Key Note Address at the Assembly of the Forex Dealers' Association of India at Bangalore on September 28, 2002 delivered by Smt K.J.Udeshi, Executive Director, RBI

Mr.Pravin Gupta, Chairman, Forex Association of India, Mr Tyagarajan, General Secretary, other dignitaries present here, ladies and gentlemen,

It is indeed a great pleasure to be amidst you all this evening. This is my first participation in the Forex Assembly. The first thing however that came to my mind when Mr Gupta approached me is that, thankfully there could not be a more opportune time for my first visit when all is apparently well with the forex market world and forex reserves are burgeoning. I thought I would take the opportunity to set out the rationale of the changes in exchange control in the context of the overall policy of liberalisation and move towards full capital account convertibility. In the external sector, India is marked out as a country which has opted for a gradual and measured liberalisation. I would in no way wish to be an apologist for our approach. In fact, we are now recognised internationally as a model country that has calibrated well the liberalisation of its external sector without any significant backtracking.

We have completed a decade of liberalisation in the foreign exchange market. The exchange rate policy has been fashioned, more specifically after 1992, to enhance the role of market forces without disrupting the basic fabric of the market structure. There has been consistent effort to bring about selective linkage between the global and domestic money markets through the forex market. With these objectives in view over the years operational freedom both to the end users and the intermediaries have been extended.

The major change came about in 1992 with LERMS and subsequently unified exchange rate in 1993 when RBI withdrew from fixing daily prices in currency. While the unification of exchange rates and a market determined exchange rate regime was a major step in the liberalisation process there was also progressive liberalisation of transactions both on current and capital accounts. The introduction of the direct quotation system in 1993 and the termination of RBI announcing it’s buying and selling rates in 1995 were important miles stones in moving towards a market determined exchange rate.

The dilemma posed to the policy makers was to manage volatility without deviating from the path of market development.

RBI's response to volatile exchange rate movements has been a combination of monetary policy and administrative measures together with intervention. A significant change in approach was made in 1998 following the sharp volatility experienced in international markets. The provisions, which allowed incentives for speculation to end-users and intermediaries, were identified and withdrawn. The focus of operation shifted directly from intervening in the market to identifying those demands that could rectify the imbalance viz. oils payments and bunched demands were smoothened by RBI. The RBI does not target any exchange rate or resist fundamentals. Thus leads and lags have become the major focus of exchange rate management. The RBI’s operations have all along aimed at evening out the imbalances and smoothening the process of two-way changes. The market has developed greater strength, has become much deeper and liquid, credibility of the currency has enhanced in the eyes of the global players and greater confidence in the system among investors. The entire spectrum of relaxations which were temporarily withdrawn have been more or less restored. The Central Bank and the market participants are exploring issues at the frontiers and I do hope that tomorrows' deliberations will be constructive and enable us to jointly forge ahead.

A careful analysis of the RBI's stance would reveal the balance it had to establish between freedom on flows in the capital account and the need for increasing the degree of operational freedom to the market participants. The objective was to ensure efficient price discovery mechanism reflecting the economic fundamentals not distorted by the speculative instincts of a few. The issue of volatility is not the preoccupation of only the RBI. As recently as 20th September 2002 the Bank of England Governor stated and I quote

“…The recent volatilities seen in the financial markets are frustrating. The movements are disjointed from the economic fundamentals.”

Earlier in the year in the context of the USD gyrations US Treasury Secretary stated :

"… The people who benefit from roiling the world currency market are speculators and as far as I am concerned they provide not much useful value…"

RBI had to craft a careful strategy to address the elements of speculation without injuring the genuine interests of the market players. The endeavour to develop a deep and liquid market reflecting domestic and global realities within our constraints has been preserved.

The market today provides freedom for risk management, freedom for asset substitution, freedom for taking limited view on rates by corporates without foreign currency exposures, freedom for anticipatory cover. The basic philosophy around which the market has been built is that any entrant to the market must have an underlying exposure. As stated by the Reserve Bank Governor, today we can look back at the developments with a reasonable degree of satisfaction.

The issue of Capital Account Convertibility (CAC)

The Asian financial crisis led to a rethinking of the various issues relating to the CAC. Earlier, CAC was the mantra on everyone's lips and even international agencies like the IMF were nudging - not too gently - countries like India towards liberalising the capital account. While on the subject of capital account convertibility, I recall the observations of our Governor, Dr.Bimal Jalan and I quote, "...It must be understood that merely by lifting all capital controls, the markets of a developing country do not get as deeply integrated as a developed country's markets. As such, each country would need to decide on its own path of capital account liberalization with regard to the timing and sequencing". The critical role played by a well capitalised, well managed and well-regulated financial system which has all along been stressed by the Indian authorities has come into sharper focus. Further, the dangers from a highly leveraged corporate structure without proper norms for corporate governance are better appreciated. Needless to say, the fiscal position has to be taken into account.
As far as developing markets in general are concerned, there would be six tenets that would need to be kept in mind by the authorities while deciding on the pace of capital account liberalisation.

