FedConTech

Financial Market Volatility – Resilience and Challenges

By

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Key Talking Points

Introduction

- Volatility was there in the past, is present now and would be present in future too as long as market economy exists
- No one knows what is in store in future but it is sure that Volatility would be present
- Volatility is not the issue. The issues are whether an economy has the resilience to withstand and sustain the volatility without facing much damage, what are the challenges the volatility posed and how resilience can be built up further for facing future onslaught of volatility

Volatility

- Volatility is either way movement of prices in vast variation from the normal movement.
- Even in normal walk of life we say 'that man is volatile today, better be careful'. What we mean by that is that man is normally aggressive which is alright but today his aggression is more than his normal aggression and therefore, be careful. Same thing applies to market too.

Address by Mr. Krishnamurthy on "Financial Market Volatility – Resilience and Challenges" in the seminar on 'Financial Horizon and Regulatory Complexity' conducted by FedConTech on October 5, 2016 in Chennai

- There can be so many models on volatility but it is for sure that no two volatilities events are the same. Each phase of volatility is different from the previous one and therefore, obviously, the measures/strategy to handle the volatility has also to be different
- There cannot be any textbook like solution to handle any volatility in a standard manner, like by a formula driven model
- Volatility is generally felt, a psychological impact and intensity understood measured only based on the aftereffects of the asset prices.
- Variation in movement can be explained by ratios etc. but the impact of the unfavourable and unexpected movement is largely psychological as always the market moves more often triggered by expectations
- When commodity prices strengthen or rupee appreciates or equity prices soar or bond market strengthens no one complains but when the prices move the other way, then the whole market would seek action for immediate containment of volatility
- Volatility is dynamic, what was considered volatile yesterday may not be treated as volatile today
- Therefore, the approach to manage the volatility, each time, has to be dynamic and different
- There is another way to look at volatility. The asset prices during the boom period tend to get distorted due to speculative investment and when the unexpected volatility hits the market, it alters the asset prices in a few trading sessions and when the market calms down, the price discovery process comes into play and the asset prices stabilize around the fair prices. What went up must come down and it may be added that for the system as a whole it is a zero-sum game
- Take the recent Brexit event. Before the results market gained but after the decision of Britain to pull out of EU, the market tumbled. Though there was initial market reaction in our market, it calmed down once there was realization that this is going to impact only some segment but in the west the impact had been much larger in currency movements

- But then who likes volatility? The traders!! If no volatility, then they have no job except to run the market on a thin spread

Resilience

- Resilience is the ability to withstand the onslaught of volatility, both its magnitude and period of volatility
- Let us not mistake risk management for resilience. Risk management is the measures taken to handle normal business risks. But when tsunami hits the financial market, one cannot relax saying the risk management measures have been put in place and they would handle the volatility
- Central banks keep looking at markets intently throughout the business hours, within its jurisdiction and across the international markets as well, for any unusual signals
- When the volatility hits the market, the central bank looks at the economic reasons for it and initiates measures i.e. market intervention as well regulatory and monetary policy actions
- Regulatory actions by themselves would not be able to quell the volatility. Strong market intervention supported by regulatory action could contain the volatility
- Take the Brexit for e.g. no one imagined that Brexit would really happen and when the voting results came out, it stunned the financial markets amongst others and it immediately impacted the asset prices. Before Brexit the market was built up expecting the Brexit not to happen and when it happened, it corrected the market prices to the emerging ground realities.
- In all this build up who made loss and who made profit, god knows. But what is very important is that the stakeholders should know that the central banks have the ability to handle the volatility that helps the market makers to be active in the market. This is very important for trade and commerce to flourish, and to determine the fair value of asset prices

