H R Khan: Regulating capital account – some thoughts

Inaugural address by Mr H R Khan, Deputy Governor of the Reserve Bank of India, at the 9th Annual Conference of the Foreign Exchange Dealers Association of India (FEDAI), Cape Town, 12 April 2014.

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Contributions of Shri H S Mohanty & Shri Surajit Bose of Reserve Bank of India are gratefully acknowledged by the speaker.

1. It gives me great pleasure to be with you in this beautiful city of Cape Town for the 9th Annual Conference of the Foreign Exchange Dealers Association of India (FEDAI). Cape Town is a celebrated tourist destination, particularly at this time of the year. The place and time are ideal for mixing business with pleasure. For me, speaking to you, the pleasure is mixed with some trepidation because we are living in times when there is uncertainty all round not only in the unfolding of events but also in the way we think about them. You may be aware that close to this place is a great tourist attraction which is called "The Cape of Good Hope" for as many as 300 years because it provided a sea–route to India and the East Indies. But, only till opening of the Suez Canal in 1869 when the complexion of East-West sea faring changed. There are thus many events in the course of human history which change dramatically our approach to issues and problems. The events of the past few years – both in the domestic as well as in the global arena – have made us think afresh about many of our approaches to public policy relating to regulation. I intend to discuss some of the current issues relating to our approach to capital account management as it has evolved over time and I beg your indulgence if some questions come up to which answers are not yet as clear as we would wish them to be.

2. The FEDAI, set up in 1958 as a section 25 company, has been a multi-faceted organization, playing an important role in each of its functional domain. It has had immense contribution in development of the interbank forex market, promoting uniform bank-client business practices, training bank personnel working in foreign exchange desks, and most importantly, acting as an interface between the Reserve Bank and the Authorised Dealers. During the last 56 years of its existence it has seen, rather played a major role in, the transition from a fixed exchange rate regime to almost floating exchange rate one; from a non-existent or at best a shallow interbank forex market to one whose activity not infrequently causes the regulator to sit up and take notice, and sometimes act; and from an era when every non-trade forex transaction with a client required a "Exchange Control Permit" to a time when the Authorised Dealers (ADs) have more power and freedom than they are perhaps willing to exercise.

Capital controls: old paradigms & new realities

3. The evolution of the foreign exchange market in India has been shaped by the exchange rate regime and the changing degrees of control. With full convertibility on the current account since 1994 and enactment of Foreign Exchange Management Act, 1999 (FEMA), controls on the capital account have been the principal theme of foreign exchange management during the last two decades. The motivation for imposing controls and restraining the freedom of the residents to transact with non-residents stems from one major concern: addressing the structural imbalances in the balance of payments. But the philosophy and the form of controls have evolved over time. Let me give an example. India has had two major devaluations following severe balance of payment crisis: in 1966 and in 1991. Post 1966 devaluation, we had moved in an inward looking direction with the help of a very stringent exchange control regime. Post 1991 devaluation, however, we moved in the exactly opposite direction: towards more openness on current and capital account and in due course, a legislation with a different objective and a different orientation. This approach has

in a sense stood us in good stead. Counterintuitive as it may seem, is it then that greater external openness, particularly capital account openness, provides a more stable solution to balance of payments problems? As Robert Aumann says, though in a different context, in his Nobel Prize Lecture: "*You want to prevent war. To do that, obviously you should disarm, lower the level of armaments. Right? No, wrong. You might want to do the exact opposite*." Let me give another instance of how the thinking changes. In the 1990's it was a widely held normative belief, though not uncontested, that capital controls ought to be avoided and free flow of capital promoted. In the aftermath of the Asian crisis of the late 1990's, the substantive argument did not undergo any change, but was only tempered to the extent that removal of capital controls has to keep pace with strengthening of domestic financial sector. Post the global financial crisis, capital controls have come to be seen as an active tool of macro-prudential policy albeit in difficult situations.

