Reimagining Regulations to Invigorate Markets

Mr Pradhan, Chairman, Forex Association of India, Mr Kumar, my colleague in the Bank of India and Secretary, Forex Association, Members of the Managing Committee, dignitaries present here, ladies and gentlemen,

2. Good evening as we gather here on the auspicious Vijaya Dasami day which signifies the victory of the good over the evil as per Indian mythology. Thank you for inviting me to address the 28th Forex assembly of the Association in this beautiful country. This is one of the events that I and my colleagues, while in the RBI used to look forward to as a platform for interacting with the practitioners. Times and Rules have obviously changed in the RBI. This new order also changes the old dictum, “once a dealer, always a dealer” to the new dictum, “once a forex regulator, always a possible substitute for a forex regulator”. That is why I am standing before you.

3. This incidentally is my first visit to Dubai. This part of the world exemplifies how good planning, execution and right labour policies can transform a desert into a beautiful oasis. As many of you may be aware, I hail from a state whose fortunes depend a lot on the fortunes of the Gulf, a state where you are looked upon as “queer” if atleast one member of the family is not in the Gulf. In my address today, I shall flag some contemporary issues facing the Indian markets.

4. Regulation, one of the three key levers of state power (together with fiscal and monetary policy), is of critical importance in shaping the welfare of economies and society. The objective of regulatory policy is to ensure that the regulatory lever works effectively, so that regulations and regulatory frameworks are in the public interest. It addresses the permanent need to ensure that regulations and regulatory frameworks are justified, of good quality and “fit for purpose”. An integral part of effective public governance, regulatory policy helps to shape the relationship between the state, citizens and businesses. An effective regulatory policy supports economic development and the rule of

law, helping policy makers to reach informed decisions about what to regulate, whom to regulate, and how to regulate. Evaluation of regulatory outcomes informs policy makers of successes, failures and the need for change or adjustment to regulation so that it continues to offer effective support for public policy goals.

5. In 2005, OECD had put out certain guiding principles for regulatory policy. It called for establishment of clear objectives and implementation strategy, periodical review thereof, ensuring that they are non-discriminatory and transparent, ensure competition except where competition needs to be curbed to serve public interest, eliminate unnecessary barriers to trade and investment through continued liberalisation and finally ensure that different regulations do not work at cross purposes. These principles have been adopted in several countries.

6.Keeping these broad principles in mind let me now assess how Indian regulations have moved so far as it relates to the Indian financial markets. I intend to focus on certain specific issues on which the stance taken by the regulators in the past was not entirely in support of the market. We shall discuss whether in view of subsequent developments, the earlier stance of the regulators needs to be revisited.

(i) Non deliverable forward markets

7. The central bank believed for a long time, to quote an ex colleague, the off shore tail could never wag the onshore dog. So as long as we don't permit integration of the off shore and on shore markets there were no reasons to worry. But this was disputed by an internal study in 2013. The NDF markets have been showing a healthy growth since last several years. The 2016 BIS Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity ("the Triennial") reconfirmed for a second time, that the market has been growing. The Triennial Survey shows that NDF turnover grew by 5.3% in dollar terms between April 2013 and April 2016. This growth is significant in three currencies with large NDF markets – the Brazilian real (BRL), the Indian rupee (INR) and the Russian

rouble (RUB). At the same time there has been a marked drop in turnover in the renminbi (CNY) NDF. The report flags some important conclusions for this trend.

8. The report argues that these divergent trends across currencies point to three stylised paths for the development of FX markets, from a starting point where restrictions on foreign participation in the domestic FX markets and offshore deliverability have fostered the emergence of an NDF market. One is a sudden liberalisation of FX trading and the capital account. The second is market development around an entrenched NDF market. And the third is a controlled opening up of the FX market within a regime that retains effective capital controls.

9. The rouble had followed the first path. It became fully convertible in mid-2006 amid current account surpluses, large foreign exchange reserves and official ambitions for its international use. Among six currencies covered by the survey, the rouble NDF accounted for the smallest share among the different instruments used for RUB trading. Bloomberg stopped publishing a separate exchange rate series for the rouble NDF in 2014, citing its price convergence with the deliverable forwards. Still, the rouble NDF lingered for 10 years and even enjoyed a modest revival recently due to various credit, legal and political issues faced by Russia.

