H R Khan: Indian financial markets – fuelling the growth of the Indian economy

Address by Mr H R Khan, Deputy Governor of the Reserve Bank of India, at the inaugural session of the conference on "Indian financial markets – fuelling the growth of the Indian economy", organized by the Confederation of Indian Industry at the ADB Annual Conference, Greater NOIDA, Delhi NCR, 4 May 2013.

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The speaker acknowledges the contributions of Shri. Himansu Mohanty & Shri. Surajit Bose of the Reserve Bank of India in preparation of the address.

Dr. Arvind Mayaram, Secretary, Department of Economic Affairs, Ministry of Finance, Mr. S. Gopalakrishnan, President, Confederation of Indian Industry (CII), Mr. Jignesh Shah, Chairman, CII National Committee on Financial Markets, Mr. Chandrajit Banerjee, Director General, CII, distinguished delegates. Let me start by complimenting CII for selecting *Indian Financial Markets: Fuelling the Growth of the Indian Economy* as the theme of the session. It is now well known that a well-developed financial sector plays an important role in economic growth. As John Hicks observed, the technology that made industrial revolution in England possible was in existence for a long time before it was commercially exploited; it had to wait till the financial sector developed well enough to make the necessary resources available[1]. But it has to be recognized that while absence of a robust financial sector can retard growth, financial development on its own cannot secure growth. Finance thus is a necessary but not a sufficient condition for economic growth.

In India, we have traversed a long way since the economic reforms started in the early 1990's. The reforms of the early 90's were focused on three pillars – Liberalization, Privatization and Globalization (LPG). The financial sector has also undergone significant changes during the period to not only to support the rapid growth but also to do so without disruptive episodes. Let me briefly mention some of these changes, if only to stress that our confidence to meet future challenges is based on the bedrock of past achievements. I am deliberately not touching upon the issues relating to capital markets as they are not my areas of competence.

Bank-based financial sector of India

Indian financial sector has traditionally been bank based. The banking sector has so far played a seminal role in supporting economic growth in India. The assets of the banking sector have expanded nearly 11 times from ₹ 7.5 trillion at end-March 1998 to ₹ 83 trillion at end-March 2012. The non-food credit has expanded by more than 14 times from ₹ 3.1 trillion 1998 to ₹ 45.30 trillion during the same period. The credit to GDP ratio which stood at about five per cent in 1950–51 improved to about 25 per cent in 2000–01 and further to about 52 per cent at the end of 2011–12 (Chart 1).

The pre-emption by way of Statutory Liquidity Ratio (SLR) has declined considerably from 38.5 per cent in 1991 to 23.0 per cent of the Net Demand & Time Liabilities (NDTL) in 2013 (Chart 2). All the while, the banking sector has been robust, meeting all prudential standards as per best international practice. During the recent global financial crisis and slowdown in the global and domestic economy, the Indian banking sector has proved to be resilient. There are, however, issues relating to liquidity, asset quality, capital adequacy in the context of Basel III and earnings which have surfaced in the recent past mainly due to economic

[1] Hicks, John, A theory of economic history (1969).

slowdown and have to be tackled expeditiously for continued resilience of the Indian banking system.

The Indian financial markets

The Indian financial markets have also grown considerably. The market capitalization of the equity market (National Stock Exchange) has grown from approximately ₹ 6.5 trillion in 2000–01 to approximately ₹ 60 trillion in 2009–10 and further to approximately ₹ 61 trillion in 2011–12. The total corporate debt outstanding which stood at ₹ 7.9 trillion in June 2010, has grown to ₹ 12.9 trillion in March 2013. The outstanding CP has grown from ₹ 575 million in 2003 to ₹ 11 billion in 2013. Similarly, outstanding CD has grown from ₹ 91 million in March 2003 to ₹ 39 billion as on March 22, 2013. Notwithstanding the impressive growth of the debt markets, there is a great deal still to be done. I shall shortly return to this.