4. Why have any controls on capital account? The history of capital account openness has been chequered. It may be recalled that capital controls were a part of international milieu throughout the Bretton Woods era and it was only in the 1970's that the advanced economies started dismantling them. This was followed by several emerging economies, particularly in Latin America and East Asia. The argument in favour of opening up of the capital account was mainly based on "allocative efficiency": the capital-scarce but projects-rich developing countries can surely improve their welfare and better their lot with the help of capital inflows. The crisis in several Latin American countries and the East Asian countries in the late 1990's pointed out the destabilizing effect of capital account openness and raised many question about its desirability. Subsequent literature has shown, on the one hand, that capital account openness by itself may not induce growth in absence of appropriate institutions and on the other, capital controls can indeed be used as a macro-prudential tool to restore or promote stability. In the Indian context, we have had two committees – at a gap of about a decade – look into the issues relating to a possible roadmap for fuller capital account convertibility.[1] The macroeconomic preconditions emphasized by these Committees, viz., sustained, low inflation and strong fiscal position have not yet materialized. As mentioned earlier, the issue of free capital flows versus capital controls have evoked a wide range of response over time and the academic literature does not provide clear and consensus view in the matter except some stylized themes, such as, need for capital inflows for augmenting domestic investment, possible destabilizing impacts of free capital/financial flows, improvement in domestic conditions to enable better utilization of capital flows and lessen the possibility of instability, need for capital controls in extreme situations, and need for coordinated capital flows management policy across nations. Considering our state of affairs and realizing that there is no certainty on the consequence of full CAC, we have committed to progressive opening up of the capital account in a calibrated manner for several reasons including greater integration with the global economy, need to finance the persistent current account deficit, and above all to mobilize resources for the investment needs of a growing economy, particularly the infrastructure sector. At the same time, the vulnerabilities of an open emerging economy and the problems of extreme volatility in the exchange rate informs and guides our approach.

Stability in exchange rates: means & mechanics

5. The proximate problem that a central bank faces is maintaining a reasonably stable exchange rate, a variable that captures not only the external sector imbalances but also the future expectations of the relevant fundamentals. Empirical studies show that, in the short run, exchange rates behave as asset prices and follow a "random walk". Even so, any sharp

[1] Unfortunately, both these Committees' report preceded financial crises, the East-Asian and the Global Financial Crisis, and hence their recommendations were not pursued as seriously as they would have been otherwise.

depreciation in the exchange rate is likely to see large scale capital exodus by the short-term investors before the value of their investment is further eroded. At the same time, through the instrument of derivatives, it is possible for exporters, importers and others to adjust their inter-temporal demand for foreign currency: to either postpone the present demand to a future time or advance the future demand to the present time. Like any other asset price, a sharply falling exchange rate has the tendency to gather quick momentum. The problem of an appreciating currency in the face of surging capital inflows poses a separate set of problems, principal amongst which is loss of export competitiveness.

6. The question then is that whether such situations should invite regulatory response? An influential line of thought in this context is to solve the problem of the impossible trinity by leaving the exchange rate out of reckoning: letting the exchange rate find its own level depending on the market process. Though the merit in this position cannot be logically denied, it may not be an optimal solution in real life because though exchange rate behaves as an asset price, it is an important macroeconomic variable that influences optimal decision making of a large number of economic agents in an economy progressively integrating with the rest of the world. Secondly, sharp movements in the currency capture as well as breed expectations for future, often in a self-fulfilling spiral, and perhaps need to be addressed in the same spirit as sharp and persistent rise in the general price level needs to be addressed lest it entrenches inflationary expectations.

7. The most obvious and immediate tool for dealing with heightened volatility or sharp movement either way is the central bank's intervention operations. For instance, in the face of sharp appreciation, the intervention is directed at mopping up the excess supply of foreign currency in order to preserve export competitiveness. Such operations obviously do have monetary implications and steps to neutralize these involve a cost. On the other hand, intervention in the face of sharp depreciation is a difficult choice for several reasons, including loss of reserves, particularly in a country like India where the external liabilities far exceed the official reserves.

8. As an aside, let me add that the importance of a sufficiently large kitty of official reserves to deal with sudden flow reversals has been underscored time and again. In fact, the large reserves that many emerging market economies have built up post Asian-crisis is often viewed as a bulwark against contagion effects of global crises and risk aversion. Therefore, accumulation of reserves as an objective by itself rather than a byproduct of market actions of the central bank to stabilize the exchange rate is a theme that cannot be dismissed out of hand, more so when there is no assured and easy access to any collective insurance for the EMEs like India.

