

Gurumoorthy Mahalingam: Some thoughts on forex markets in India

Keynote address by Mr Gurumoorthy Mahalingam, Executive Director of the Reserve Bank of India, at the India Treasury Summit, Mumbai, 25 February 2015.

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Contribution by Shri Anand Prakash, Director, Financial Markets Operations Department in preparing the speech is gratefully acknowledged.

Introduction

It is indeed a pleasure for me to be here at the India Treasury Summit to share my thoughts on the Indian Foreign Exchange Market. This forum provides an important platform for interaction amongst the corporate treasurers, finance professionals and market participants and it is being held at a time when the financial world is beset with uncertainties regarding economic growth prospects, oil and commodity prices and monetary policy stances of major economies. Given this uncertainty as the backdrop, I would like to touch on some key issues which impact the development of Indian forex markets.

Indian forex market has come a long way

Foreign exchange market in India has developed significantly in the post-reforms era following the phased transition from a pegged exchange rate regime to a market determined exchange rate regime in 1993 and the subsequent adoption of current account convertibility in 1994. With the abolition of liberalized exchange rate management system (LERMS) in 1993, the exchange rate of the rupee became market determined. There has been a significant increase in both depth and liquidity in the spot as well as forward market segments, which could be gauged from the rise in the average daily forex market turnover from approximately US\$ 16 billion in 2005–06 to nearly US\$ 55 billion in 2014–15 so far. The depth of the foreign exchange market can also be gauged from the fact that the bid-offer spread in USD-INR pair is quite narrow now.

In the context of integration of Indian financial market with international markets, the approach of Reserve Bank of India to market development has been that of cautious gradualism, informed by the experience of other developed and developing countries. Even within the constraints imposed by a gradualist approach, Reserve Bank and the Government of India have taken several steps that include progressive liberalization of capital flows, calibrated 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, expansion of the menu of risk management instruments, etc.

Proper risk management system is another issue of utmost importance where significant progress has been made. The setting up of Clearing Corporation of India, which commenced its operations in 2003, has helped in significantly enhancing the efficiency and security of settlement system for government, money market and forex market.

As far as Over-the-counter (OTC) derivative products are concerned, significant progress has been made in the recent past. In 2012, trade repository became operational in India when Reserve Bank of India advised that all/selective trades in OTC foreign exchange and interest rate derivatives between the banks/market makers (banks/primary dealers) and their clients should be reported on the CCIL platform subject to a mutually agreed upon confidentiality protocol. The reporting arrangement covering OTC foreign exchange derivative trades between Authorised Dealers (AD) banks and their clients has now been fully operationalised.

Forex market movements

The forex market conditions have generally remained orderly with intermittent episodes of volatility in the past two decades on account of external or internal factors or a combination of both. The day-to-day movements in the exchange rate of the rupee are market determined, i.e., determined by forces of demand and supply. India's approach to exchange rate management has been to avoid volatility without targeting any level. The EMEs' experience, in general, in the past two decades has highlighted the growing importance of capital flows in determining the exchange rate movements as against trade flows in the 1980s and before. An issue of paramount significance in this context is the volatility in capital flows to EMEs including India. In the aftermath of global financial crisis of 2008 and more recently after Chairman Bernanke's testimony in May 2013 about the possibility of quantitative easing (QE) tapering, managing exchange rate volatility in EMEs like India has been rendered more challenging, in the background of volatile capital flows.