Debt markets

Government bond market

With a large section of population underprivileged, the welfare commitments of the Indian state have to be supported by a large government borrowing program. The outstanding marketable government debt has grown from ₹ 4.3 trillion in 2000–01 to ₹ 29.9 trillion in 2012–13. The size of the annual borrowing of the central government through dated securities has grown from ₹ 1.0 trillion to ₹ 5.6 trillion during this period. It is no mean achievement to manage such large issuances in a non-disruptive manner in the post Fiscal Responsibility & Budget Management (FRBM) regime and declining SLR. A large number of initiatives have been taken over the years, such as, the Primary Dealer (PD) system, Delivery Vs Payment (DVP), centralised clearing, anonymous dealing system based on order matching, floating rate bonds, STRIPS, Inflation Index Bonds (IIBs), etc. The liquidity in the secondary market has also increased significantly from a daily average trading volume of ₹ 9 billion in February 2002 to ₹ 344 billion in March, 2013. The development of the debt and the derivatives market in India needs to be seen from the perspective of a central bank and a financial sector regulator which has a mandate to facilitate development of debt markets of the country.

Corporate bond market

The need for development of the debt market has assumed some urgency in recent times for several reasons. A vibrant debt market plays an important role in enabling the newcomers to bring their ideas and enterprise to fruition. The impending large scale expenditure for improving our infrastructure critically depends on the debt market. It is difficult for the public sector to finance development of a world-class infrastructure of the magnitude envisaged because of its other commitments and the limitations imposed by fiscal prudence. Though the banking sector has been playing an active role in infrastructure finance, there are limitations imposed by Asset Liability Mismatch (ALM) mismatch, exposure norms, and de-risking the financial system to provide stability to the financial system.

Developing a vibrant bond market

A vibrant corporate bond market provides an alternative to conventional bank finances, thereby providing the corporates an additional avenue for raising resources and reducing reliance on bank finance. A robust corporate bond market also ensures lower dependency and therefore vulnerability of foreign currency sources of funds. A vibrant market will also help in matching the investment needs of savers with the borrowing needs of the corporates. A well-developed debt market enables efficient pricing of risk, promotes product innovations and leads to greater financial stability. Further, mobilization of long-term funding for the infrastructure sector critically depends on a deep and liquid debt market with a large set of diverse and sophisticated investors and a wide array of instruments not only to provide vehicles of investment but also to manage the risk entailed. In a developed bond market,

banks, who would require long-term funds in the context of Basel III requirements, would also be able to raise resources easily.

Development of government and corporate debt market may be approached within a framework of seven key components, viz., *Issuers, Investors, Intermediaries, Infrastructure, Innovation, Incentives and Instruments* – what I have called a *7i framework.* Sovereign securities dominate the fixed income markets almost everywhere. In India too, the central and state governments remain the main issuers. The large supply of securities, due to enhanced borrowings, has enabled creation of benchmark securities with sufficient outstanding stock and issuances across the yield curve. The issuances across the risk-free yield curve in turn, have provided benchmarks for valuation of other bonds/financial assets and benefitted the corporate bond market. Fiscal consolidation efforts of the Government of India and the State Governments enhance the quality of the issuers. In the field of corporate bonds besides financial sector entities, large well rated non-finance companies have also been issuers. The traditional investor base for G-Sec in India comprised banks, provident funds and insurance companies with a dominance of domestic investors and limited foreign participation. In the corporate debt market, investor base is mostly confined to banks, insurance companies, provident funds, PDs and pension funds. An approach of gradual opening of the domestic bond market to the foreign investors has been adopted in India keeping in view the macro-economic risks involved in providing unfettered access to them. Intermediaries play an important role in development of the market by facilitating the transactions, providing value-added services and increasing efficacy of the processes. In India, the major intermediaries are the PDs, industry associations like Fixed Income Money Market & Derivatives Association/Primary Dealers Association of India, Gilt Mutual Funds and the Infrastructure Development Funds (IDFs). Infrastructure plays an important role in development of markets and want of an efficient, transparent and robust infrastructure can keep market participants away on one extreme or cause market crisis on the other. India can boast of being one of the few emerging countries with such a state of the art financial market infrastructure for the G-Sec market. A state-of-the-art primary issuance process with electronic bidding and fast processing capabilities, dematerialized depository system, DvP mode of settlement, electronic trading platforms (Negotiated Dealing Systems and Negotiated Dealing Systems-Order Matching) and a separate Central Counter Party in the Clearing Corporation of India Ltd. (CCIL) for guaranteed settlement are among the steps that have been taken by the Reserve Bank over the years towards this end. Financial innovation is an essential feature in the history of development of financial markets. Innovations that are motivated by the need to match the needs of the investor and the issuer or made possible by advancement in technology or knowledge are essential for evolution of financial markets. Incentives play a significant role in shaping the development, stability and functioning of the financial markets. Reserve Bank has been trying to align incentives by regulation and supervision though regulation itself may have created unintended incentives/disincentives as in the case of requirement regarding Held To Maturity (HTM) dispensation. In the process of development of new instruments, Reserve Bank's endeavour has been to ensure calibrated and orderly development of the markets with emphasis on prudent risk management and promotion of financial stability.

