

## **Kishori J Udeshi: Development of forex markets in India - review and prospects**

Keynote address by Ms Kishori J Udeshi, Deputy Governor of the Reserve Bank of India, at 15<sup>th</sup> Forex Assembly organised by Forex Association of India, Colombo, Sri Lanka, 20 August 2004.

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I am delighted to be in Colombo today to address the 15<sup>th</sup> National Forex Assembly. India and Sri Lanka have had very close and friendly neighbourly relations especially culturally, for centuries - indeed millennia. On behalf of Reserve Bank of India, I bring greetings to you all and express appreciation of the warm hospitality of the host country. RBI has always actively participated in the meetings of national Forex Assembly at Governor or Deputy Governor level. I am delighted to carry forward the tradition. Being an exclusive gathering of Forex Market participants in the region, I thought I would use this forum to share some of my thoughts on forex market developments in India. I am aware that each country has unique situations and policies. But in forex such as these, we could exchange experiences for mutual benefit.

My brief address has been structured as follows: First, I will trace the important landmarks in the evolution of forex market in India spanning over roughly three decades. Thereafter, I will proceed to dwell on measures for market liberalization and development including disclosure and transparency initiatives. Thereafter there would be a coverage of institutional development. I will conclude this address outlining the tasks that lie ahead of us and scope for further interaction among the participants.

### **Evolution of foreign exchange market in India**

The Indian forex market owes its origin to the important step that RBI took in 1978 to allow banks to undertake intra-day trading in foreign exchange. As a consequence, the stipulation of maintaining "square" or "near square" position was to be complied with only at the close of business each day. During the period 1975-1992, the exchange rate of rupee was officially determined by the RBI in terms of a weighted basket of currencies of India's major trading partners and there were significant restrictions on the current account transactions.

The initiation of economic reforms in July 1991 saw significant two-step downward adjustment in the exchange rate of the rupee on July 1 and 3, 1991 with a view to placing it at an appropriate level in line with the inflation differential to maintain the competitiveness of exports. Subsequently, following the recommendations of the High Level Committee on Balance of Payments (Chairman: Dr C. Rangarajan) the Liberalised Exchange Rate Management System (LERMS) involving dual exchange rate mechanism was instituted in March 1992 which was followed by the ultimate convergence of the dual rates effective from March 1, 1993 (christened modified LERMS). The unification of the exchange rate of the rupee marks the beginning of the era of market determined exchange rate regime of rupee, based on demand and supply in the forex market. It is also an important step in the progress towards current account convertibility, which was finally achieved in August 1994 by accepting Article VIII of the Articles of Agreement of the International Monetary Fund.

The appointment of an Expert Group on Foreign Exchange (popularly known as Sodhani Committee) in November 1994 is a landmark in the design of foreign exchange market in India. The Group studied the market in great detail and came up with far reaching recommendations to develop, deepen and widen the forex market. In the process of development of forex markets, banks have been accorded significant initiative and freedom to operate in the market. To quote a few important measures relating to market development and liberalisation, banks were allowed freedom to fix their trading limits, permitted to borrow and invest funds in the overseas markets up to specified limits, accorded freedom to determine interest rates on FCNR deposits within ceilings and allowed to use derivative products for asset-liability management purposes. Similarly, corporates were given flexibility to book forward cover based on past turnover and allowed to use a variety of instruments like interest rates and currency swaps, caps/collars and forward rate agreements in the international forex market. Rupee-foreign currency swap market for hedging longer term exposure has developed substantially in the last few years.

## **Market profile**

The Indian forex market is predominantly a transaction based market with the existence of underlying forex exposure generally being an essential requirement for market users. Similarly, regulations in most cases require end users to repatriate and surrender foreign exchange in the Indian forex market. All forex transactions of Government of India are routed through the market except for aid transactions.

The forex market is made up of Authorised Dealers (generally banks), some intermediaries with limited authorisation and end users viz., individuals, corporates, institutional investors and others. Market making banks (generally foreign banks and new private sector banks) account for a significant percentage of the overall turnover in the market.