10. The won exemplifies the second path, in which the foreign exchange market develops around an entrenched NDF. While having a generally open capital account, Korea still limits non-residents' won borrowing from banks in Korea in the DF market. As a result, the NDF has the lion's share of forward won trading in London. However, Korean banks can arbitrage between the onshore forward and NDF markets, and various interest rate and currency derivatives trade actively in the non- deliverable form. The KRW/USD pair is now by far the most traded NDF globally, and KRW NDF turnover expanded by over half between 2013 and 2016, even faster than the strong growth of KRW spot and forward trading. RBI had considered this model in the past and had taken a view that this was least

suitable to our country. Even today, my view is to disallow official integration between the two markets.

11. The renminbi's internationalisation has taken the third path. Under China's capital controls, residents have access to offshore markets, and non-residents have access to onshore markets, generally only through administered channels. Non- residents do not generally enjoy access to onshore DFs and therefore cannot use them to borrow renminbi from banks in China. Instead, the authorities have permitted, within still effective (although leaky) capital controls, a pool of offshore renminbi that can be freely traded and delivered. The renminbi forward market is thus split into three: an offshore NDF market (starting in the 1990s), an onshore DF market (since 2007) and an offshore DF market, known as the CNH market (since mid-2010). These reforms moved the markets onshore. The NDF's share declined sharply across all counter-parties. I shall argue later that India needs to follow this path of bringing off shore market on shore through well calibrated liberalisations.

12. The report also notes that international regulatory initiatives have begun to transform NDF markets, as in the case of other derivatives markets. Policymakers concluded from the events of 2008–09 that the opacity and decentralisation of derivatives markets posed systemic risks. Measures to reduce such risks include promotion of trading on electronic platforms, mandatory trade reporting and centralised clearing. As a result, NDFs, along with other derivatives, have started the transition from a decentralised, bilateral microstructure to centralised trading platforms and clearing with mandatory disclosure. According to the DTCC data, trading of NDFs on electronic platforms has risen considerably in the last few years. A large number of jurisdictions now require public trade reporting for NDFs and other derivatives.

13. Given the above international developments, as brought out in the BIS survey, how should the Indian authorities react? Particularly given the fact that NDF volumes for the Indian rupee is quite substantial? While it is natural to expect trading activity (by private hedgers or speculators) to migrate from a restricted trading place to an unrestricted trading

place, a sustained growth of NDF does raise concerns from a public policy point of view. Till 2013, RBI stuck to its stance that off shore markets can have no influence on price discovery locally. Thereafter an internal study was candid enough to admit the correlation which is stronger during volatile times. Then what are the implications? First, if price discovery is driven by offshore markets, the costs of intervention in the domestic markets by the central banks will be much higher than otherwise. Second, the non-transparent, over-the-counter nature of the microstructure of offshore markets will increase the probability of price manipulation, thereby raising the systemic risks. How should policy makers react under such circumstances? If the regulator tries to exert pressure on domestic and offshore market participants through overt and covert interventions, will it work? My own experience tells me, to an extent. So then what? Looking at the experience of other countries the best way to bring back offshore market activity to onshore markets is to develop the latter. Development of domestic currency futures markets, with liberalizing position limits on domestic financial institutions, allowing foreign institutional investors (FIIs) in onshore markets, synchronization of trading hours across onshore and offshore markets to minimize latency arbitrage etc. are some of the measures that could reduce the importance offshore markets over time. Similarly, it may be worth mulling over intervening in NDF markets when warranted. Therefore this should also be a policy option. More importantly, in the Indian context it is time to give up prescriptive documentation requirements plaguing the OTC markets. This in my view poses lesser systemic risk than allowing unfettered growth of unregulated offshore markets, with its non-transparent trading and risk management systems. In the Indian context being a country which opened up its currency futures markets, the stringent documentation requirements for OTC markets at best only gives a false sense of comfort to the regulator about fettering in speculation. Moreover, the volatility on the Indian markets have always got compounded on account of leads and lags rather than on account of unfettered speculation against the currency. To sum up, there is an elephant in the room called the rupee NDF market and the sooner we acknowledge its growing impact and make it part of the official policy discourse the better it would be for the health of the domestic currency market. Paul

Samuelson once said, “when my information changes, I alter my conclusions”. This advice is important for any policy maker.

(ii) Should India join any indices to attract more stable flows?

