longer.

So why would you want to do that as a regulator? I wouldn't want to take any experiment. I would simply find some reason to dismiss it; right?

So I understand where the regulator is coming from. And on the margin, I see this very positively. The regulator is allowing this experiment to proceed, and as I said when I narrated the little story, I do think it will happen, but with a lot of contortions.

And I think with slightly better, more proactive regulatory incentives, we would see incredibly more experimentation going on in the financial sector as well as in the real sector.

So that was my fourth point. I’ll make one last point, which comes out of this example, which is that -- and Eswar alluded to it -- which is I think that the -- that there is one important aspect of the report that I wish had been highlighted more. And I wish it because in another company that I'm involved with, which is a financial advice startup, right, I have to confront this daily. This is a startup called

I-Trust in Delhi, where a couple of my students have created a small company to provide financial advice speaking loosely to professionals in the Indian labor market who, for the first time, have let's say $5,000 of investable assets in their pocket.

And there are a very large number of these folks, and none of them existed 10 years ago, right. So it’s a start up.

But they have to engage in enormous amounts of education about financial services, about the most elementary things. And the way they do it, as true entrepreneurs, is in every possible way they're trying to figure it out. They have newsletters. They have a web presence. They have a TV show where they answer questions and kind of ham it up to make it exciting so people tune in.

And as good entrepreneurs, we track the response to the TV shows to make sure that actually we’re getting a bang for the buck, et cetera, et cetera. But through that involvement, it’s become transparent to me that even educated, sophisticated professionals have very limited understanding because of the fact that financial markets have not been something that you have to engage with beyond having a savings account or a postal deposit account or a savings account. And there needs to be an education process. And I think the private sector needs to be involved in the education process itself, much like this startup is doing.

And this is even more egregious, the more you become concerned about financial inclusion. So in the case of the micro-finance example, boy, this is a place where without any financial literacy attention, everything comes to a screeching grinding halt completely, because the end -- the person at the end of the financial supply chain in this case is a woman living hand to mouth and a family around that woman living hand to mouth, and the last thing on her mind is financial security for insurance or crop insurance or any one of these fancy things that people at Brookings and Harvard like to talk about, and until and unless she espouses a deep felt demand for it, and is willing to put some of her hard-earned money on the table for it, nothing happens. All this stuff is -- nothing that I described would happen. Nothing I described would happen.

And in practice, when I think about a board meeting at the microfinance company, that’s what we talk about. We talk about basically education of our people to get them to realize how important this could be to their lives, that it would improve their lives not twice or four times, but a hundred fold or thousandfold in a very meaningful, measurable sense.

So I wish that at some point in the future that there is some attention that some combination of luminaries and eminences can pay to financial literacy and what I refer to and Eswar adopted is the demand side of financial reform, in other words, educating those who demand financial securities or transforming what the report calls latent demand. That transformation process from latent demand to realized demand I think is hugely complicated and probably not well summarized as a black box.

That said, the report is 260 pages, and it’s an incredibly good report.

So I want to say one last thing about the report, which I think its singular contribution in time will turn out to be that is advocating a much needed repositioning of the mentality of the system to different point on what I'll describe as the risk return frontier; in other words, we are at a particular point on the risk return frontier where we take no risks and we get no returns.

And that was fine. You kind of bungled along in your own closed economy autarchic way and now that the world has opened up, and, as (inaudible) and his colleagues have pointed out, you know, we’re in an uncertain world. It is more costly to stay where we are, and we have to incur the risks so that we are not confronted -- we meaning people who are subject to the Indian financial system and this particular session -- but more generally absent taking on that different position in the risk return frontier, we probably will find ourselves in deep doo doo to use a technicality.

Thank you very much. That’s all.

MS. BRAINERD: I was going to add to -- throw in a question or two, and then I’ll open it up. I think one of the questions is just here you have a report -- it’s 260 pages long. There are a lot of potential stakeholders whose lives could be affected if the report were adopted in full, and yet the debate out there is about the inflation target. What's going on there? I mean one is that the single controversial point that has attracted so much attention as opposed to all the other things which would have a more direct impact on many of the stakeholders in the system?

