Shyamala Gopinath: Recent developments in forex, money and g-sec markets - account and outlook

Address by Ms Shyamala Gopinath, Deputy Governor of the Reserve Bank of India, at the 16th National Forex Assembly, Cochin, 13 August 2005.

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I. Introduction

It gives me immense pleasure to address this distinguished gathering of forex professionals from all over the country. Coming to these visually beautiful surroundings, it is easy to get oblivious to the fact that this state is a large contributor of 'invisibles' for our balance of payments. Both tourism earnings and private remittances have had a significant impact on Kerala's economy and the state has benefited substantially as a result of liberalisation since 1991. Putting numbers to this gain, as per a study by the Centre for Development Studies, Trivandrum[1], the average yearly gain to the state since the start of reforms has been in the range of Rs. 2000 crore.

I begin this address, Ladies and Gentlemen, in the background of this interesting perspective.

Forex market in India is undergoing rapid transformation and exciting things are engaging us professionally. At the same time, it can no longer be seen in isolation – it is increasingly getting integrated within the broad ambit of financial markets. Over the last fifteen years, momentous changes have happened in the financial sector, which are well known. While the initial reforms concentrated more on the institutions like banks or non-banking financial companies, the recent years have witnessed emphasis on financial markets.

With the financial markets in India acquiring greater depth and maturity in the recent years, the issue of greater integration of various market segments among themselves, on the one hand, and with the global markets, on the other, has come to the forefront. In my address I intend to take stock of the major initiatives that have been taken to reform the financial markets in India in the past, reflect on the present scenario and articulate the future course of reforms.

As you all are aware, the development of financial markets in India has been pursued for bringing about a transformation in the structure, efficiency, and stability of markets as also facilitating integration of markets. The emphasis has been on strengthening price discovery, easing of restrictions on flows or transactions, lowering of transaction costs, and enhancing liquidity. During the post-reform period, the structure of financial market has witnessed a remarkable change in terms of the types, the number and the spectrum of maturity of financial instruments traded in various segments of money, gilts and foreign exchange markets. I now dwell on the three segments of the financial markets which fall directly under the purview of the Reserve Bank of India. As this is a gathering of Forex Professionals, it would be in the fitness of things to dwell on the reform process of the forex market first.

II. Forex Market

Global Scenario

The global foreign exchange markets have grown manifold in the recent years. The latest BIS Triennial Central Bank Survey on forex and derivatives markets 2004 indicate a substantial rise in activity in foreign exchange markets across the world. Average daily turnover at US $ 1.9 trillion in April 2004 showed an increase of 57 per cent and 36 per cent at current and constant exchange rates compared to April 2001, reversing the fall in global trading volumes between 1998 and 2001. Both global factors, such as search for yield and a secular deepening in Asian financial markets contributed

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[1] "*Kerala's Gulf Connection : Emigration, Remittances and their Macroeconomic Impact 1972-2000*", Kannan K.P and Hari K.S, Centre fro Development Studies, Working Paper No. 328.

to the strong growth. In this context, it is important to note that the share of trading between banks and financial customers rose significantly from 28 per cent in 2001 to 33 per cent in 2004. However, the currency composition of turnover has not changed significantly. The US dollar was on one side of 89 per cent of all transactions, followed by the euro (37 per cent), the yen (20 per cent) and the Pound sterling (17 per cent). In terms of currency pairs, US dollar/euro continued to be by far the most traded currency pair in April 2004, accounting for 28 per cent of global turnover, followed by US dollar/yen with 17 per cent and US dollar/Pound sterling with 14 per cent. The percentage share of the Indian rupee, though miniscule in comparison, has almost trebled to constitute 0.3 per cent of total daily turnover.