14. This issue had attracted considerable attention during 2013 when forex market volatility primarily caused by reversal of debt market flows had raised serious concerns. There were series of meetings between RBI and Government along with market participants. There were many who argued in favour of India joining the index. Data was produced to show that Malaysia for instance which was already a part of the index had witnessed minimum volatility of flows during taper tantrum. But RBI was clearly uncomfortable since to qualify for entry into the widely-followed JP Morgan government bond index — Emerging Markets, India needed to ease rules on registration, documentation, due diligence rules for the entry of foreign institutional investors (FIIs) in the Indian debt market, besides allowing them to invest without any cap in the govt debt. RBI believed that it was too early to remove all caps given the past history of crises in other parts of the world on account of unfettered debt build up. The counter suggestion from RBI was to have a reasonably liberal limit and at the same time take steps towards internationalisation of the currency by allowing rupee denominated debt in the international markets. Market participants would recall that the latter suggestion was indeed implemented. While I shall return to the issue of rupee bonds, the issue that needs revisiting is whether the country should to stick to the earlier stance or time has come for removing limits in the debt markets for foreign investors. Yes, we have been increasing limits for debt investments but these enhancements have often been to tackle volatility in the markets rather than based on a well thought out more liberal road map, a few working group recommendations not withstanding. Perhaps, given the stable government and confidence of international investors in the Indian growth story, a new approach would serve the country and markets well. While on this theme, I will also urge the purveyors of the popular bond indices to assess countries like India based on not just ex-ante policy of restrictions on the capital account but also on ex-post experience of the foreign investors. India’s is a large and complex economy and foreign investors who have been successful

in India wouldn't have made all the money had they waited for India to fulfill all the conditions including being part of a global index.

(iii) Is India ready for CAC and Internationalisation of the currency?

15. In the past, the risks that I used to face agreeing to speak at big events like this is the possibility of your ideas getting articulated by speakers that precede you. There was an event, I recall, the game was over even before the first ball was bowled as my potential points were covered by the compère. I thought I had seen it all till my friend Sundip sent me the brochure of this event yesterday. I realised that the brochure carries my views on the subject through a speech I made in 2015. I scrambled to edit what I have to say although my views have not substantially changed and I pin my hopes on most of you not reading the major portion of the brochure except the entertainments included for this event. In my address included in the brochure I had made a distinction between capital account convertibility and internationalisation. Suffice to understand that an international currency has to be capable of playing roles of store of value, medium of exchange and unit of account for both residents and non-residents. Before internationalisation, we have to ensure a greater degree of stability in its exchange rate determined by the market forces and a deep and liquid market with availability of wide range of hedging products with easy accessibility to both residents and non-residents supported by an efficient banking system and world class market infrastructure. Full capital account convertibility and development of offshore centres are other enabling conditions for internationalisation.

16. I had also warned that unlike current account convertibility, capital account convertibility is not an unmixed blessing. It is recognised that capital flows are sensitive to macroeconomic conditions. Any deterioration in fiscal conditions, inflation management, balance of payments, or any other macroeconomic shock may cause a cessation or reversal of capital flows. Further capital flows, inasmuch as they result essentially from trade in financial assets, are prone to volatilities derived from information asymmetries, herd behaviour, panics etc. Further as a consequence of impossible trinity, an open capital account demands a complete 'let go' of the exchange rate management and volatile capital flows and can therefore lead to extreme volatility in the exchange rate and large departures from its equilibrium value. Many researchers have also expressed reservations

about the most touted about contribution of capital account convertibility, that is, its role in better allocation of global savings. On the other hand, free capital accounts were not necessary for the phenomenal growth recorded by several countries in the diverse parts of the world. Before, I try and answer the question whether India is ready for CAC let may broadly touch upon India's liberalisation story.

17. All current account including trade transactions have very few restrictions except that repatriation requirements continue to apply. As long as this country is facing a current account deficit these requirements cannot be lifted. Indians have been enabled to acquire businesses overseas with fairly liberal limits for overseas investments. Inward investments have been put on even keel with other countries and as a result India is a very attractive destination for foreign direct investments. Even FIPB which had over years become a power centre in itself has been abolished. Perhaps the only pain point is pricing guidelines and the manner in which it is being implemented but that is something to which I shall return to. Moving on to the External Commercial Borrowing regime, it is fairly liberal despite having implications for foreign exchange rate management. We took baby steps towards internationalising our currency by permitting borrowings in rupee. There has been some back tracking in this respect but that was more driven more by the jugaad type antics by the participants rather than rethinking of the move itself by the regulator. Finally, regarding individuals' use of forex, earlier, there were days when a person could leave the country without his family or friends knowing but could not escape the RBI as he had to draw foreign exchange for travel based on permits issued by RBI. Compare that with $250000 annual limit for every citizen in this country under the Liberalised Remittance Scheme. So, yes, we have moved a long way.