MR. PRASAD: The one nice thing about India is that anytime you propose something that is a debate, and a very lively and vigorous debate as a matter of fact. I use the word cacophony to describe that because Indians like to talk and you heard about the argumentative Indians, and they argue in public and print and so on. And it turned out to be a particular conjecture that it is because at the time the Indian rupee had appreciated quite significantly by almost 10 percent over a one-year period, and there was a great concern that, in fact, this could harm the manufacturing sector quite significantly, and it also came in at a time when the Reserve Bank of India was essentially patting itself on the back for having achieved very good macro economic outcomes, and there was a very rich debate out there about whether this thing was going to be sustainable and what the right framework was going to be for the Reserve Bank of India going forward.

Some of the other recommendations were very technical in nature, but things like inflation get the passions inflamed in India, so I think it was partly a result of that.

Now over time, the debate has become somewhat broader, but it is true that at the time, the macro part did receive a good deal of attention, mostly because of circumstances being what they were. Do you have any other thoughts on that?

MR. KHANNA: No, I mean, I think this debate has actually been planning -- there’s a correlation in some sense, which is that this debate is actually happening in every developing country, but inflation it just happens to coincide with (inaudible) of the report, so a conflation is a good term.

MS. BRAINERD: I guess another question is I think the way you do it is very interesting here. You've got small steps. You've got low hanging fruit. I mean, this is not your typical economist report. It’s pretty savvy about the political environment, and yet it's not clear who are the stakeholders that are going to push in your democratic system that you described to adopt these. I mean, you know, if you looked at this kind of a debate taking place in a political system like the U.S., you really do have some very powerful interests that are pushing. And yet, if you look at -- in the Indian system, where is that source of demand, not maybe at the micro micro level, but, you know, at the sort of powerful interest level to kind of push these recommendations forward.

MR. PRASAD: There are two sets of stakeholders that I think the ultimate demand would have to come from. One is from the burgeoning middle class, which is seeing that financial reforms can actually help them in a variety of ways.

But I think the bigger issue is related to Tarun's point, which is a very important one, about how do we get the grassroots person to, in a sense, realize what he or she is missing, because the (inaudible) is partly not there. One can think about it as a financial literacy issue, but these are not things where there is a clear conception of what can be achieved through a financial system. There is some degree of a culture of a dependence on the government that if something goes wrong or if you need to achieve certain social objectives like reducing poverty, that should be done through the redistributive system of the government.

And I think recognizing that some of this could be done through the financial system is something that we hope we can start getting the message out through this, but that has to be tied in with this issue of financial literacy, getting people at the grassroots level just plugged into the financial system. And I think with that, you'll have much more of a demand.

The other major stakeholders I think have been pushing for a while, but they are seen as having interests that may not necessarily be aligned with those of the common man.

But I think, in fact, there is a commonality of interests.

MR. KHANNA: Can I just make this supplementary point? I mean, I think this is a bit of a caricature, but I think one of the big differences between Indian democracy and U.S. democracy is that in the U.S. the political inclusion debate is about the socioeconomic leave less advantaged; that we worry about how do we get the person who’s not able to get to the voting booth to the voting booth.

In India, it’s a flat -- you know the rich have generally abdicated from the voting process, and are politically disenchanted I think as a way to say it. And, therefore, the person voting is the poor person. Unless the poor person pushes for financial reform, ultimately the votes just don't add up to get the politician to do something.

And that’s where the constituency has to come, which is what makes the literacy issue even more I think, literacy in a sort of encompassing sense, much more important.

MS. BRAINERD: Let me open it up to questions. I’ll ask you to identify yourself.

MR. KAROFSKY: Yes, I’m Per Karofsky. A couple of years ago, I was an executive director at the World Bank, and some have even told me I'm reincarnated as an Indian. So let me just phrase a question here. And this is in reference with the lack of incentives for the regulator, because when we read third in these uncertain times, financial stability is more important than ever. We are receiving a message again that they were taking away incentives for the regulators to do anything, but only to be concerned about banks and financial system not defaulting.

And if I've gone to a party and if I have a headache, I put my headache in reference to how good the party was. So we need to find a way -- if the whole cycle of development -- hmm -- the boom cycle and the trailer thereafter, if it's been worthwhile. But we're focusing so much on just strictly financial crisis itself, so we're not measuring the overall cost, which makes it difficult for us to see things like the big benefits that South Korea had with their financial crisis when compared to the very few results that the current crisis in the U.S. seems to have produced.

So put that overall cycle in perspective is something that I think that I would like to hear some comment on.