Indian Forex Market

In an open economy environment, the foreign exchange market assumes critical importance for stability of the financial system since banks' balance sheets are influenced by the foreign capital inflows and various other external transactions directly or indirectly through credit exposures. The Indian forex market has widened and deepened since the 1990s on account of implementation of various measures recommended by the High Level Committee on Balance of Payments in 1993 (Chairman: Dr. C.Rangarajan), the Expert Group on Foreign Exchange Markets in India in 1995 (Chairman: Shri O.P.Sodhani) and the Committee on Capital Account Convertibility in 1997 (Chairman: Shri S.S.Tarapore). With the transition to a market-determined exchange rate system in March 1993 and the subsequent gradual liberalisation of restrictions on various external transactions, ensuring orderly conditions in the forex market in India has become one of the key objectives. The Reserve Bank has undertaken various measures towards development of spot as well as forward segments of foreign exchange market. As a result, the average gross daily turnover increased to US $ 12.1 billion in 2004-05 (April-March) from US $ 3.7 billion in 1996-97. The top 30 banks in India account for approximately 90 per cent of the overall turnover in the market.

Approach to Reforms in Foreign Exchange Market

While the operating environment is no doubt relatively more flexible in countries with current account convertibility and open capital accounts, the approach in other countries, the approach has remained cautious with a clear emphasis on the need for safeguards against potential financial instability that could arise due to excessive speculation in the foreign exchange market even when macroeconomic fundamentals are reasonably good. The Indian approach to opening the external sector and developing the foreign exchange market in a phased manner from current account convertibility to the ongoing process of capital account liberalization is now considered a prudent and desirable approach for liberalization.

The recent past has witnessed significant changes in the external sector policy approach of the Reserve Bank. The focus of the measures has been to gradually dismantle controls and provide an enabling environment to all entities engaged in external transactions. The approach to liberalisation, adopted by Reserve Bank has been characterised by greater transparency, data monitoring and information dissemination and to move away from micro management of foreign exchange transactions to macro management of forex flows. The emphasis has been to ensure that procedural formalities are minimised so that individuals are able to obtain hassle free remittances facility for all current account transactions and exporters and other users of the market are able to concentrate on their core activities rather than engage in avoidable paper work. Besides, the Reserve Bank has also striven to ensure that strong Know-Your-Customer (KYC) guidelines are in place. In this enabling environment, today the Indian corporate sector is reaching out to the global production and distribution networks not only through greater orientation towards exports or imports but also through strategic takeovers, overseas acquisitions and joint ventures. Apart from attracting Fortune 500 companies to open shops in India, Indian corporates are making their own places in the list at scales which was hitherto unimaginable.

Significant Policy Developments

Keeping in view the robustness of the external sector, a number of far-reaching changes have been effected in a phased manner in the recent years to liberalise the capital account, which include more flexible and liberal investments norms in order to promote Indian investment abroad and to enable Indian companies to reap the benefits of globalization and become globally competitive. The other measures relate to allowing two-way fungibility in the case of GDRs / ADRs, permission to Indian

mutual funds to invest in overseas equity market subject to certain limits, permission to Indian companies to make acquisitions of foreign companies or make direct investment abroad in Joint Ventures/Wholly- owned Subsidiaries, permission to various participants in the foreign exchange market, including FIIs, to avail forward cover subject to genuine underlying exposure, permission to residents to open foreign currency denominated account, etc

Alongside the measures taken to encourage overseas investment by resident corporates, steps were taken to contain and calibrate debt-creating inflows. The thrust of the new ECB policy is to encourage investment in the real sector and infrastructure while at the same time restricting debt flows for purposes other than those adding to the capital stock.

RBI also encouraged the setting up of CCIL to reduce settlement risk. CCIL has functioned as an efficient enabler of settlement offering netting and operational benefits, in addition to substantial risk mitigation. CCIL settled over 900,000 deals for a gross volume of USD 900 billion in the last year alone.

Issues for the road ahead

The Report of the Internal Technical Group on Forex Markets, set up by the RBI and announced last year at the same conference, has made various recommendations for further liberalization of the extant regulations. Some of the recommendations, such as, freedom to cancel and rebook forward contracts of any tenor, delegation of powers to ADs for grant of permission to corporates to hedge their exposure to commodity price risk in the international commodity exchanges/ markets and extension of the trading hours of the inter-bank foreign exchange market have already been implemented. The Reserve Bank has placed the report in the public domain for comments and the feedback received will be taken into consideration for arriving at a final decision in this regard.