9. Coming back to our discussion, given the problems with sustained or aggressive intervention in the face of sharp movements in exchange rate– leaving aside its optimality or desirability – what tools do we have to deal with it? Mainly two: modulate capital controls appropriately and restrain the freedom of market participants to carry out derivative transactions which can be used to speculate on the currency and camouflage capital flows. During the periodic bouts of volatility in the Rupee since late-2011, we have used a mix both tools, to which I now turn. You will recall that the Rupee had exhibited relative stability after the post-Lehman volatility of 2009 and traded in a narrow band during most of 2010 and 2011. The volatility started in the second half of 2011 on the wake of US downgrade and related problems. Since then we have had three different spates of volatility: end-July 2011 to mid-December 2011 (about 18% depreciation of INR against USD), end-February 2012 to end-June 2012 (about 12%) and end-April to end-August 2013 (about 19%).[2] Most emerging market currencies also fell in value during the period and this elicited varying response from

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[2] Source: Bloomberg.

the respective authorities which included capital controls on the one hand and taking measures to attract relatively longer term flows on the other.

Capital inflows & outflows: hierarchy of choices

10. Let me now make some comments on capital controls. Our framework of capital account management, has been more inclined towards capital inflows than capital outflows. In a, capital scarce growing economy with large investment needs, it has been our long-standing policy to encourage capital inflows to augment domestic savings with a bias towards flows that are stable, long term and those that are least prone to sudden stoppages and reversals. Here I would like to highlight our approach to some of the critical elements of capital flows.

Foreign Direct Investments

11. Foreign Direct Investment (FDI), characterized by lasting interest and some degree of management control by the investor, is positioned high in the hierarchy of capital inflows not only because of it is resource augmenting but also because it usually brings in better technology and more efficient management and business practices. The framework for FDI, which gets legal sanctity under the regulations notified by the Reserve Bank under FEMA, is set by the Government of India in consultation with the Reserve Bank of India, and the only restriction on FDI pertains to sectoral investment limits – the degree of control that can be ceded to a non-resident- motivated by strategic or socio-economic considerations. The rest of the regulatory framework is a matter of procedural detail, and we have been continuously trying to rationalize and streamline the regime to make it as investor friendly as possible. To illustrate the point, one can cite some of our recent measures, such as, doing away with the regulatory prescription of pricing methodology, introduction of optionality in inward FDI, etc.

Foreign Portfolio Investors

12. There is a tendency to see inflows on account of foreign portfolio investment as "hot money" which can cause sudden stoppages or reversals. Over two decades of experience as well as recent studies show that this fear is perhaps exaggerated. Portfolio investment flows do exhibit some volatility and surge either way, but at an aggregate level there is a fair degree of stability. Since its introduction in 1992, the regulatory regime for portfolio investment has evolved over time. You are all aware of the recent simplifications and liberalizations brought about in the scheme in sync with regulations notified by the Securities and Exchange Board of India (SEBI) wherein the FIIs and QFIs have been merged into a single class of investors known as Foreign Portfolio Investors (FPI) and simplified the KYC verification norms have been prescribed for opening of bank accounts for the portfolio investors. Foreign portfolio investors were granted access to the Government securities segment of the domestic debt market in 1999. Over the years the scope of their investment has been expanded to include corporate debt and the limits for investments in Government securities and corporate bonds have also been progressively increased. As we have seen, our cautious approach is based on perception of potential risk of sudden stops & swift reversals during periods of uncertainty. The investor appetite in this segment has been biased towards the securities of short term maturity: treasury bills, commercial papers, and bonds maturing in less than a year. Both with a view to developing the market as well as encouraging long term flows, the current policy priority is to encourage investment in bonds of relatively longer duration. Accordingly, we had created, and subsequently expanded, a separate window for long-term foreign investors. We have recently moved towards restricting incremental access to treasury bills and government securities with less than one year residual maturity segments to the foreign portfolio investors. The less than expected response of the foreign investors to the debt instruments even in relation to relatively small limits available to them has presumably also to do with the lack of liquidity in this segment. This is an important goal for us and several steps have been taken and are being

contemplated to deal with this problem, particularly in the light of the recommendation of the Working Group on Enhancing Liquidity in the Government Securities and Interest Rate Derivatives Markets (Chairman: Shri. R. Gandhi).