MR. PRASAD: Tarun characterized it very nicely as this decision about where we are in the risk credit frontier, and we have chosen -- the Indian regulator has chosen a high degree of caution as being the right approach to this. And the notion has been that the results are there for all to see during the times of the Asian financial crisis and during the recent turmoil, the Indian financial system has sort of held together.

It’s much harder to measure the foregone benefits from allowing some degree of financial innovation and promoting financial inclusion. And those benefits to tend to be spread much more broadly. And that's sort of what we tried to push very hard in this report; that an excess of caution in a sense may protect you from a lot of things, but it creates its own risks over time.

As this economy becomes harder to manage, unless you take certain steps, it is going to be a problem. Let's take -- I'm any macroeconomist, so I lean towards macro issues -- when you think about macroeconomic policy, the notion that having an inflation objective constrains the Reserve Bank of India, and that, in fact, in this setup, having a degree of freedom to manage the exchange rate of sometimes, to manage monetary policy and sometimes may, in fact, make things easier for the central bank.

It seems plausible and makes sense, but the reality is that it confuses everybody that makes the central bank a lot less effective at what it does. When you think about the food price inflation now, there's nothing a central bank can do about today's prices. But what monetary policy can do is manage inflation expectations three years down the road.

And if there is this multiplicity of objectives and the market is not entirely sure, if, in fact, you will have this focus on inflation, which allows inflationary expectations to generate their own dynamic and possibly get out of control requiring an even harder attempt to bring down inflation in the future.

Now one can think of very many examples, even from the financial system, where the lack of innovation essentially imposes costs, although these may not be entirely obvious. So I -- I mean, my sense is exactly along these lines: that you need financial stability, but the approach towards financial stability is not to hunker down and shut off the walls and limit financial development. Some degree of risk-taking and I think ultimately is what will lead to broader stability.

MS. BRAINERD: Tarun, did you have a

comment? Other questions?

MR. KHANNA: I don’t have a mike here.

MS. BRAINERD: Oh, sorry. We’ll come back to you.

MR. PRASAD: You have the power.

MS. BRAINERD: You’re next in the cue.

SPEAKER: Okay. There was a few slides on the Indian stock market. And I think it is a positive twist that it's deep, especially the last four or five years, the portfolio flows have been sizable.

I want to allude to one fact which happened last year and see your view on that because I personally think it is a very important step by the regulator. And the question would be, the question is, like, what do you think of this step? October last year SEBE passed a ruling on the use of participatory notes in Indian equity markets. Why is this important? Half the flows coming in recent years, FIA flows, were through P-notes, participatory notes -- I'll just call them P-notes.

I personally think they were very volatile. There have been episodes in ’04 and ’06 where the market just tanked, and the P-notes were the catalyst for some of this. There have been inquiries that SEBE has been in the corner, et cetera, et cetera.

So the long and short is, do you think the regulator, who I think took a very important step, probably after the BOP crisis in 1991, they attracted FIIs through this treaty and this and that.

Finally, in October, they made a major change. Is this -- was this change good given in light that Dubai has come up with Indian rupee futures. Singapore has the NDF market. A lot of FII stuff can be done from around India than out of Bombay.

And if you think the regulators to do the job, can you explain the market decline from 20,000 to 12, 000, giving you also say the stock market has deepened?

MS. BRAINERD: You want to summarize that question?

MR. KHANNA: Okay. The question is essentially about these instruments called participatory notes or P-notes. In India, foreign institutional investors are allowed to come in, but they have to register, and many FIIs don’t like to register, so the participatory notes are effectively a way of getting around the registration requirement.

That is, a domestic or foreign financial firm can issue something called a P-note, which is restricted in terms of how many P-notes can be issued and what the institution issuing them has to do in terms of registration. But then the person who invests through these P-notes is in principle anonymous, because he or she doesn't wish to be identified or go through these registration processes.

So it’s a way around. But a more fundamental question is why do you have P-notes, and that I think is the crux of the issue. You have P-notes because there is an attempt to control capital flows in a very particular way and to put restrictions on capital flows in a particular way. This might seem like relatively innocuous restrictions at some level -- some of the registration requirements.

But again, there are registration requirements, and there are registration requirements. And as Tarun alluded to in his point, some of these can become relatively taxing controls in terms of getting through the bureaucracy.