Greater liberalisation requires banks to act responsibly in order to provide confidence to corporate entities going in for derivative transactions in addition to satisfying regulations. In this context, customer suitability and appropriateness issue has assumed significance. The “appropriateness standard” ensures that banks use the same principles for taking credit decisions in respect of complex derivative transactions as they do for non-derivative transactions. Banks are expected to evaluate the purpose of the derivative transaction and make an assessment as to whether it is appropriate to the customer’s needs and level of sophistication. While some banks already have an appropriateness policy in place, many banks do not. Instances of international banks encountering compensation claims due to slackness on their part in this area are well known. It is, therefore, important that all banks introduce a customer suitability and appropriateness policy.

Further, greater clarity is required in the area of derivative accounting in the books of corporates as well as banks in regard to revenue recognition and valuation of assets and liabilities. In general it may be a desirable practice to have convergence in the accounting standards for both foreign currency and INR derivatives and between on balance sheet and off balance sheet items. There is also need to eliminate incentives to drive a wedge between on-balance sheet and off-balance sheet items. Clarity is essential to differentiate between hedge and trading transactions. In respect of transactions classified as trading, and hence marked to market, an important issue that needs to be addressed is whether there is a liquid market for these products. If not, what should be a prudent approach for recognizing income or losses. RBI is in the process of compiling a master circular on all derivatives including issues related to accounting and valuation for banks in consultation with industry associations and the ICAI. We also welcome suggestions from the Forex Association in this regard.

However, there is equal need and urgency to formulate accounting standards for interest rate and certain foreign currency derivatives for all corporates. Indian accounting standards are still in formative stage as regards derivative accounting both in regard to hedge and fair value/ cash flow accounting as well as coverage of the products. ICAI is seized of the issue and it is important that the forex association also facilitates the process by providing suggestions to the Institute.

In the context of good corporate governance, the issue of greater disclosure on the part of banks and corporates has become important. In the case of complex structured products, it is imperative on the part of the banks / corporates to be transparent and disclose the nature and quantum of risks contracted and the systems put in place to monitor these risks.

While accounting and disclosure issues are engaging our attention, the RBI is also examining other recommendations of the Technical Group for phased implementation. One of the recommendations relates to covered options. As things stand, the corporates are only allowed to purchase options

supported by genuine underlying transaction/receivable. Any structured product involving cost reduction is allowed provided it does not increase underlying risk and there is no net receipt of premium. Covered options, allow the corporates to write covered calls and puts subject to adequate risk management systems being in place. This is expected to impart greater depth and liquidity to the options market and provide greater flexibility to the market participants.

Similarly, we propose to revisit the procedures in respect of crystallization of unpaid export bills which were formulated long ago. Another recommendation of the Group relates to price fix hedge. Currently, residents engaged in import/export activity can hedge the price risk of these commodities in international commodity exchanges. The suggestion is to allow price fix hedges to the extent of the average quantity of commodity bought/sold during the previous three years, or during the previous year, whichever is higher. This would be applicable both to commodities imported/ exported and procured domestically. RBI welcomes inputs from the Forex Association in regard to the recommendations under examination.

A proposal from CCIL to extend guaranteed settlement of US$/INR forward transactions from trade date is being currently examined by us. Since settlement guarantee will extend from the trade date, we expect the liquidity and depth in the forward market to increase significantly. The risks that banks today carry on their books on account of large outstanding forward positions will be significantly reduced.

Let me now turn to the G-Sec market.