18. Having said this, let me flag a few issues as well. Take the area of FDI. Even though the flows continue to be robust, we need to be conscious of the fact we are competing with rest of the world to attract the pool of investments. In such a scenario, regulations will have to be minimal, unambiguous and investor friendly. When regulations focus on preventing outlier cases then we end up inconveniencing the majority. Today the extent of enquiry that goes into inflows needs a relook, in my view, if they are received through the banking channels from FATF compliant countries. Second, while simplification of pricing guidelines has been achieved, why should FEMA continue to prevent two consenting parties agreeing to a price in today's liberalised regime? If the worry is on account of ECBs

masquerading as FDI or assets being transferred through off market pricing, is it not better to address them separately than through FDI pricing? It is hoped that atleast after a few high profile arbitration rulings that went against the FEMA regulations, government and RBI would come out with more pragmatic regulations. Another reason why this assumes importance is opportunistically, this area is best addressed when our main competitor for FDI flows, China is slowing down. Let me flag one more area viz. Indians investing globally. FEMA has to enable an Indian resident to compete with a Chinese or a Mexican or a Brazilian for instance. But we continue to have all sorts of restrictions whether they relate to multi-layered structures or overseas Indian companies investing back into India out of genuine surpluses generated abroad (dubbed as round tripping) or for that matter what is permissible under the LRS for undertaking overseas investments. We seem to be attempting to address all sorts of concerns be it tax evasion, or money laundering through FEMA which creates unnecessary complications. Further, FEMA being administered through regulations, notifications and circulars sometimes results in one being in-consistent with another. The changes being carried out in one often gets omitted in the other. This results in varied business practices as a result of what I would term as "interpretation asymmetry".

19. Now let me come back to the question I posed at the beginning of my discussion. Are we ready for capital account convertibility? Let me juxtapose the observation of Paul Samuelson and ask myself the question, two year after I made that speech has my information changed to alter my conclusions? As I mentioned earlier, capital flows, first and foremost, are sensitive to macroeconomic policy. Therefore, a freely convertible country must have sound, credible, and time consistent macroeconomic policy. What does that translate to, operationally? Fiscal prudence and low inflation. Where do we stand in respect of these parameters? I wouldn't think we are very comfortable here. But let us also accept that fiscal management and inflation have their own logic and dynamics in a large, diverse, developing country like India. Should the country throttle social expenditure and blow up interest rates just to attain capital account convertibility? The second threat emanating from capital account convertibility is contagion of disturbance in the global financial markets. The brunt of this has to be borne by the domestic financial system. Though tightly regulated, the financial sector, particularly the banking industry is surely not

in the pink of health as of today. The NPA problem is not going to disappear in a hurry although several proactive steps have been taken by the authorities.

20. Therefore the question of readiness for full convertibility has to be expanded to the same set of questions I had raised earlier: Is capital control retarding investment and growth of the economy? If so, remove them. Is any socially useful project unable to proceed beyond the drawing board because the entrepreneur is unable to raise resources either domestically or in offshore markets? I don't think by and large this issue is being faced. What will be the incremental benefit of full convertibility that we (by we I do not mean treasury) are denying ourselves? If we can tweak some of the regulations and resolve issues that I had flagged with relation to FEMA, the answer will have to be in my view, very little. What are the institutional and infrastructural developments we must have to reap the full benefits of further liberalisation of capital account? Deep and liquid markets, a strong banking system and fiscal prudence. As I had warned, the answer has to be based on economic logic and not on what Bhagwati calls "banner-waving". At the same time, further liberalisation of procedures and use of rupees for international transactions must progress. Let me now turn to an issue attracting lot of regulatory attention, world wide.