So the participatory notes were a way of capital coming into the market, and there was a sense that these were not being handled very well. So there were restrictions imposed on P-notes.

So, as I said, the crux of the issue is why do you have P-notes existing. What are these requirements that make foreign institutional investors who want to bring money into the India use this very complicated rule. And therein, I think, likes the real problem.

Given all the regulations that there are in the system, there are these artificial ways of trying to restrict the flow of capital, and they end up not working terribly well, and they, in fact, lead to a little more murkiness in the system.

So, in fact, there have been various committees that have looked specifically at the issue of whether P-notes should exist or not, and that is a whole debate in itself.

But to me, again, the fundamental question is what are the distortions in the system that creates room for instruments such as P-notes to exist and are they distorting things further.

Now, I didn’t mean to argue that the Indian stock market is the paragon of efficiency. It's a bright spot in a financial system that has improved in many ways. Compared to, say, the Chinese stock market, it works a lot better. Compared to many other emerging markets, the technical infrastructure of the trading systems are very good. It's become a lot deeper over time. This is not to say it doesn't have its own problems. In fact, in terms of the regulation issues, I think there are serious problems that still need to be confronted.

The other part of your question was about the currency futures and the fact that some of these derivative transactions can be done in places like Dubai and so on, so why bother about Bombay. There again, the way I see it is that it suggests problems in the system, because if there is such a lack in demand for hedging currency exposures, because, after all, India is becoming much more open, and firms are being exposed to this currency volatility.

It doesn’t make any sense to restrict these trading in India, have it migrate offshore, and this way the regulator, which tries not to allow this market to be fostered in India and tries to solve its problem, ends up pushing the issue of broad, and, therefore, has even less control.

So this comes back to the earlier question. This notion of cautiousness actually ends up creating even bigger problems at one level. So I think that again to me is emblematic of problems in the regulators' minds and because there is a clear demand for something, but rather than let that market thrive in India, again with the (inaudible) regulation and so on. It just gets pushed abroad, where it's even harder to control.

So I would view both of these as manifestations of deeper problems in the system.

MS. BRAINERD: Okay.

MR. CARDENAS: Thank you. Mauricio Cardenas from Brookings. I very much like the approach that the Commission has said in terms of upgrading India's financial sector in terms of a series of small steps, and it's more of a long-term agenda. But one of those were some of the steps are more important than others. And I wonder what the Commission thinks about pension reform, because pensions are, you know, I would say one of the most important steps in the process in order to generate long-term savings and also in terms of the development of the demand for products in the capital market.

So that's one aspect in which I think the payoff could be the largest. And talking about other important steps that you mentioned in your presentation, but I think the Commission also worked on, are the issues that are more related to the micro structure, issues like creditors' rights, the flow of public information about debtors, credit bureaus, things like that that are the areas in which reform is the hardest for political reasons, at least judging from the experience of Latin America, because that's where the end user of the financial sector is more at odds with the reform because it's easy to portray these reforms as something that's going to hurt the people rather than benefiting them.

So I wonder what the Commission thought about these things related to the micro structure.

And if I might say just one final point. In your two stories, to me, the common theme is still a sense of reluctance to foreign capital, some apprehension towards foreign capital. And I think in today's world, it's really hard to upgrade the financial sector without access to that capital, because, by definition, this is a sector that requires a lot of capital. And, you know, there are the funds -- venture funds -- everyone waiting to make investments and it’s a sector -- and unless you soften a little bit those restrictions, it’s going to be very hard to have India -- India's development of the financial sector at par with its own economic growth.

And at some point, we’re going to see economic growth in India slowing because of the lack of development of the financial sector, especially because of the needs that India has in terms of infrastructure. So I think that apprehension -- I don't know what -- I mean we could go, you know, centuries back to understand it, but that apprehension is going to hurt at the end development of the sector.

MS. BRAINERD: Tarun?

MR. KHANNA: I’m in complete agreement with the last point that ultimately these are symptoms of apprehension of the financial sector. This in the interest of being a little bit provocative, let me say that some of that apprehension I think relative to the liberal consensus here has reasonable efficiency roots and some of it is pure rent seeking and protectionism, right. So the rent seeking part is easy to understand. That’s the stuff that we've discussed here many times in these forums, where, you know, industrialists and protected people like to be more protected and like to have a semi-monopoly positions and marking power and so they resist entry of all sources, especially foreign entry.