External Commercial Borrowings

13. In contrast with foreign investment in rupee-denominated marketable domestic debt securities, External Commercial Borrowings (ECBs) are bi-partite loan contracts denominated in foreign currency and initiated by the domestic borrowers. The approach here has been that since the external liability of the economy should not be allowed to expand excessively, the ECBs need to be allocated, as it were, to their most productive use. This objective is sought to be achieved through a regulatory regime comprising restrictions in regard to quantum of loan, end use, tenor, lender credentials, and cost of borrowing. The last, the ceiling on cost of borrowing, may seem to be superfluous in view of the restriction on the quantum of borrowing. But it has to be appreciated that there is an automatic route for ECB, and it is necessary to address the adverse selection problem so that ECBs do not flow into risky projects. In recent years, keeping in view the need for capital inflows as well as the investment needs, particularly for those in the infrastructure sector and those having forex earning capabilities to service ECBs, we have relaxed the regulatory framework for ECB in several respects.

14. In this context, let us examine the motivation for firms resorting to ECB. If a firm has a foreign currency revenue stream it is optimal for it to borrow in foreign currency as well so that its balance sheet does not carry any currency risk. But if its revenue is all in Rupees, it ought to fully hedge its foreign currency liability and a fully hedged ECB should offer no arbitrage in ideal market conditions. Unhedged foreign currency liability poses a currency risk, potentially explosive in volatile times, and also a risk to its other stake-holders, particularly the domestic lenders. Individual corporate vulnerability could easily aggregate to systemic stability risks. The issue then is: do the domestic lenders assess this risk price it appropriately while granting various facilities to the firms concerned? We are not sure. Hence the regulatory prescription for incremental provisioning and capital requirements has been introduced for bank exposures to firms with unhedged foreign currency liability.

Non-Resident Deposits

15. Incentivised deposit accounts for diaspora Indians was one of the earliest measures to strengthen capital inflows. It has served us well when the other forms of capital flows were either non-existent or at best, weak. Though the importance of NRI deposits has relatively declined over time, we still have a fairly friendly set of schemes to encourage the diaspora to use the Indian banking system for their banking as well as savings needs. In fact, in the recent periods of currency volatility, more incentives were offered to such NRI depositors to attract long-term flows.

Rupee bonds abroad

16. So far, because of non-convertibility of the Rupee on the capital account, we had been averse to the idea of Rupee-denominated bonds in overseas markets. Such an instrument, to replicate a Rupee-pay-off, will need an onshore Indian asset and further, the investor will require access to the onshore derivative market to hedge her currency risk. Both of these were restricted. Approached by the International Finance Corporation (IFC), and recognizing that there are keen offshore investors with Indian interest which can be tapped, we have permitted Rupee-linked bond to be floated abroad for US$ one billion and proceeds invested in Indian assets. This is a pilot project and the experience, including market impact, will guide us in further expanding such issuances. In fact, some other multilateral institutions are also now evaluating the option of similar bond issuances.

Regulations on capital outflows

17. In a capital scarce economy like ours, it is perhaps logical that there should be close monitoring of out-bound investments. The case for overseas direct investment (ODI) rests on permitting Indian entrepreneurs to exploit avenues for profitable investment abroad. With this in view, we have progressively liberalized the regulatory regime for ODI. But as in case of any investment, ODI must also yield returns over time. Notwithstanding not very satisfactory experience so far in respect of inflow of income from our investments abroad, an investor friendly regulatory regime continues in place. Recent changes in the ODI regulations no way seeks to dent globalization efforts of Indian investors but only that under extraordinary circumstances investments beyond a threshold, other than financing by ECBs, have been moved to the approval route. Going forward, as stability in forex markets becomes well established, we shall be unwinding them partially or fully. The case for portfolio investment by individuals rests on affording an opportunity to Indian residents to diversify their portfolio. We have been progressively liberalizing the facility till the last bout of Rupee volatility when we had to take steps to moderate it. It may be recalled that it was raised substantially to US$ 200,000 per annum when we had massive inflows. Such limit under the Liberalised Remittance Scheme (LRS), used widely for current account transactions and also some capital account transactions, including acquisition of property abroad, was brought down when there were apprehensions of large scale transfers in the face of currency volatility. It must be noted that as a measure of further liberalization setting up of companies abroad by resident individuals now has been permitted under the revised LRS.