- During the phases of the volatility the impact on asset prices could be very significant, affecting the business confidence. The volatility during the global meltdown was quite catastrophic
- Generally, the spreads during normal market days are very fine but during the periods of volatility, the spreads widen, the sources of finance dwindles, and the liquidity dries up. At this time, both currency and interest rate markets add to the momentum of the volatility
- For e.g. during the global meltdown period, when the mortgage institutions had huge problem, the institutions did not know who was in trouble, then they stopped lending to other financial institutions This lead to huge liquidity crunch. So, during the crisis, those institutions that had surplus, preferred to deposit with the central bank with the trust solely on the central bank
- To answer the question whether at all we need a central bank, I would say, yes, we need them at least to handle the crisis of volatility and equally importantly, the crisis of confidence
- Resilience therefore is the ability to manage and contain volatility. The ability, the resources, the tools and the ability to hand hold the market out of volatility, and to sustain that effort as long as volatility prevails and then restore the market back after the calm returns to the shaken market
- If we look at the 2008 meltdown, the depth of the volatility, the geographical spread of the volatility, the variety of asset prices that were impacted the volatility witnessed was one of the most turbulent periods of volatility in the post war era. The efforts of the central banks, both conventional and unconventional, world over to contain the volatile movements and ease the liquidity crunch showed the strength of the resilience of the system
- In tune with the efforts of the central bank, if the market reacts positively, then the volatility could be quickly contained. But if the situation is not properly assessed and the intensity of the efforts fall short of the market expectations, then the market volatility continues

- Post 2008, the interest rate almost remained at the floor level for a long time, and even now it is abysmally low, some economies charge a negative interest rate in case money is deposited with the central bank
- So, resilience also means the ability to tune the tools according to the crisis situation. While handling the market, the regulatory prescriptions were watered down to enable the stakeholders to tackle the resource crisis Unconventional measures very quickly adopted as conventional measures fell short of the efforts needed to contain the volatility
- Post 2008, the central banks took to provide liquidity by purchasing the papers from the institutions which normally even banks would not entertain for giving loans. Looking at the bloated size of the Fed Reserve for e.g. one can gauge the extent to which the central bank kept providing the liquidity for a sustained period till the situation came to normal. Even now, the balance sheet of the Fed Reserve has not shrunk appreciably

India and Resilience

- Fortunately for India, the 2008 crisis did not devastate the markets as it did in the West
- People were trepid that the markets here would crash because it happened in the developed markets. It was more psychological than economic reasons that the volatility was expected to be severe
- In our country, what happened was that the FIIs pulled out money by selling their assets due to the liquidity crunch in their domains. This vitiated the asset prices and also the currency movements
- The central bank was in the forefront of the measures to contain the volatility. The measures were to provide liquidity to market, ensure availability of currency and smooth flows across the segments
- But the real question or the ability of resilience depends significantly upon the level of reserves that a central bank can unleash to quell the volatility

- Can it defend endlessly by drawing from the reserves? How much it can provide, how long and at what time, are the critical questions. These can only be answered by the experienced hands who have the sense of the markets and the economy
- So, managing volatility is a very complex process and there is no standard solution. It keeps varying with every type of volatility and the times of the crisis. Each central bank acts differently. The U.S and the EU let the rates fall down almost to the floor level and provided the liquidity, and left the remaining to the market forces to determine the fair prices of the assets. The efforts of the central banks were not to allow the economies to fall in to deep depression as a result of the volatile negative asset price movement
- In our jurisdiction, the effort gets more complicated as vicious currency movements had to be tackled as a result of the external shocks
- The Reserve Bank took several measures at the same time to the unfolding meltdown scenario. Interest rate management, currency rate management, provision of enough foreign exchange liquidity, and easing domestic liquidity crunch
- Liquidity provision was made to banks as well as NBFCs. Though NBFCs were not provided directly, measures were taken to ensure enough liquidity was available to NBFCs also. Ultimately, only few NBFCs availed of the facility but what is important is the signal to the market that the central bank has the ability and intention to manage the volatility
- The CRR was cut drastically to make available huge amount of liquidity, to dampen the liquidity crunch even before it happened
- The regulatory measures were also eased in tandem to enable the institutions to tide over the crisis
- As a result of the combined action, the impact of the external crisis was significantly smothered
- In the recent episode of 2013, the Reserve Bank took steps to manage volatility by taking new measures