The average monthly turnover in the merchant segment of the forex market increased to US\$ 40.5 billion in 2003-2004 from US\$ 27.0 billion in 2002-2003. In the inter-bank segment, the turnover has moved up from US\$ 103 billion in 2002-2003 to US\$ 134.2 billion in 2003-2004. Consequently, the average monthly total turnover increased sharply to US\$ 174.7 billion in 2003-2004 from US\$ 130 billion in the previous year. The inter-bank to merchant turnover ratio hovered in the range of 2.9 –3.9 during the year.

## **Trade and financial liberalisation**

There is large empirical literature suggesting that trade integration benefits a larger number and helps promote economic growth. In contrast, recent empirical research is unable to establish a clear link between financial integration and growth. There is therefore now a consensus among academicians and policy makers that trade liberalisation should take precedence over financial liberalisation. The RBI approach makes a distinction among the different participants in order to assess, on an ongoing basis, the gains as well as the vulnerabilities of foreign currency exposures to the system. In the capital account, apart from the Government's, there are three balance sheets that we take into account whether for residents or for non-residents : the balance sheet of the households, the corporates and the financial intermediaries. Although in theory, everything may be integrated, in our phase of development, definitely these three are distinct in terms of their immediate reactions to market forces. In particular, this approach recognises the need to put in place appropriate prudential regulation in regard to the financial intermediaries in so far as foreign currency transactions are concerned. There is virtual unanimity that the currency mismatches of financial intermediaries is a major source of risks of financial integration which has to be mitigated by monitoring and regulations and furthermore, that currency mismatches in the corporate sector can also be a source of risk to the financial sector. Hence the advice to banks to monitor unhedged exposures of borrowers. I would rejjig your memory a bit - at the Ninth Forex Assembly at Goa, the then Deputy Governor Dr.S.S. Tarapore had alluded to these risks saying "banks and FIs cannot distance themselves from the risks taken by corporates as these risks can involuntarily devolve on the banks as their lendings to corporates can easily turn into NPAs". Prudential regulations in the financial sector should not therefore be construed as capital controls.

This approach has been reflected in the recent liberalisation of the policy on external commercial borrowings. The whole process of permitting such external debt may be either through the automatic route or non-automatic route, but slowly the automatic route is being expanded and the non-automatic route reduced. The recent External Commercial Borrowing(ECB) policy makes clear distinction between corporates and financial intermediaries. Therefore, while corporates have been given freedom to borrow under automatic route up to \$500 million per year subject to certain conditions, a different approach has been adopted for financial intermediaries in the interest of financial stability by regulating access to overseas borrowings and issue of guarantees.

Another example is in regard to overseas investments. To enable corporates to become global companies overseas investments up to their net worth is permitted under the automatic route. They can also access ECBs under automatic route to invest overseas. In regard to resident individuals, in order to provide a hassle-free facility to make remittances overseas to meet both current and capital account requirements, they have been allowed to remit on an annual basis US\$ 25000/- on a mere declaration of the purpose.

## **Disclosure and transparency initiatives**

RBI has been transparent in making available, in public domain, appropriate data relating to forex market and those resulting from RBI operations in the foreign exchange market. RBI disseminates the daily reference rate which is an indicative rate for market observers through its website. The movements in foreign exchange reserves of the RBI are published on a weekly basis in the Weekly Statistical Supplement(WSS). WSS also carries data on exchange rates of rupee against some major currencies. The monthly Bulletin of RBI gives data regarding purchases and sales of foreign currency undertaken by RBI against the rupee. The data regarding the Balance of Payments and the External Debt profile of the country is put out on a quarterly basis. RBI has already achieved full disclosure of information pertaining to international reserves and foreign currency liquidity position under the Special Data Dissemination Standards (SDDS) of IMF.

