G Padmanabhan: Internationalisation and integration of Asian capital markets – expanded role for Asian currencies, including the Renminbi

Comments submitted by Mr G Padmanabhan, Executive Director of the Reserve Bank of India, circulated at the OMFIF (Official Monetary and Financial Institutions Forum) – LKY (Lee Kuan Yew School of Public Policy) meeting "Asia's role in the global economy forum", Singapore, 12 July 2013.

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I am indeed indebted to the organizers, Lee Kuan Yew School of Public Policy, National University of Singapore for providing me this opportunity to share my thoughts on an issue, which has the potential to alter the global financial landscape in the years to come.

Global financial crisis and its aftermath have renewed the debates pertaining to functioning of international monetary system (IMS) and the need for multi-currency system. Is there a viable alternative for the mighty US Dollar? These debates coincided with the Chinese authorities taking a number of steps to bring about greater internationalization of Renminbi (RMB). At the present juncture, the global financial system is still dominated by the US Dollar, followed by a few other advanced economy currencies, at the margin. In sharp contrast, emerging market (EM) currencies are hardly used for international transactions, notwithstanding the fact that these economies are increasingly getting more integrated into the global economy and their contribution to global growth, trade and financial flows is accelerating.

Since the topic of discussion focuses on the link between internationalization and integration of Asian capital markets, I shall limit my observations to the issues relating to the development and integration of Asian capital markets, and the role this can play in possible greater internationalization of Asian currencies, especially the Renminbi. Successful internationalization is generally associated with financial openness, allowing for the free flow of capital and contributing to the development of domestic financial markets, as restrictions on the convertibility of a currency for capital account transactions are likely to raise the costs of transactions denominated in the currency, and limit foreign access to domestic stores of value. Further, the depth and liquidity of financial market is a very important element as it provides borrowers and investors access to deep and liquid financial markets onshore, and also enable hedging of currency and credit risks. Additionally, offshore markets also play an important part in currency internationalization efforts and their development should go in tandem with financial deepening onshore.

According to a recent BIS paper (2012), there has been significant progress over the years in achieving greater regional financial integration in the Asian equity and bond markets. The extent of integration, however, still seems to be limited. The process appears to have stalled in recent years, and the two major regional blocs – mature and emerging markets – seem to have different degrees of integration. According to another BIS study, there has been de facto integration in Asia, but it is Sino-centric, not so much multilateral, involving bilateral trade between China and other Asian countries. Full-fledged integration of the European sort has not taken place in Asia because of various reasons.

To this enlightened audience, I would like to propose that internationalization needs to be viewed as a continuum and not as two extremes, as different currencies may have different levels of internationalization. Internationalization merely refers to greater international use of that currency and should not be confused with international reserve currencies like the US dollar, which are in a league of their own.

Integration of Indian financial markets

Now let me turn to the issue of integration of Indian financial markets with global financial markets. The Indian financial markets are now increasingly getting integrated with global financial markets which are reflected in the increasing volatility in Indian financial markets as a result of spill over from turmoil emanating from international markets. As witnessed in the recent weeks, the Indian Rupee came under some pressure primarily on account of external developments and both equity and bond prices witnessed volatility because of global factors like deleveraging by FIIs on fears of impending winding up of the quantitative easing by the US Fed.

In the Indian context, broadly speaking, integration of financial markets has been facilitated by various measures in the form of (i) free pricing, (ii) widening of participation base in markets, (iii) introduction of new instruments and (iv) improvements in payment and settlement infrastructure. Free pricing in the form of market-determined exchange rate, freeing of interest rates, gradual liberalisation of capital account, etc., helped in greater integration of the Indian financial markets. The advent of FIIs who have access to both domestic as well as international markets, have had a profound impact on the domestic financial markets. The linkage between the domestic foreign exchange market and the overseas market (vertical integration) was facilitated by allowing banks/authorised dealers (ADs) to borrow and invest funds abroad (subject to certain limits), and to lend in foreign currency to companies in India and by allowing Indian companies to raise resources from abroad, through American/Global Depository Receipts (ADRs/ GDRs), foreign currency convertible bonds (FCCBs) and external commercial borrowings (ECBs). Several new instruments were introduced, especially the derivative products, which facilitated the deepening of market and enabled participants to hedge currency and interest rate risks. A number of institutional measures, and significant improvement in technology and payment and settlement infrastructure, such as, introduction of DvP, Government securities order matching platform christened NDS-OM, RTGS, electronic trading system at the exchanges, etc., have significantly strengthened the financial sector market infrastructure.