Now that part I understand. But there is a sense in which relative to a benchmark like China, which has been much more open to certain kinds of financial flows, certainly on the direct investment front, which India is still very resistant to, one has to remember that the opening up to FDI in a place like in place like China happened in the aftermath of a draconian event, the Cultural Revolution, where everything was wiped clean and there really wasn't any option, realistic option, to jumpstart growth without going to the overseas Chinese to help out, which is really the genesis of FDI and of that FDI wave.

In India, there was no such draconian event.

There has always been an indigenous industrial class. It was never wiped out. Some of them are, I think, extremely good industrialists, even by world standards, and lately you've seen the flowering of some of those. And some of them are, you know, people surviving under protectionism.

So there’s a good news-bad news side for the allergy towards continued foreign investment.

But at the end of the day, I do agree with you that from the regulatory standpoint, there is still a fear, and I just come back to my earlier point that unless the regulator sees that there is some upside to experimenting, there really is no reason for them to do it. There's only downside to it.

So I think the interesting policy question is there anything proactive that commissions like this one for others or other well-minded folks can do or suggest that would move us a little bit faster in that direction other than waiting for a generational transition, which is all too slow.

MR. PRASAD: Let me add that on issues like pension reform and so forth, I think there is a clear feeling that those also come under the rubric of financial inclusion, which is not just about providing credit, as used to be the traditional notion. But in India, this also ties into the notion of actually that bridging that last mile, because that actually is very important even when you think about things like pensions. How do you deliver these social transfers to the person who should be receiving them? You don't have efficient mechanisms of doing that. So there have been approaches like thinking about banking using mobile phones, using retailers who could have direct access to customers. But this is where the regulatory constraints have become very binding. But they need to fix this last mile problem in addition to thinking about how to structure things like the pension system.

So unless we solve both of those, the inclusiveness is going to be very hard to accomplish.

MS. BRAINERD: All right. In the back. Why don’t we take -- actually, I’m just looking at my watch. Why don’t we take a series of questions and then you can respond to them. So, again.

MR. CHUNDRAN: I’m Sara Chundran. I work at IEO at IMF. I was very fascinated to listen to all the three of you because I had the experience as a policymaker in India in both at the national level as well as at the state. And I'm fascinated by the last recommendation that we should be the focal point. We should be pushing these reforms, and you suggested that a committee at the level of the finance minister would be a good thing because if you look at how the reforms have taken in the '90s, there was one entity, which was the finance ministry which was pushing the reforms and the current prime minister and (inaudible) they were in the lead.

I think if you need -- if you want to see the second wave of reforms, and I -- you need to identify a critical point where these reforms can be pushed. The question here is, it's an unenviable task to present this report at this time when the financial sector is having so much strain even in a free market economy as the U.S. to sell this idea to the policymakers. And, as you said, there's a large debate, but having defined a particular agency to push us is absolutely -- I think that's a very good point, which I thought resonates.

But my issue is you said reforms need to take place in a broader front and on the fiscal side, on the financial side, and maybe on, you know, these sub nationalist.

Again the question is that the risk involved in making a quick change, as you said, you know, does the country have time to wait or does it have to move along quite quickly? But the political ramifications of a failure of a sudden opening up of some of these bright ideas which you brought up is so grave that a finance minister may not be able to take that kind of risk. You know, this is one constraining point.

And what I see as a brighter light in this particular set of issues is that, as you said, for the Reserve Bank, it’s becoming almost difficult to manage three different policy goals, and the capital sector is opened up. Would that momentum itself force a system to adapt and change and move forward, you know? And, you know that -- my feeling is that the momentum itself will make it untenable for these restrictive regulations were, or, you know, the constraining environment to last. Thank you.

MS. BRAINERD: You want to answer or you take a few more? Okay. Let’s take a few more. Yeah.

MS. ABASA: Hi, I’m Freya Abasa from the

World Bank. And I was actually involved in some parts of this report, so, you know, I'm not pretty common on the report as such. But I would like to take it back to the point that you made, Lael, at the beginning about bringing in the stakeholders sort of into the process.

And I think this report more than any other report I've seen on the financial sector needs to bring in a wider constituency of stakeholders if the reforms are going to be pushed through. And why I say this is because I think the big contribution that this report has made is really on the financial inclusion agenda. There are a lot of really good suggestions. There are things that, you know, maybe long-hanging fruit, but the pressure for that really needs to come from those who are going to benefit from financial inclusion. It’s the poor in rural and urban India we need to push for these reforms.