With the concurrence of Government of India, RBI decided to compile and make public half-yearly reports on management of foreign exchange reserves for bringing about more transparency and also for enhancing the level of disclosure in this regard. The first such report with reference to September 30, 2003 was put in public domain through websites of both the Government of India and RBI in February 2004. The second report on foreign exchange reserves with reference to March 31, 2004 is now available at RBI website.

## **Institutional development**

It has been well documented that the vast size of daily foreign exchange trading, combined with the global interdependencies of the forex market and payment systems involves risks stemming from settlement of forex trades on gross basis. Settlement of forex transactions spans different time zones and payment systems. As a result, counterparties assume various types of risks in the course of settlement. As suggested by the Sodhani Committee, RBI took the initiative to establish CCIL in 2001 to mitigate risks in the Indian financial markets. As India's first centralised clearing and settlement system for the financial sector, CCIL's role in facilitating settlement of both debt and forex transactions is perhaps unique.

CCIL undertakes settlement of forex trades on a multilateral net basis through a process of novation and all trades accepted are guaranteed for settlement. On an average, CCIL daily settles over 3500 deals covering an average gross volume of around US\$3.5 billion, representing over 80% of the market. CCIL has been able to offer netting advantage consistently. In addition to benefits of risk mitigation, CCIL's intermediation also provides to its members other tangible benefits such as improved efficiency, lower operational cost and easier reconciliation of accounts with correspondents. CCIL has improved operational efficiency with a zero failure rate. We will be happy to share our experience with our Asian friends.

Since it started its operations, CCIL has consistently endeavoured to add value to the services, and has gradually brought the entire gamut of forex transactions under its purview. It has also, over time, added more and more functionalities enhancing the value of its product. Similarly, CCIL has also launched a Forex Trading Platform to facilitate US Dollar /Rupee deals by banks in India. This platform has been given to members free of cost. The platform offers both Order Matching and Negotiation modes for dealing. The USP of the platform is its offer of Straight-Through Processing capabilities as it is linked to CCIL's settlement platform. RBI encourages the authorised dealers to take full advantage of this and intends monitoring the use of this platform to make it more user friendly and widely used.

In India, the Foreign Exchange Dealers Association of India as a self-regulatory organisation formed by authorised dealers plays a constructive role in market development by initiating debates on important issues, organising training programmes and providing technical expertise on various matters. We expect the FEDAI to enhance its catalytic role in market development in the years ahead.

To further the participatory process in a more holistic manner by taking into account all segments of the financial markets, the ambit of the Technical Advisory Committee (TAC) on Money and Securities Markets set up by RBI in 1999 has been expanded in 2004 to include forex markets and the Committee has been renamed as TAC on Money, Securities and Forex Markets.

## **Tasks ahead**

The Reserve Bank will continue to adopt an approach characterised by gradualism in respect of future liberalisation of forex markets. In terms of sequencing, forex markets have to be aligned to external sector reforms and development of financial markets as part of overall reform. There are several aspects of reform in external sector and forex markets is one of them. Therefore, further liberalisation in forex markets have to be harmonised with progress in other areas.

As you are aware, all major reforms in the market have been brought about after soliciting the opinions of market participants and thus the system of participatory process in market development is very much in place and will continue. In order to further the participatory process, I am happy to inform you that yesterday I had discussions with my colleague Dr. Rakesh Mohan and Governor Dr. Reddy. It has been decided that RBI will immediately set up a Committee to undertake a comprehensive review of the liberalisation process set in motion in the last decade, study recent international experience and identify various options for future forex market development in India. The Committee will interact with market participants and experts for this purpose. The Committee will prepare a report within three months which will be placed before TAC. The report will then be placed in the public domain for inviting suggestions. On the basis of the suggestions received, a road map will be drawn up for further liberalisation to reach global standards. No doubt we will be associating, as usual, the Forex Association to assist us in this endeavour.

Let me conclude by thanking the Assembly for giving this opportunity. Our officers are also participating in the deliberations and we will get a feedback from them. Wish you all the best in your endeavours.