Progress with regard to internationalization of Asian currencies, especially Renminbi and Rupee

China’s fast economic growth and its increasing economic integration with the world have accelerated the progress of Chinese currency’s internationalization. At present, RMB is not yet a currency playing the role of store of value, nor an anchor. However, at a limited level, China’s endeavor to internationalize the RMB has begun as some progress is already visible in transactions with its trading partners. RMB is being widely used in trade and other current account transactions with Vietnam, Laos, Myanmar, the Central Asian states, Russia, and so forth. Additionally, with respect to capital transactions, China has promulgated provisional rules governing the issuance of RMB-denominated bonds by international development institutions. China has permitted invoicing of any trade with Mainland China in RMB. In regard to its management of foreign exchange reserves since the outbreak of the global financial crisis, the People’s Bank of China (PBOC) has entered into a series of bilateral currency swap agreements whereby the PBOC and other central banks (over 20 in number) have agreed to exchange the RMB (not the US dollar) with the respective counter-party currencies. The Chinese authorities have also been taking a number of proactive steps towards developing an offshore market for RMB.

Comparisons are bound to be made between Renminbi and Indian Rupee on the issue of internationalization. Indian Rupee is not fully convertible at this stage. While the current account has been made fully convertible, we have consciously followed a calibrated approach towards capital account convertibility. It is also important to understand that unlike China, which runs large current account surpluses, India has generally been a current account deficit country. In view of the large current account deficit, the exchange rate of the rupee is susceptible to the influence of large capital movements, especially during crisis periods. This does not mean that the country does not aspire to see the Rupee as an international currency particularly as we increase our global integration through trade and investment channels. In order to promote Rupee invoicing for trade related transactions, Reserve Bank of India has taken several steps in recent times.

Constraints to internationalization of Asian currencies and the way forward

Let me conclude by flagging five issues. First, as I have already outlined above, a number of recent studies on integration of Asian financial markets have, based on empirical analysis, concluded that regional integration of Asian financial markets, both equity and debt markets, have progressed over the years but is still incomplete and there is a lot of divergence in the level of integration. China has been making definite moves, but there is hardly any integration in the rest of Asia, though spillovers from international markets are increasingly being felt in other Asian markets, including India, which is indicative of growing integration of the Asian markets with global markets. Apart from local factors such as credit or liquidity risks in some Asian economies, the divergence and the lack of progress in financial market integration can be attributed to several factors, particularly the failure to harmonise standards in the regions' capital markets.

Second, currency internationalization, which entails market liberalization, requires putting in place regional financial market infrastructure that includes a regional system of clearing and settlement, regional credit guarantee institutions, hedging facilities, and regional credit rating agencies to foster cross-border investments. This will also need to be accompanied by the harmonisation of legal and regulatory systems, market practices, rating standards, accounting and auditing practices, and withholding taxes on bond coupon payments across countries in the region. Additionally, greater internationalisation of Asian currencies would require existence of well developed and deep forex markets with diversified forex hedging instruments, which will facilitate issuance of foreign bonds in domestic markets and local currency bonds by foreign entities. At the present juncture, such preconditions are not being fully met in the region. How do we proceed?

Third, ASEAN countries are nowhere near forming a single market as in the EU. There have been proposals regarding formation of an Asian Monetary Union and a single regional currency but these proposals have not reached anywhere. Full-fledged integration in the region will require creation of a supranational institution on the lines of EU but that is just a far-fetched thing at this juncture. The lessons from not so happy experience of European integration through a monetary union mechanism will also weigh on the minds of the Asian policymakers. In any case, the greater integration and internationalization of Asian currencies would require an agreement between the participating countries to be bound by collective decisions rather than bilateral ones. How do we achieve this?

Fourth, in view of the obstacles to regional integration mentioned above, most of the Asian countries are individually linked to the global economy more as compared to the regional economy. Financial market integration is, however, important to the region's economic development. The slow pace and the varying degrees of integration in the region warrant concerted policy actions to surmount the constraints. Asian countries have shown their political support for greater financial co-operation and integration. There is certainly huge scope for channelizing regional savings in the region, particularly say for investments in infrastructure development. There is a need to address obstacles in areas such as differences in economic structure and development, maturity of individual markets and infrastructure. Can we hope for a co-ordinated strategy for promoting integration of the Asian financial markets that will go a long way towards facilitating internationalization of Asian currencies?

Fifth, one final thought. As we discuss the issue of internationalisation, we also need to be conscious about the problems of unfettered integration with global markets, where the local fundamentals recede to the background and the global factors start playing a major role in creating unwarranted volatility in the markets as the recent developments have amply demonstrated. How do we address this issue? India approached this issue exactly the same way as the country has approached capital account convertibility – as a process rather than an event, by a gradual rather than the Big Bang opening of the door. It is for each country to strategise its approach.

Thank you