And, as I’ve been watching the debates sort of in the media, in the Indian media, I find that really the debate doesn't really go beyond sort of the few elite in the capital cities of India. You know, those who are going to benefit from the reforms that are recommended are not really included in the sort of debate and discussion.

So I wonder whether, you know, you’re thinking in terms of, you know, maybe translating parts of the report into vernacular languages, bringing people who are going to benefit from these reforms more into the discussion, creating pressure not just, you know, amongst elite policymaking circles in Delhi, but, you know, pressure from below, a sort of -- you know, from the grassroots. So that's one broad comment I had.

And the question I had was you talked about financial literacy and, you know, the importance of that, and I couldn’t agree more with you.

But who do you think should do this? I mean, who should be responsible for this? Is it the government’s role or, you know, just your sort of ideas on how this process should pan out over the medium term.

MR. PRASAD: On the first point, by I think is sending Tarun out into the villages to do our job for them. So that’s why we brought him on board.

MS. BRAINERD: Leonardo?

MR. MARTINEZ: Leonardo Martinez from Brookings. I just wanted to highlight one aspect that has been the downfall of many an emerging market banking sector liberalization program; that is, the links between the financial system and the non-financial large corporate sector.

Indonesia, for example, which has a financial system that in the ‘80s was comparable to that of India’s today, during its stabilization process saw a lot of its banks then become very closely linked to conglomerates, which then proceeded to engage in incredible related-party lending, which then fueled and led to the financial crisis and the banking crisis in ’97-’98.

The Koreans in the meantime set up their own commission for financial reform in 1997, and they were determined to avoid the same mistake, and so they impose some limits on the links between non-financial companies, the chaebol , and the banks.

However, the chaebol just simply bought up the entire non-financial -- non-bank financial intermediaries, and it led to a similar kind of outcome. I'm wondering in India is this also a concern? And what kinds of measures could the -- that the Commission, if it discussed this, recommend to avoid it? Thanks.

MS. BRAINERD: Let me do the following. We'll take that last 30 seconds, but I'm worried. You have a flight?

MR. KHANNA: Yes, I have.

MS. BRAINERD: Do you need to dash out or do you want to make a final -- why don't you make a final, you know, sort of nod, and then gather all his thoughts.

MR. KHANNA: You know, maybe on the -- was it Freya -- Freya's point of -- I don't have a good answer, but it's something that I hope that people can pay attention to, which is the literacy side in the demand side, because absent that, I just don't see any -- see that's the engine that moves the politician, which moves the bureaucracy. And, as you point out, even in the debates on TV, the poor people who are the order of magnitude beneficiaries of this financial -- alleged financial reform that will happen -- don't have a voice so that -- so society has to invest in finding a way to do that.

You know the record of the public sector in fostering education in India, as you know, is not so hot. So is it the private sector? I suppose, you know, perhaps it is playing more and more of a role, but it's -- my concern is more of a role in education in general. And, by extension, you would say that that would extend to financial education or financial literacy also.

But my concern is that I have yet to see a scalable solution, a solution that has some of that characteristic that you know you can multiply this a thousand-fold were 10,000 fold, because that's the kind of thing that you need, but absent that, at least a start that encourages that debate because there are millions of minds more creative than certainly than mine or even this room that it would be nice to get that debate going.

On the related-party transaction issue, my feeling is that this is not remotely as much of a concern here as it was in Korea and in Indonesia for a variety of reasons that one can go into. But I think it's an appropriate caution, a very appropriate caution, to learn from.

MS. BRAINERD: So why don’t you go catch your flight?

MR. KHANNA: Okay.

MS. BRAINERD: And thank you very much.

MR. KHANNA: Thank you very much. I’m sorry to dash out.

MS. BRAINERD: And we’ll finish up with Eswar.

(Applause)

MR. KHANNA: I’ll leave the mike.

MR. PRASAD: Okay.

MS. BRAINERD: And before Eswar responded, you were going to --

MR. MARTINEZ: Yes. A brief point again, with the regulators. They were so risk adverse, so they empowered the credit rating agencies, and they (inaudible) it was like (inaudible) over the precipice of the sub-primes.