- The measures may sound new but such measures were taken in the past too. In the previous episode, the measure was in the form of India Development Bonds while in 2013 it was by way of buying foreign exchange from the banks who raised deposits abroad
- With India Development Bond scheme the Reserve Bank built up sizable reserves, The Reserve Bank has over a period of time built sizeable reserve position so that it can contain the market volatility effectively There was lot of speculation in the market that in the run up to pay back the foreign currency deposit raised by banks, there would be volatility and the markets would experience problems. It was negative sentiments not based on facts and past trends
- The repayments were to start from the end of September and now almost first week of October has gone by. Where is the volatility. Markets are normal. It is because the Reserve Bank has built adequate reserves that it could smoothly meet with demands
- At the most what could happen is some mismatches in maturities but the Reserve Bank would easily handle that by way of swaps
- Therefore, from our experience, it is fair to say that the repayment of the foreign currency deposits may not pose any major volatility

Challenges in managing Volatility

- The long-standing guiding principle of the Reserve Bank is that it handles and manages volatility but it does not change the basic direction and price movements. It always allows market to determine the prices
- It is extremely difficult and hazardous to go against the market for long. It is very difficult to judge the depth to which the market can plunge and therefore, without having sufficient knowledge and expectation of the magnitude of the impending correction, it would be unwise to set a target and keep defending it
- We have seen how some central banks tried to save the rates and after splurging huge amounts, they gave up and market found its own fair value and settled at

that. We hear some authorities openly state that they have initiated action but were not sure of the containment

- If we look from another angle – what triggers volatility? There are two sets of people in the market. One is the real traders/capital infusers. The other is the non-trade people who bet on the currencies. If one studies the market, it would be very evident that the non-commercial & non-trade volume is very high compared to the trade based volumes. So, people take position based on certain perceptions, expected internal as well as external developments etc. And as herd mentality goes, the position keeps building up momentum, attracting market volume and liquidity. And then if the expectation is proved wrong, correction takes places very swiftly, and everyone runs to cover their positions which instantly affects the prices and liquidity
- In India's case, early days prior to LERMs, the U.S. Dollar rate was determined by the Reserve Bank and was announced, which was picked up by the entire economy and the market for pricing. RBI was available to meet demand and absorb supply at the price.
- So, the exchange rate risk was borne by the central bank. But with the reform process, the central bank moved from the regulated rate to LERMS etc. Over a period of time, gradually the central bank freed the rate and it came to be market determined
- So, the exchange rate risk slowly shifted from the RBI to corporate balance sheet. Along with the shift, newer instruments were also introduced in order to enable the corporates to manage their currency risk
- The fundamental issue in foreign exchange rate volatility management is how much of a country's foreign exchange reserves have to be used. Now, how much should be used in turbulent times, how much can be spent to retain the rate at a given level and what are the concomitant measures that needed to be taken along with the rate management are the critical issues
- If the market feels that the volatility and market forces are stronger than the reserves, then the volatility goes out of hand

- So, the kind of freedom that is allowed in the market has to be in proportion to the ability to control it
- There could be lot of options to build the reserves to get the quantum of currency requirement to meet the volatility challenges. Like getting funding from multinational institution like IMF, World Bank etc. But ultimately, a country has to build its own reservoir to give the confidence to the market of its ability to manage crisis. The former governor of the Reserve Bank Shri. Bimal Jalan famously said during the East Asian currency crisis that to fight the rate volatility build your own reserves
- India is well on its course to build such high level of foreign exchange reserves.
- Building up reserves adds its own dimension of problems such as money supply, excess liquidity issues etc. So, mopping up without much side effects is another challenge
- Challenges in building resilience need to be overcome if a country wants to successfully manage volatility.

Thank You