First, it is not necessary for a country to have a totally open capital account. Secondly, it is imperative to make a distinction between controls that hinder efficient international intermediation and those that are necessary to control potential problems while sequencing the capital account liberalisation.

Thirdly, a developing country with underdeveloped financial markets should reserve the right to reimpose controls if warranted. By a well paced calibration of the liberalisation process we have had a remarkable record of minimal backtracking.

Fourthly, it is important to remember that it is necessary to have an overall environment where the measures on outflows are well sequenced.

Fifthly, the Asian Crisis clearly demonstrated the dangers of hidden risks in the balance sheets of highly leveraged corporates. Therefore, information about the potential impact of corporate activity at times of crisis could prove very useful to the authorities. Reserve Bank took a definite step in this regard recently by directing banks to collect information relating to unhedged exposures of their clients.

Finally, it is important to recognise that the more we liberalise the more we would need to monitor flows and we need not be defensive of the monitoring of flows.

Some facts about capital account liberalisation.

In the absence of a well chalked out sequencing, the liberalisation of capital account has often been followed by crisis in many countries. It is often a mistake to over emphasise the permissive factor of capital account liberalisation while under estimating the importance of weakness in fiscal policy as well as the compatibilities between the desirable monetary and exchange rate policies and the actual ones followed in practice. At the same time, it also stands to reason that the cost of maintaining controls and the inefficiencies and distortions that result should be carefully evaluated. Nevertheless, given the fact that effect of a crisis is often of a long term nature as far as real sector of the economy is concerned, economists are increasingly recognising the merit of a gradual, well thought out, prioritised opening up of capital account.

What lessons do we need to draw from the episodes of crises in other countries? First, countries need to pursue sound macro economic and trade policies to minimise risk while carefully opening up the capital account. Secondly, countries should strengthen their financial and supervisory systems before going capital account convertible. Thirdly, a strong corporate sector with good governance is an essential pre-requisite for a faster opening up of the capital account. Fourthly, CAC essentially pre-supposes a market determined exchange rate system. This brings me to the issue of India's march towards CAC, which has hastened in recent times and our efforts at liberalising various procedures.

There is an erroneous impression in certain quarters which are meant to be otherwise well informed. It is stultifying to claim that the Indian approach to CAC is one of encouraging inflows while discouraging outflows. Nothing could be farther from the truth. Capital inflows were always encouraged and repatriability assured. In fact, the thrust of the policy in recent years has been to minimise or totally abolish administrative hurdles. The added emphasis in the last few years has been a gradual and measured opening up of outflows by residents e.g.:

Resident individuals can now get upto $ 500 without filling any form or submission of any documents. Remittance of foreign exchange for medical treatment upto $ 50,000 is also without submission of any docouments. Remittance of foreign exchange for travel and education or gifting of funds upto $ 5000 had already been freed. Individual professionals can now retain upto 100% of his foreign exchange earning in EEFC accounts.

To the NRIs we have sent a strong and unequivocal signal and thereby to the world at large about our commitment to convertibility

- Repatriable status accorded to all non-resident depositors except balances in NRO accounts.
- Capital transfers for NRIs upto $ 1,00,000 out of sale of immovable property as also inheritances and legacies, permitted.

- Even for balances in NRO accounts greater freedom for repatriation of balances for medical treatment, studies, etc.

For exporters, suffice it to say, that it is a continuous process of rationalisation of procedures, with a view to minimising transaction costs, and to ensure easier and cheaper availability of credit.

To increase the competitiveness of the Indian corporates, limits for Indian direct investments under the automatic route has been doubled to US$ 100 million.

- Software exporters are encouraged by permitting them to receive 25% of the value of their exports in the form of equity of start-up companies.

Two-way fungibility of ADRs/GDRs were operationalised to bring about alignment in the prices of Indian stocks in the domestic vis-à-vis international markets.

Corporates have also been accorded greater freedom to raise (upto $ 50 million) and prepay foreign currency borrowings (upto US$ 100 million).

- Corporates have also been accorded greater freedom to raise short-term suppliers/buyers credit for imports (up to US$ 20 million).
- An even greater relief to corporates and banks alike is the relaxation in the submission of exchange control copy of Bills of Entry for imports upto US$ 25,000.
- The freedom of FIIs in the Indian financial market has been substantially increased and they are allowed to trade in exchange traded derivatives.

Alongside, liberalisation has also been effected in the foreign exchange market. For instance, the freedom to rebook cancelled contracts has been restored, so also booking of contracts based on past performance. Swap and open position limits available to banks have been enhanced to enable banks to offer finer rates to the customers.

RBI is also actively considering introducing rupee based currency options. A Committee constituted to look into various related aspects is expected to submit its recommendations to the Reserve Bank very soon. I also understand that the Forex association has aptly

arranged a panel discussion on this subject tomorrow. I hope that my colleagues who will be participating in the discussions will carry back several useful suggestions on the subject.