India's response to taper tantrums

As I mentioned above, India, like most other EMEs, is facing the challenges associated with volatile capital flows and is susceptible to shifts in risk appetite of international investors on account of external developments completely exogenous to whatever happens in the country. This was amply demonstrated during the May-August 2013 episode of taper tantrums. The mere hint by Chairman Bernanke about possibility of an early QE-tapering led to an exodus by the FIIs, especially in the debt segment. The rupee went into a tailspin and depreciated sharply by over 19 per cent, touching a historic low of 68.85 on August 28, 2013. Of course, India's weak macro-economic fundamentals, especially high current account deficit, that existed then, exacerbated the situation. In order to stem the sharp and excessive depreciation of the rupee, India resorted to a mix of policy measures including forex market intervention, monetary tightening through reduction in banks' access to overnight Liquidity Adjustment Facility (LAF), increase in Marginal Standing Facility (MSF) rate and increase in daily minimum Cash Reserve Ratio (CRR) maintenance requirements, coupled with other policy measures, such as, gold import restrictions, special dollar swap window for PSU oil companies, special concessional swap window for attracting FCNR (B) deposits, increase in overseas borrowing limit of banks, disallowing banks from carrying proprietary trading in currency futures/exchange traded options, etc. Additionally, FII investment limit in government debt was enhanced by US\$ 5 billion to US\$ 30 billion in June 2013 to attract greater inflows.

Positive developments during 2014–15 lending support to the rupee

The various measures taken by the Reserve Bank in conjunction with the Government of India helped in restoring stability to the forex market with the rupee recouping most of its losses during September-October 2013. The rupee exhibited greater two-way movements during 2014 on the back of sustained FII inflows, especially in the debt segment. As compared to major currencies as well as some of the other emerging market peers, the Indian Rupee has exhibited greater stability during the recent months. Positive factors including continued FII inflows to the domestic equity and debt markets (around US\$ 39.3 billion in 2014–15 so far), sustained FDI flows, political stability, fiscal consolidation (lower fiscal deficit target of 4.1 per cent of GDP in 2014–15 vis-à-vis realized fiscal deficit of 4.5 per cent of GDP in the previous year), continuation of reform measures by the new government at the Centre, significant reduction in current account deficit during the first half of the current financial year (1.9 per cent of GDP), improvement in macro-economic parameters, such as, CPI inflation (5.1 per cent in January 2015) and GDP growth (7.4 per cent during April-December 2014 as per new methodology) have contributed towards the stability of the rupee.

India's forex reserves have also increased significantly in 2014–15 so far and stood at an all-time high of around US\$ 333 billion on February 13, 2015. Recent experiences, especially

after the global financial crisis, suggest that large reserves in the case of emerging market economies (EME)s like India with sustained current account deficit act as a buffer and help in weathering the impact of sudden stops/reversals in capital flows, especially during crisis period. Earlier, having large reserves was considered wasteful on account of quasi fiscal costs but the global financial crisis led to a renewed debate about the adequacy of reserves, as EMEs with large reserves could weather the crisis relatively better leading to the current thinking that the benefits of holding larger reserves far outweigh the costs, especially in the case of EMEs like India.

Additionally, the sharp downward movement in imported commodity prices, especially crude oil prices, has also buoyed the market sentiment and contributed to the resilience of the rupee in the recent months. The stability exhibited by the exchange rate of the rupee in the recent months, despite completion of the process of tapering of QE by the Federal Reserve in October 2014, reflects the improved confidence of global investors in the Indian economy.

Overall, financial markets in India, unlike global financial markets, have exhibited greater stability and resilience. The outlook for foreign portfolio flows to India also remains quite positive during 2015, as India is quite well placed vis-à-vis its peers on account of the positive factors mentioned above and remains an attractive investment destination. Additionally, unlike commodity exporting countries like Russia, India stands to gain substantially from the steep fall in crude oil prices through improvement in current account deficit, fall in inflation, reduction in fiscal burden on account of oil subsidy, etc. All these factors would contribute towards ensuring stable conditions in the domestic forex market in 2015.

Normalisation of US monetary policy and weak global growth pose significant risk

However, potential for volatility still remains, which emanates largely from external factors. Despite significant improvements in macro-economic fundamentals and the overall prospects of the Indian economy, as outlined above, the spillover impact from global financial market volatility to India could be disruptive, especially once normalisation of the US monetary policy stance begins with the commencement of tightening of interest rate cycle in the US in 2015 and beyond.