Within the limited scope of its engagement with the corporate debt segment as the Securities and Exchange Board of India (SEBI) being the main regulator of this segment, Reserve Bank has taken steps, such as, introducing Credit Default Swaps (CDS) to manage credit risk, repo in corporate bonds to enable funding of positions, limited market making role for the Primary Dealers, providing a pooling account facilities to the clearing corporations of the exchanges to settle the trades in the books of the Reserve Bank of India, etc. There has been a demand for increased direct or indirect support from the banking sector for expanding the corporate debt market. Reserve Bank views such proposals with caution because of the prudential concern for the health of the banking sector as well as the fact that the intention is to generate incremental resources and not redistribute the existing ones. As we know banks are already substantially exposed to the infrastructure sector. Hence, demand for credit

enhancement by banks has to be seen in the context of the fact that it would only increase their exposure. Further, credit enhancement by banks will not lead to development of a real "corporate" bond market. Credit enhancements by way of partial guarantees by multilateral institutions, such as, the Asian Development Bank is likely to attract investments from insurance and pension funds in the infrastructure sector and lower the cost of funds for companies. Such credit enhancement measures outside the banking system could be the way out.

Foreign exchange market

Current account deficit & capital flows

In the context of foreign exchange market, one of the most talked about issue is the rising current account deficit (CAD). In recent times, CAD has been increasing and reached a historic high of 6.7 per cent during the quarter October-December, 2012. It is of course not sustainable in the long run. Therefore, a structural shift in the composition of our trade account – increasing exports and curtailing non-productive imports, such as, gold – is imperative. What needs to be emphasized is that the current account deficit has so far been successfully financed without any drawdown on our foreign exchange reserves. This has been possible with sustained capital inflows, which though not as buoyant as in the pre-crisis days, has still been impressive. Nevertheless capital inflows cannot be taken for granted and there is a need to create the enabling conditions to attract and retain long-term foreign capital. The urgency now comes from two sources: the need to bridge the current account deficit and the need to provide resources – particularly of the long term type – for infrastructure and other investment needs.

Capital account management

In the Indian context, management of capital account has been challenging. So far, the approach of Reserve Bank of India has been that of cautious gradualism, informed by the experience of other developing countries in Latin America and East Asia who perhaps liberalized their capital account too soon and too fast. Yet, it should be recognized that as far as the real sector is concerned, the capital account is substantially open with regard to sourcing debt and equity from abroad as well as exploiting investment opportunity abroad. The restrictions in capital account are pronounced as far as the financial sector is concerned. The policy caution is motivated by apprehensions of sudden cessation or reversal of flows, which some influential commentators believe to be unfounded. Even within the constraints imposed by a gradualist approach, Reserve Bank and the Government of India have taken several steps that include progressive increase in investment limits for Foreign Institutional Investors (FIIs) in government and corporate debt, introduction of Qualified Foreign Investor (QFIs) as a separate investor class, etc.

Exchange rate volatility

Talking about the external sector, I would like to briefly touch upon the issue of Rupee volatility, because next perhaps only to the stock indices, sharp movements in the Rupee usually agitate market participants, including those who have no direct exposure (Chart 3).