18. This brings me to an important issue in foreign exchange regulation, or any regulation for that matter. Any regulatory framework first and foremost has to be predictable and time-consistent. Investment and business is a matter of trust and investors and firms can plan and execute their strategies only if they believe that the regulatory regime will not change in the midway. Since the external factors in the today's world change rapidly, there will be great temptation to adjust the regulatory framework as well. Let me give an example. During 2007–08, we faced an unprecedented surge in capital inflows. Sharp appreciation of the Rupee, Reserve Bank's market operations, consequent liquidity impact and the fiscal cost of sterilization are all in recent memory. Several measures were taken in this milieu, such as, increase in the limits for LRS, allowing foreign companies to raise capital in India through Indian Depository Receipt (IDR), introduction of currency futures, etc. The situation changed rapidly post onset of the Global Financial Crisis (GFC), and, after some lull during 2010–11, again post US downgrade, EU crisis, etc. Do we unwind all the decisions and measure taken during times of plenty? This, in a way, justifies the approach of cautious gradualism that we have been adopting so far.

Regulating derivative contracts: onshore & offshore

19. Now I come to the other tool I mentioned about for controlling Rupee volatility: restriction on derivatives. Our view of derivatives has been to treat them as a tool of risk management and as an instrument of hedging foreign exchange risk. This is reflected in the regulatory regime for forex derivatives in the OTC market which has the following two distinguishing characteristics. First, the ability of a firm or an individual to execute a derivative contract is based on an underlying exposure embodying risk. Second, these contracts, at least those involving Rupee, are predominantly to be executed by physical delivery. Over the years, to enable the firms to manage their foreign exchange risk flexibly and efficiently, several relaxations have been introduced, such as, carrying out derivative transactions on the basis of past performance rather than on the basis of individual underlying contracts, cancelling derivative contracts even as the underlying exposure exists (and getting the benefit or bearing the loss thereof) with scope to rebook the contract against the same exposure, etc. These relaxations can potentially be used to take a view on the Rupee when expectation of sharp depreciation (or appreciation), rightly or wrongly, is strong. This aggravates the market conditions. We have often resorted to curtailing the freedom of market

participants in respect of booking derivative transactions both to curb panic as well as to stem speculative view taking on the Rupee.

Non-Deliverable Forward markets

20. The issue of forex derivatives has become complex because of two reasons. First, there has come to exists a large offshore market in Rupee. Rupee futures are now traded in some of the international exchanges. There is a sizeable Non-Deliverable Forward (NDF) market in Rupee in several international financial centers. This market is opaque and the exact size or details of participants is not known. Our interaction with market participants tend to indicate that the figures published by the Bank for International Settlements (BIS) in the last two triennial surveys may have been over-estimated, but surely they are large enough to impact the domestic market, particularly during periods of heightened volatility. Notwithstanding absence of any clear link between the onshore and offshore markets, it cannot be ruled out that some arbitrage may be happening.

21. What is the reason for an NDF market to exist? The increasing global linkage of the Indian markets on the trade, capital and financial account on the one hand and inadequate or cumbersome access of international agents with Rupee exposure to the onshore domestic market on the other seems to be the obvious answer. There are many investors – mostly portfolio investors – who hold Rupee assets but are either not allowed to hedge their risk in the onshore market, or if allowed, the regime, with restrictions on rebooking of cancelled contracts, may not suit their hedging strategy. There may also be a large home country bias inasmuch as they would prefer an entity in their place or jurisdiction of residence as counterparty rather than an AD in an alien place. The same set of logic holds also for many multinational firms in India who use transfer pricing and/or have centralized treasury. There is also the question of economic/potential exposures in a rapidly globalizing world, where one without explicit foreign exchange exposure, could still be affected by exchange rate movements. Be that as it may, NDF has now warranted closer attention of the regulators.