The US dollar has already appreciated significantly against most of the major as well as EME currencies in the recent period with the dollar index rising sharply from the second half of 2014, taking cues from the divergence in the monetary policies pursued by major central banks coupled with shifts in economic outlook. While the US has completely tapered off its QE, the Euro Zone and Japan have increasingly resorted to QE for propping up their economies against the backdrop of faltering growth, leading to depreciation of their currencies. Market volatility in many EMEs has increased. In fact, the Indian rupee has remained relatively stable amidst volatility in other markets. However, tightening of interest rates by the US Fed later in 2015 can lead to some reallocation of FII portfolios away from the EMEs to the US on the back of improved growth prospects of the US economy. Though, it is unlikely that the episode of taper tantrum will be repeated this time as the markets have already factored in the likely tightening of the US interest rates, some volatility in the EME forex markets is inevitable.

Risks also emanate from a prolonged period of weak global growth, which could hamper Indian exports. Though global growth may receive some fillip from decline in oil prices, this may be largely offset by negative factors like decline in investment associated with diminishing medium-term growth prospects. Oil exporting countries are facing enhanced external and balance sheet vulnerabilities on account of steep fall in oil prices. Stagnation and low inflation continue to remain a concern in the Euro area and Japan and geopolitical tensions continue to remain high. The recent developments in Greece have added a new dimension of uncertainty to Euro. China is also facing significant slowdown in growth momentum and the outlook for EMEs also remains weak. Thus, the uncertain global growth prospects pose significant risks to stability of Indian financial markets. A sudden reversal in

commodity prices, especially crude oil prices, could enhance volatility in the Indian financial markets, especially the forex market.

Thus, given the uncertainties, it makes eminent sense for an EME central bank like the RBI to have sufficient tools in its toolkit and use them in a proactive manner.

Unhedged corporate exposure remains a major risk factor

Unhedged foreign currency exposure of corporates remains a major risk factor for EMEs like India. Corporates in many EMEs have taken advantage of benign global financial conditions to increase their overseas borrowing and leverage. In a recent Working Paper, Bank for International Settlements (BIS) has traced a strong relationship between the widening yield differential and growth in off-shore USD credit (both in terms of bank credit and dollar bond issuances) of non-bank corporates outside the US. The outstanding US dollar credit to non-bank borrowers outside the US has jumped from USD 6 trillion to USD 9 trillion since the Global financial crisis. This could expose the corporates in EMEs with large forex exposure to significant interest rate and currency risks unless these positions are adequately hedged. Greater corporate exposure could, in turn, increase vulnerabilities for both local banks and the financial system more broadly. Shocks to interest or exchange rates could generate adverse feedback loops, especially if credit risks prevented the rollover of existing bank or bond market funding. A point of comfort for India is that the Indian corporates do not contribute significantly to this increased exposure (basically because of the macro prudential measures put in place in India); however, if a wave of corporate defaults happen in other EMEs, this can lead to some cascading impact on India and its financial markets.

I feel that against the backdrop of imminent tightening of US interest rate cycles, and there are sufficient indications in this regard, there is a pressing need on the part of corporates to improve their risk management practices in order to preclude the possibility of huge losses in the event of unexpected developments. In this context, hedging of forex exposure by the corporates assumes paramount significance. While large treasury profits are alluring, it should not become an all-consuming passion exposing the corporates to unacceptable risks. Every corporate needs to formulate a well-deliberated hedging policy and ensure strict adherence to it. The RBI has been sensitizing the corporate and the banking system about the need for hedging and has devised appropriate regulations in the recent period but it is more important that corporates take these exhortations seriously and act accordingly. Apparently, there exists some misconception that RBI will always lean against the wind in the event of sharp depreciation of the rupee but this may not always be true. Banks also need to diligently factor in these risks while extending credit to corporates and hedging by corporates needs to be encouraged further to reduce risks.