In this context it must be recognized that in the post-Bretton Woods era, most currencies have had their own episodes of volatility and particularly in the past few years during and after the crisis, exchange rate volatility has become a way of life. Stance of Reserve Bank of India has been not to target any band or level for the exchange rate, thereby enabling Indian Rupee to move as per the market fundamentals but being ready to intervene to curb excessive volatility. Second, Reserve Bank of India, over the years, has introduced a wide array of hedging instruments which can be used by the real sector to deal with volatility in the exchange rate. If on the other hand, businesses are unwilling to pay the cost of hedging (which is directly proportional to the degree of volatility) and intend to take a view on the

exchange rate rather than concentrating on their own line of business, they must be fully aware of the consequences.

Issues in liquidity management

At this particular point in time, Reserve Bank of India does not see paucity of resources constraining economic growth, particularly in view of the fact that banks are holding about ₹ 3.5 trillion of government debt in excess of the mandated limit. During the first half of the year 2012–13, average net liquidity injection under the daily liquidity adjustment facility (LAF) stood at ₹ 730 billion which increased to more than ₹ one trillion during the second half. To alleviate liquidity pressures during the year, the Reserve Bank has lowered the Cash Reserve Ratio (CRR) by 75 bps and the SLR by 100 bps besides additional liquidity injection of more than ₹ 1.5 trillion through the open market operations (OMOs). Reserve Bank remains alive to the requirements in time to come and will appropriately manage liquidity to ensure adequate credit flow to the productive sectors of the economy.

Financial inclusion

Let me now turn to an area of weakness of the Indian financial system – lack of depth of financial inclusion – that needs to be addressed with alacrity. Taking cognizance of the extent of the problem and recognizing importance of financial inclusion based on the principle of equity and inclusive growth with stability, Reserve Bank of India has initiated a number of policies. In its recent Annual Monetary Policy 2013–14, Reserve Bank has extended the Lead Bank Scheme to the metropolitan districts of the country. Extension of the scheme to these areas is expected to provide an institutional mechanism for co-ordination between government authorities and banks for reaching doorstep banking to the financial excluded population. To further improve the banking penetration through alternate channels, Reserve Bank of India has permitted non-bank entities to set-up White Label ATMs (WLAs), to operate as Business Correspondents and to facilitate large scale use of electronic banking and alternate delivery channels. Under the new bank license policy of the Reserve Bank, new entities are expected to enhance the banking penetration in India. These measures are also expected to provide platforms for launching innovative processes, partnerships and products for ensuring a deeper financial sector with a focus on sustainable financial inclusion. Enriched access to the financial sector is expected to enable the marginal population to deal better with uncertainties, enhance their productivity and bring them to the mainstream of the growth process.

Concluding thoughts

In conclusion, I would like to mention that the role of financial markets in the process of a country's economic development needs no emphasis. At the same time, as the recent crisis has shown, financial markets can be the epicenter of crises that derail the growth process itself and unleash great misery. Thus, in countries like India, where financial markets are yet to achieve the size and sophistication as those of the more developed countries, perhaps there is merit in adopting a cautious approach to financial development.

That said, I wish to emphasize that Reserve Bank remains committed to ensure availability of funding for all productive endeavour across the spectrum of economic activities. Though the banking sector has done a great job so far in this regard, financial markets have to play an increasingly important role in generating incremental funding, particularly for expansion of the infrastructure sector. This explains the regulatory push towards the development of the corporate bond market as an adjunct to the bank-dominated financial system of India. Importance of the banking sector in the Indian financial system, however, remains critical. The agenda to make the financial sector responsive yet resilient has to include improving liquidity in the G-Sec market across the tenor, create a liquid yield curve to provide a basis for pricing private debt, further development of the corporate bond market, expanding the set

of products and participants in the derivative market to provide adequate hedging options for credit, interest rate and forex risks, particularly at the long end and gradual capital account liberalization within the framework of financial and macro-economic stability.

It may be noted that the role of the financial sector as well as its regulators is only enabling. Ultimately, the enterprise and entrepreneurship in the real sector should be unshackled to exploit and implement opportunities and ideas. As Joan Robinson remarked, economic growth creates demand for financial instruments, and, where enterprise leads, finance follows[2].