(iv) Code of conduct

21. As this audience is well aware, the foreign exchange markets in several parts of the world have recently been rocked by broad, unethical misconduct. A recent series of investigations in a number of countries established that serious misconduct and collusion had occurred in the foreign exchange market. The investigations led to a string of regulatory actions and fines against some of the largest banks active in this market, and criminal pleas across multiple jurisdictions. These developments have resulted in damage to the integrity of the global FX market—damage that will not easily be undone. The resulting loss of the public's faith and trust in this critical market comes with a cost: Let's recall that it is ultimately the public that stands to lose from an FX market unable to play its vital role in the global economy. Among several initiatives to ensure ethical conduct, mention must be made about the Global Code of conduct issued by the BIS in May this year after two years of work. RBI was part of its FXWG (Foreign Exchange Working Group). It has strongly supported the principles of good practices within the Code and will be engaging local market participants to promote adherence to the Code. The regulators, including RBI have agreed to adopt the Code first by signing the Statement of

Commitment. The code is a set of global principals of good practice in the FX market and is intended to promote a robust, fair, liquid, open, and appropriately transparent FX market. It is voluntary in nature and does not impose any legal or regulatory obligations. It will be morally binding on those market participants who adopt the code. The code is organised around six leading principles, viz. Ethics, Governance, Execution, Information Sharing, Risk Management and Compliance, Confirmation and settlement process. Once fully implemented, the Code will bring in a lot more ethics and transparency in the market and help in erasing whatever little mistrust might occur between the participants. Reserve Bank, I am sure will direct adoption of this code in the Indian markets sooner than later. Before I conclude, let me briefly comment on one more issue that, of late, has attracted lot of attention in India

(iv) Is the level of foreign exchange reserves hurting the economy?

22. This question has gained prominence as the country crossed the land mark figure of $ 400 billion. Chest thumping, smug smiles and all-knowing nods from pundits not withstanding, the question about adequacy of reserves in the Indian context is always tricky. Please recall, just before the GFC broke out, RBI had stopped intervening in the forex markets as it was concluded that we have enough reserves based on any of the internationally accepted parameters be it money based or trade or debt based indicators, or the Guidotti Rule. The subsequent events in 2011 and 2013 proved that we sounded the bugle too soon. Today IMF has added a few more indicators like the medium stress or extreme stress scenario and even a more conservative insurance model. The level of reserves today may be adequate adopting most if not all of these indicators. However in practice, we need to consider certain other aspects as well. Let me amplify. For the purpose, there can be no better reference than a seminal speech made the Governor Reddy more than 15 years ago.

23. Dr Reddy cautioned that theory not withstanding in practice the dominant concern of policy is maintaining confidence in our ability to provide liquidity and, there is no precise way of defining at what level the confidence factor would be undermined. The policy also needs to make judgements on (a) the difficulties in reviving confidence once it starts getting eroded; (b) the focus of market participants on incremental changes more than

total size; and (c) demonstration of willingness to use the reserves when warranted without committing to do so and getting locked into a straitjacket situation. The issue of managing the level of reserves thus becomes, in many ways, as important as the level itself. Secondly, there are judgements involved in assessing whether the level of forex reserves provides comfort in the face of weakness in domestic fundamentals. Thirdly, the factors governing drawdown by residents through capital flight are not easily assessed. Fourthly, the leads and lags in trade and even invisibles can significantly influence supply and demand in markets, particularly when markets are not fully developed. Further, where there is lumpiness in demand and supply as is the case in India, the forex reserves have to be used for meeting the temporary mismatches in forex markets. Finally, let us not forget that the level of reserves considered as adequate by all indicators is still below the external debt of the country even today.

Conclusion

24. Let me sum up. What I have tried to convey is that world over regulations are being re-looked at so as to maximise economic welfare by benefitting business and society. It is now recognised that for achieving this, the regulations must be principle or risk based rather than product based, should be proportionate and should be consultative and agile. India has also achieved a lot and moved on along the paths of liberalisation. Technology has enabled efficiency in many areas. How can regulatory architecture be reimagined to invigorate the markets? I attempted to relate this to a few major issues, off shore non deliverable markets, India joining the emerging market global indices and capital account convertibility. While Indian regulations are increasingly becoming consultative and attempts to take into account all policy options including self-regulatory, co-regulatory and non-regulatory approaches and choosing the one that generates the greatest net benefit, it is important to periodically review them to ensure that they remain relevant and proportional over time.

25. Let me conclude with a reference to the difficulties of policy making candidly admitted by the former RBI Governor Dr Rajan in his latest book, ***I do what I do,*** **"policy making invariably involves taking measured risks in the face of uncertainty, for one has neither a prior template nor the luxury of indecision".** So let us admit, we may or may not live in interesting times. But a regulator's life is always challenging filled with damn if

you do, damn you if don't situations. Given this, it will be reasonable to conclude that by and large our regulations and regulators have served us well and would continue to do so.

Thank you