Way forward

Greater internationalization of the rupee

India has been pursuing calibrated approach towards capital account liberalization and a more liberalized capital account would require a deep and liquid forex market with wide variety of instruments, especially hedging instruments, to reduce volatility resulting from large capital flows. Further development of forex market assumes greater significance against the backdrop of greater internationalization of the rupee in future as India's economic strength increases. Governor Rajan in his statement on taking office on September 4, 2013 stated the following in regard to internationalization of the rupee: "As our trade expands, we will push for more settlement in rupees. This will also mean that we will have to open up our financial markets more for those who receive rupees to invest it back in. We intend to continue the path of steady liberalisation." Against the backdrop of intense exchange rate volatility witnessed during 2013, promoting invoicing of trade in domestic currency, which has hitherto not been very successful, needs to be given a push. Banks and other stake holders have to

actively explore the opportunities for popularizing invoicing in INR in an environment when the global investors/ corporates seem to have an unending appetite for rupee-based assets.

Reducing the interest in the NDF market through liberalization of currency futures

The Non Deliverable Rupee Market is a symptom of growing international interest in a currency which is not fully convertible. The growing importance of India in the global economy has led to an increasing interest in the rupee. Thus, the interest in the rupee along with the existence of capital controls in the onshore market has led to the development of an offshore rupee market mainly in Singapore, Dubai, London and New York. Going forward, it is imperative to try to bring the offshore activities onshore, to the extent possible, in order to deepen the domestic markets and thereby enhance the trickle-down benefits. As you are aware, RBI has taken a number of steps in the recent past to liberalize currency futures market to obviate/reduce the need for the NDF market. This may help in bringing some offshore participants onshore and reducing the reliance of such participants on the offshore market.

Better alignment between OTC and exchange traded markets for currency futures

In the case of currency futures market in India, due to cash settled nature of the transactions undertaken on the exchanges with no mandated requirement for delivery, there is a non-level playing field between OTC and Exchange traded markets. There is a need for regulatory alignment between OTC and exchange traded segments of the currency futures market. It is generally understood that exchange traded currency futures, rather than being used by the real sector are mostly being driven by speculative interests. Currently, the liquidity in exchange traded market is confined to very short-term. If such products are to be positioned as a credible hedging products then the liquidity has to extend beyond short-term. These issues need to be addressed going forward for development of a deep and liquid currency derivatives market for hedging currency risks.

Use of options

While there is increasing interest amongst end-users in using currency options, not many banks in India have scaled up their expertise in this area and the option activity remains confined to just a few banks. This prevents development of an active options market. It is necessary that banks enhance the necessary skill-sets in this product which has been catching the attention of the end-users. While this will give a fillip to market development, the end-users' hedging needs will also be met in a more competitive environment.

Liberalization of net open position limits (NOPL) of banks

Another important area is the net open position limits (NOPL) of banks. Large open forex positions have systemic risk implications and need to be monitored closely. However, relaxation in these limits is essential to deepen the currency market as excessive restriction on speculation hinders the development of the market. Thus, a fine balance has to be maintained between the need to minimize risk and deepen the forex market in India. Data collected by RBI reveals that, at least in the last few months, banks have healthy bi-directional views on Rupee (in contrast to general unidirectional bias), which have helped promote healthy markets.

Polling for financial benchmarks

RBI has already chalked out a programme to move over to trade-based financial benchmarks from a polling-based system in a gradual and non-disruptive manner. In the last few months, stung by the regulatory actions abroad, many banks have shown a great amount of reluctance to participate in the polling process in India. It needs to be recognized and borne in mind that that the move from a polling based system to trade-based system is a carefully calibrated process and cannot be accelerated at the cost of bringing the system to disruption.

It is, therefore, necessary, in the interests of market integrity, for the active players to continue to participate in the polling process till the alternative system is on track.

Concluding observations

Going forward, further development of forex market would include introduction of more instruments, particularly derivative products, widening of participants base, commensurate regulations along with modern risk management systems and improved customer service. Additionally, there is a need to increase liquidity in long-term hedging products. Development of markets for long-term hedging products is necessary to reduce risk in the system. Use of most advanced payment and settlement infrastructure in the forex market is required along with improvement in other market infrastructure.

Reforms in the foreign exchange market will continue to be an on-going process and will have to be harmonised with the evolving macroeconomic environment and the needs of the real economy as well as the development of other segments of the financial market, particularly the money, the equity and the government securities markets.

Thanks for your attention.