The issue of capital account convertibility also leads me to the current spate of debates and opinions in respect of the level and cost of reserves. Should countries hold larger reserves or less reserves? Countries need to set their reserves holding on the basis of capital as well as current account variables. Apart from the computable charge on the reserves arising out of commitments relating to capital account transactions both long and short term, as well as trade requirement, the impact of external and internal shocks have to be kept in view in formulating policy on reserves. As the capital account becomes more open and international capital flows more readily, the demand for reserves will increase. Merely comparing global interest rates with domestic interest rate as a proxy for cost of reserves may not be appropriate. It is not the arithmetical difference in interest rate on substitutable assets but the various other unquantifiable benefits that the economy derives on account of strong reserves which needs due recognition in such discussions.

Two aspects relating to liberalisation need reiteration even at the cost perhaps of repetition. First and more important for the fruits of liberalisation to reach the common man the role of officials at the bank branches is crucial. Our experience based on the feedback from media reports and the public in this regard is unfortunately not too encouraging. There is just no purpose in talking about CAC from high podiums if action at the grass roots level is still embedded in FERA mindsets. Let me emphasise on one important irritant that a common man is concerned about. He is becoming increasingly intolerant and sensitive to too much documentation particularly for small value transactions. Our efforts in this direction are yet to bear satisfactory results. My message to you, perhaps the most important one, is, to put in special efforts to ensure hassle free service to customers.

Second, a more technical one. Recent market developments have underscored the importance of improved risk management practices in the financial sector. To amplify this let me recapitulate the exchange rate movements in recent times. Moving away from pronounced one way movement; the market has started exhibiting fair degree of

two-way movements and finer prices. Unlike the earlier periods when market spreads narrowed down faster even at times of volatility the observed pattern of merchant supply and demand viz. falling supplies with a weakening rupee in anticipation of further weakness and shooting up demand due to worry of further weakness and vice versa continue. The more volatile the currency gets, it is the end-users, rather than the intermediaries, who get hurt in the process. It is therefore disconcerting that the two-way movements have not resulted in activating risk management strategies among the end users. Instead, two-way movements have been looked at as opportunities for staying away from the market by opposing segments. Corporates are looking at the treasury as a profit centre. There is a great deal of work to be done by the banks in widening the awareness of risk management among business entities who are yet to look at the market as a place for disposal/acquiring currency rather than a place for profit maximisation. It is necessary that the business entities do not look at exchange rate movements as an exclusive source for profit enhancement of the business. Corporates must appreciate the risks involved. RBI has cautioned banks extending foreign currency loans about the need for assessing the market risk in their clientele books arising out of unhedged currency risks. There is a convincing need for banks and corporates to look at the business balance sheets and identify the sources of market risk, implicit and explicit, and mange it meaningfully in tune with the business objectives of corporates.

Another aspect that needs to be given serious thought is the invoicing of trade. The market seems to be very much focussed on the USD -Re rate and the opportunity available in other currencies appears to have been completely over looked. The invoicing pattern of trade reveals that USD continues to be the major currency of invoice. RBI communicates with the market in the language of USD–Re. The stability of Rupee against USD does not mean that Re is equally stable against all the other currencies.Though it is not the intention to discuss invoicing strategy here it is necessary that the end users look at the global currency movements and effectively use the relaxation permitted to evolve appropriate risk management strategies.The increasing integration of the economy with the global markets may bring about change in the currency composition of trade. Recognising this possibility in the long run Government of India recently permitted RBI to use Euro as another currency for intervention.

In the context of the market one of the other issues is transparency in rate quotations. Electronic trading platforms are taking over the role of brokers and gradually the volumes through these platforms are increasing in the global markets. With an outright offer and bid price and volume available price discovery has become superior. India cannot be away from the developments and I am sure this development would gain further ground in the times ahead.

The recent development in the context of capital markets transactions, relaxing several regulations are an indicator of the emerging trend. The country is committed to a gradual and well calibrated move to capital account convertibility. Convertibility is not a one-time affair; it is a process of evolution and the process is an on-going one. As we move towards an increased level of convertibility, it must be emphasised that the responsibility of the end users and the intermediaries becomes significant. The freedom would bring in two way capital flows and the impact of these flows must be absorbed in an efficient manner. It is necessary that the market develop adequate risk transfer mechanisms, which would provide shock absorption capability in the event of adverse movements. We have to move together to develop risk management products beyond the current age-old product viz. the forwards.

There is one last aspect I would like to emphasize. The world has undergone cataclysmic changes in the last year as matters relating to money laundering and terrorist funding have come to the fore. We are of the view that banks and financial institutions must exercise utmost care. To know your customer is your right and it is your duty to know the purpose of remittances. Some may needle us that these developments are encouraging the control to revert to restrictions. This is sheer nonsense and I would urge banks and financial institutions to be totally vigilant.

With these observations, I once again thank you for inviting me for this Assembly and wish your deliberations all success.

I am thankful to S/Shri P.Krishnamurthy and G.Padmanabhan, General Managers, Reserve Bank of India for the inputs provided.