Thank you for your attention.

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2 Robinson, Joan, "The Generalization of the General Theory," in The Rate of Interest, and Other Essays. (1952). These remarks were made to deemphasize the role of the financial sector, but there is a great deal of truth in the remarks in so far as the nexus between the real and the financial sectors is concerned.

Chart 1: Bank credit as a percentage of GDP

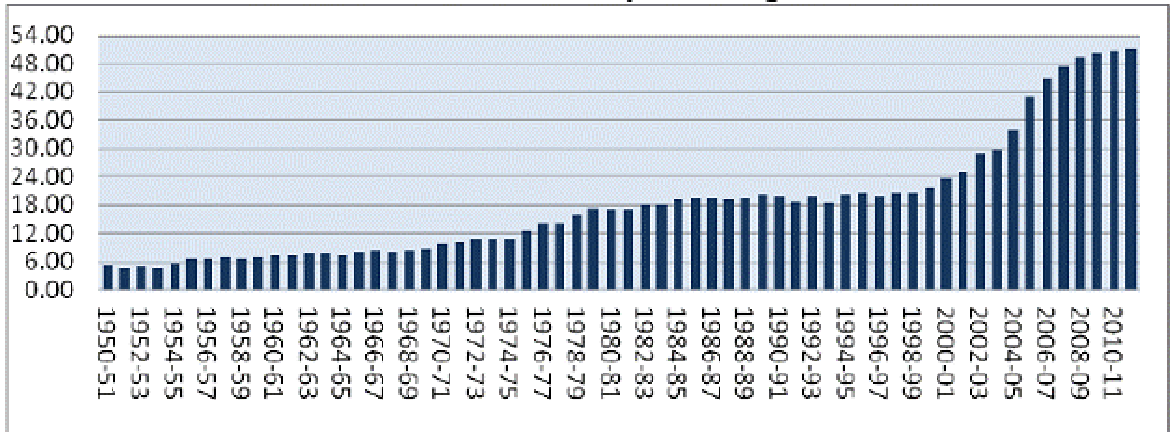

Chart 2: Movement in Statutory Liquidity Ratio

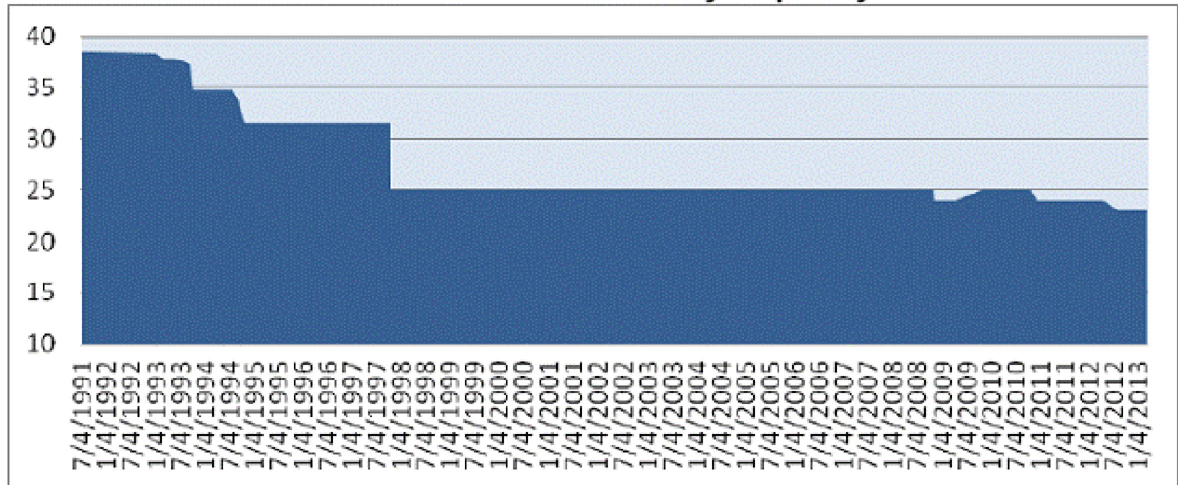

Chart 3: Movement of Indian Rupee and Sensex