Exchange Traded Derivatives

22. The second issue relates to the on-shore Exchange Traded Derivative (ETD) market introduced in 2008 when the external situation was quite different. The objective was to afford real sector agents – particularly the small entities – an easy, safe, transparent and cost-effective instrument to hedge their currency risk. This market is very different from the OTC segment in respect of the two characteristics we mentioned earlier: (a) there is no requirement of underlying exposure for accessing this market and as such, entry as well as exit is unrestricted and (b) contracts are cash settled. In other words, it may be used for hedging, but it is also a perfect instrument for speculation for it makes trading in exchange rate just like trading in any other financial asset. The question that arises is: how can the two markets – the OTC with the regulatory restrictions and the ETD without – coexist? More importantly, will the restrictive measures in the OTC market to control rupee volatility not be rendered completely ineffective if market participants are free to migrate to the ETD segment? With this perspective, at the height of Rupee volatility, we, and, at our request SEBI, were constrained to take several measures in respect of the ETD segment including putting a ceiling on individual positions/open interest, restricting arbitrage between the two markets through banks and increasing the margin requirements. Here I would like to add that with return of stability in the exchange rate, we have already unwound some of the restrictive measures in the OTC/ETD market and, in fact, gone further for hedging in the OTC markets (e.g. permitting hedging up to US$ 250,000 without any documentation requirements). Similarly some more relaxations in the ETD segment, including permitting participation of foreign investors are under consideration.

23. The emergence and growth of NDF market as well as its possible impact on the domestic market poses two important questions. Should attempts not be made to bring the offshore market in Rupee onshore and thereby add depth to our markets and also possibly,

income and employment? Secondly, since NDF market is often seen to be affecting the domestic markets, implying thereby the possibility of arbitrage, should domestic banks be allowed to participate in this market? Let me add here that in some countries, the central banks are reported to have intervened in the NDF market of their respective currencies to curb the volatility at its root.

24. If the answer to both questions is positive, it requires some fundamental rethinking on the regulatory framework for foreign exchange derivatives. Already, as mentioned above, we are committed to allowing foreign investors access to the ETD segment with minimal restrictions. But will this access be inviting enough to the investors if the futures prices are not tightly linked with the spot prices? But this is possible only by permitting frictionless arbitrage between the two markets. Secondly, if we are to allow access to the offshore markets to domestic entities, it may not serve any purpose if arbitrage between the offshore and onshore markets is blocked. If we are to pursue it to its logical end, this leads us to a situation where there is no restriction on forex derivative transactions in domestic markets and across the borders – either on eligibility, entry and exit of participants or on settlement.

25. Here, what tempers our thinking is the principle I mentioned earlier: the imperative of regulatory consistency and irreversibility over time. Do we have the appetite and wherewithal to tide over any possible future spate of volatility without undoing any relaxations we contemplate bringing about? This consideration argues in favour of moderation, gradualism and pacing our steps. The challenge is to hit an optimal middle path between throwing caution to the wind and allowing excessive caution to prevent any forward movement.

Concluding thoughts

26. Having outlined some of our policy dilemmas in respect of capital controls and forex market development and regulations, let me now in conclusion turn to the role FEDAI and its member foreign exchange dealers can play in appreciating the challenges and actively engaging with the regulators. Between the world where they just had to execute a transaction according to an RBI permit and the world where a foreign exchange transaction will be like any other inland rupee transaction except the currency risk falls a large territory where the foreign exchange dealers will have to facilitate external trade and investment related transactions keeping in view the genuine needs of the real sector without losing sight of the prudential requirements. Authorised Dealers will have to constructively engage themselves in appreciation of the evolving regulatory dispensation and, more importantly, provide a friendly, efficient and transparent interface with the end-users. Regulatory framework, of course, has to evolve, amongst others, keeping pace with the way business is done and it is important for Authorized Dealers to be conversant with the purpose and principle behind change in regulatory regime not only for effective implementation but also for providing a conducive atmosphere for doing business. We find many violations of regulations occur not intentionally but due to ignorance or lack of appreciation. There is surely enough scope for bringing in improvement in this regard. The well thought out sessions planned for this conference, in a sense, will provide many insights to our understanding of some of the current issues relating to our financial markets. Lastly, I wish to emphasize that there is a need for establishing highest standard of code and ethics of doing business and guarding against temptations of perverse incentives, particularly in the financial sector. The financial markets and institutions survive and thrive on trust and it must be our constant endeavor to continue to deserve that trust.

Thank you very much for your attention.