III. G-Sec market

As a debt manager to the Government, the development of a deep and liquid market for Government securities is of critical importance to the Reserve Bank as this would result in better price discovery and reduce the cost of Government borrowing. Such markets also provide an effective transmission mechanism for monetary policy, facilitate the introduction and pricing of hedging products and serve as benchmarks for other debt instruments. Efforts towards development of the Government securities market have focused on three areas: institutional measures, innovations through instruments, and enabling measures. As a result of gradual reform measures taken over the years, the Indian G-Sec market has seen a transition for the better, as reflected in the following developments:

- the market has become increasingly broad based.
- consolidation of securities, albeit in a passive manner, has resulted in the development of several benchmark securities,
- a high degree of sophistication achieved in the auction process has narrowed the gap between the cut-off price and the weighted average cut-off price and has resulted in a strong correlation between the bids at the primary auction and secondary market yields, indicating improved price discovery.
- the increased volume of trading in the secondary market has resulted in a reasonably smooth yield curve;
- the yield curve has been elongated up to 30 years maturity to reduce bunching of redemptions and minimise the rollover risk;
- through a process of novation, a central counterparty, like the Clearing Corporation of India Limited (CCIL) has provided excellent infrastructure and contributed to better risk management.
- to address important issues regarding pricing, choice of benchmark, and liquidity in respect of floating rate bonds (FRBs), a Sub-Group of the Technical Advisory Committee on Money, Forex and Government securities markets has been constituted.
- RBI has enhanced the efficacy of NDS by incorporating screen based anonymous order matching system under its ambit with effect from August 1, 2005.

Given this backdrop, let me now turn to some of the recommendations made by the Technical Group on Government Securities which are under examination.

First, since RBI would not be able to participate in the primary auction market with effect from 2006-07, an internal Technical Group in RBI examined and recommended an appropriately restructured primary

issuance process. The Technical Group suggested that Primary Dealers(PDs) may have to take up a greater role in underwriting and may accordingly need to underwrite 100 per cent of the notified amounts in future auctions.

Second, the larger responsibility cast on the PDs may need to be compensated with appropriate incentives and one of the suggestions is to extend exclusivity in auctions, which is a typical feature in most countries with PD system. However, another view is that this may disadvantage other players in the Government securities market who have been participating directly in auctions.

Third, PDs are also required to play the role of market-makers by always offering two-way quotes, thereby imparting liquidity. However, it has been represented that the absence of short sales constrains the market-making role of PDs. The issue for consideration is whether short sales, with appropriate safeguards would be necessary for PDs to play this role of market-making.

Fourth, a numbers of challenges have emerged in monetary and debt management: To meet the emerging challenges, the Reserve Bank is taking steps to fine-tune its open market operations. This would need greater accuracy in forecasting market liquidity over the short- to medium-term. Operationally, open market purchases and sales may have to be undertaken, necessitating a review of processes and technical infrastructure consistent with market development.

Other recommendations made by the Group to further develop the efficiency and liquidity of secondary market for Government securities include (i) active consolidation of securities, (ii) introduction of a 'When Issued' market in a phased manner, and (iv) a securities borrowing window for PDs.

As per the announcement in the Union Budget 2005-06, a Bill to amend the RBI Act,1934 for providing, among other things, legality to OTC derivatives has been introduced in the Parliament. Similarly, the Government Securities Bill seeks to broaden the market for Government securities by facilitating retail interest while also ensuring an orderly secondary market. Some of the substantive improvements expected in the management of public debt on account of this Bill are: (i) stripping and reconstitution of Government securities to facilitate improved secondary market liquidity, on the one hand and to enable better risk allocation in the appropriate investor class, on the other, (ii) provision for hypothecation, pledge and creation of lien on Government securities, etc.

Let me now turn to money market.

IV. Money Market

The money market forms an important part of the financial system by providing an avenue for equilibrating the surplus funds of lenders and the requirements of borrowers for short periods. It also provides a focal point for central bank's intervention for influencing the liquidity in the financial system and thereby transmitting the monetary policy impulses. The primary aim of the Reserve Bank's operations in the money market is to ensure that the liquidity and short-term interest rates are maintained at levels consistent with the monetary policy objectives. In recent years, the Reserve Bank's approach has been to foster balanced development of different segments of the money market, introduce new instruments, reduce dependence of participants on uncollateralised exposures, facilitate price discovery in the short-end and upgrade the payment system infrastructure. Accordingly, the Reserve Bank's strategy has focused on developing pure call/ notice money market, instituting full-fledged Liquidity Adjustment Facility(LAF), developing infrastructure, promoting transparency, and various measures pertaining to instruments for non-bank participants. The following are some of the important developments pertaining to the money market:

- With a view to transforming the call/ notice money market into a pure inter-bank market with participation of banks and primary dealers (PDs) only, a phased exit of non-banks from the call/notice money market was started in May 2001. With effect from August 6, 2005, non-bank participants have been completely phased out of the call money market.
- Several new financial instruments have been introduced. The traditional refinance support on fixed terms has been replaced by a full-fledged Liquidity Adjustment Facility (LAF) was introduced on June 5, 2000 with a view to modulating short-term liquidity under diverse market conditions.
- The development of the payment system infrastructure was strengthened with the introduction of the Negotiated Dealing System (NDS) in February 2002, formation of the

Clearing Corporation of India Ltd. (CCIL) in 2001, and the implementation of Real Time Gross Settlement (RTGS) system in March 2004

- Measures have also been taken to make various other money market instruments (such as CDs, CPs, *etc.*) freely accessible to non-bank participants. These measures were intended to improve the depth of as well as the efficiency and transparency of operations in the money market.
- As part of the development of new instruments, a major initiative pertains to Collateralised Borrowing and Lending Obligation (CBLO), which was operationalised as a money market instrument through CCIL on January 20, 2003. With a view to developing the market for the CBLO, the Reserve Bank allowed certain exemptions in the form of CRR relaxation.

V. Interaction between Forex, Government Securities and Money Markets

The far-reaching financial sector reforms have also facilitated India's movement to an open economy framework in which interaction between forex, Government securities and money market has become quite important. The opening of the economy has brought about gains in terms of inflows of foreign investments, which have contributed to growth and employment. However, these gains have also posed new challenges for managing the macroeconomy amidst large and volatile capital flows. This has had implications for monetary management. We have addressed this challenge with appropriate monetary-fiscal coordination. Suitable changes were made in the LAF scheme and MSS was introduced to address more enduring portion of the liquidity overhang.

In view of the growing integration of markets across borders, it is imperative that domino effects are minimised by refining and upgrading the financial infrastructure in all its vital components, such as accounting standards, including income recognition and provisioning norms, disclosure standards and insolvency laws. This upgradation is to be attained in conformity with international best practices. In this regard, the Reserve Bank has strengthened the consultative process for all major policy steps in a transparent manner by involving market participants and other experts.

VII. Concluding Observations

The reforms have been successful in bringing significant improvements in various financial market segments improving their depth, liquidity and efficiency. The money market is now reasonably developed with a wide array of instruments. The character of the Government securities market has changed from being a captive market to a broad-based, deep and liquid market enabling the Reserve Bank to pursue its monetary policy through market-based instruments. Various reform measures have resulted in sharp growth of the foreign exchange market. Reforms have also been successful in creating and sustaining orderly conditions in the market. These factors have led to increased inter-linkages across financial institutions and markets. In the more recent period, the various segments of the financial market in India have, by and large, exhibited stability.

RBI will endeavour to provide an enabling environment for healthy development of financial markets. The enabling environment also encompasses harmonization of reforms in financial sector with the real sector. Large gaps exist in demand supply of infrastructure services such as transport, electricity, ports etc. It needs to be emphasized that sound macroeconomic policies and a competitive domestic sector improve the capacity of the economy to absorb higher capital inflows, reduce the cost of capital, translate external flows into higher investment levels and provide cushion against unexpected shocks in more liberalized external markets.

With progressive financial sector reforms, various segments of the financial market, including Forex, money and G-Sec markets, have made tremendous strides. While we have come a long way from the controlled regime of the yester years, we believe in following a gradualist approach to opening up. A calibrated approach towards financial sector liberalization has been the hallmark of financial sector reforms process and has paid rich dividends to the economy by insulating it from the vagaries of international capital flows and the contagion effect of various crises faced by emerging market economies in the 1990s. Let me conclude by thanking the Association for giving me this opportunity. I am sure the deliberations in this conference will be quite useful and I wish the conference all success.

Thank You.

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