So now, if there -- we cannot create incentives for the regulators to change, how do we change them, because they aren't really a closed circle. They have really drawn all their wagons against the Indians. They are very circled. You know, it’s very difficult to get in there.

How can we bring in new lines of thought to the regulators, because in many ways they are the prime obstacle at this moment for changes.

MS. BRAINERD: All right. I think that gives you plenty of material, and any final thoughts?

MR. PRASAD: Okay. I think the thread through all of these questions actually lies through Ms. Basu’s question: ultimately how do you get the people who should be demanding change to demand change. I'm a little more optimistic in the sense that I think the change can come if we can create a little bit of momentum here and there taking a few of these small steps, once it can be seen that the benefits are there and these benefits could be significant. I think we can have this happening now.

The regulator, of course, has been very concerned, again, as Tarun pointed out, with some good reasons. For instance, if you think about the small banks and their having an ability to reach smaller customers, many small banks were very poorly governed. You did have a history of problems with these banks. But then to shut off their entire system I think is rather harmful. So ultimately it has to be a few small steps that get people to see what possibilities there are, and then to have the demand come up from there.

Now financial literacy can have a role in this as well, trying to introduce these ideas into the debate. And again, Freya has the right point that some of these debates tend to be captured by a very, very small group of people who tend to define the terms of the debate, and I don't think that's productive.

So we have to get beyond that and find ways, perhaps through reaching out in more substantive ways, perhaps with the World Bank's help, to get these messages across. And we really need to do that.

So we have to start changing the debate at the macro level and then ultimately we have to get this change coming from the micro level, so I can’t pretend that we have any easy answers about this, and I think once we introduce these ideas into the debate, we need to think very hard about how to make these changes happen.

Now ultimately again, in terms of changing the incentives of the regulators, the groundswell has to come from the people who would benefit from these reforms. The education, the public debate all have a role in this.

And ultimately I think there are two ways that reforms come into place. Either you have a crisis or some sort of transformative event like that or you have personalities who become very important.

And this is an interesting juncture, in fact, where the present Indian government is not relying on the Communists for support as it was in the past, and there is a window before the next elections when things could, in principle, be set in motion. And I hear encouraging noises from Delhi, and there have been some changes at the senior leadership of the Reserve Bank of India which could help move some of these changes along.

The other thing, as the earlier question suggested, was when events sort of shape these polices, and that I think is a little unfortunate, because it does have long-term effects. So if you think about the Reserve Bank essentially not being able to manage these multiple objectives anymore, then it ends up eventually being driven towards an inflation objective, but, by that time, it becomes much harder to manage inflation expectations and to manage the process.

So it’s sort of a constructive way of moving toward. Likewise, on the capital account, this notion that we have the luxury of allowing controls to remain in place and slowly take them off, and that's becoming practically irrelevant, because if you put restrictions on one type of flow, it just comes and disguises another type of flow or it comes in through trade mis-invoicing.

So that doesn’t work very well either. So managing that process in more proactive way, although jargonistic as that word sounds, I think is a much better way of dealing with these issues. And the other effects are if you deny firms the ability to hedge their currency risk in India, the market moves offshore. And then, as a response, if you try to open up your markets, some of those markets are never going to come back, because there is an efficient trading platform outside.

So I think this again will start seeping into the conscience of the regulator that there are some real opportunities being lost.

This report, again, did not come from (inaudible). There was a previous report which talked about India becoming an international financial center, the (inaudible) Report, as it’s called. And that had a much more narrow focus and was much more ambitious in its recommendations. But I think some of the points made in the report are coming into play, but there are some opportunities that have been lost, and are going to be very difficult to pull back.

So in that sense, again, I think the juncture is a critical one. There are very rich opportunities right now in terms of the political environment, in terms of the demand potentially arising from the stakeholders who really matter. So one can only hope that change will start.

MS. BRAINERD: Well, certainly I didn't read the whole 260 pages, but I did read the Cliff Notes, and it is a very thoughtful set of recommendations and much more realistically framed than most such exercises that I've seen, so certainly I hope that you succeed some part of the way, although there is the question mark about the engine, I think is the really big question. And if it's going to be the sort of the smallest scale part of that system how you mobilize that I think is very tricky politically.

But in any case, it’s a very interesting discussion, and, if you have a few moments to, you know, sort of informally address questions, great. Thank you very much for your time.

(Applause)

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