Forex Markets in India: Some Thoughts*

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It gives me great pleasure to address this gathering of forex professionals from all over the country. Looking at the list of speakers from the central bank who have addressed this august assembly in the past, I find that you have opted for change by inviting the regulator/ supervisor rather than the exchange rate policy maker and manager from the RBI. Although I am not very certain as to why, may be the fact that I was on your side of the market till a few months ago might have prompted this change!

Ever since I accepted this invitation, I have been pondering about the contents of this address. I shall not obviously be speaking at great length either about the RBI's Exchange Rate policies or Management. We have left nobody in doubt about our intentions in this regard *i.e.,* ensuring orderly market conditions and combating excess volatility. Having achieved this to a great degree of success, even in the face of turmoil all round us, this is perhaps the ideal forum for an informed debate as to how we should move forward.

It was Keynes who once remarked that knowing nothing about the past makes a man as primitive as knowing nothing about the future. In other words, one cannot live in the present alone. Although in the financial markets, future need not have a link to the past, nevertheless, it is important to know a bit of the past to make informed predictions about the future. The outline of my address would, therefore, be to take a bird's eye view of the past, reflect on the present scenario and charter a road map for the future.

In a market-oriented economy, segmented markets tend to obscure the transmission of public policies and often result in sub-optimal allocation of resources. In India for a long time the pace of development in the financial market segments like the money market, foreign exchange market, government securities market and the capital market have been slow and consequently the markets remained segmented. A comprehensive package of reform measures recommended by the Narasimham Committee in 1991 became the starting point of gradual deregulation of the financial sector and the integration of various segments of the financial market. However, it was the implementation of the recommendations of the Sodhani Committee on foreign exchange markets that furthered the course of integration between call money market and the foreign exchange market.

The linkage between the call money and forex market existed in a small way even in the past as banks were permitted to maintain nostro account surpluses or avail of overdrafts to a limited extent. This has further strengthened following the introduction of FCNR (B) scheme and particularly after the permission was accorded to borrow and lend overseas upto 15 per cent of Tier I capital. This linkage is often more pronounced in times of volatile market conditions.

The emerging linkages among money, government securities and foreign exchange markets have required the Reserve Bank at times to use short-term monetary measures alongside meeting demand-supply mismatches to arrest excessive volatility in the foreign exchange market. While there is no settled conclusion about the appropriateness of an exchange rate regime, the primary objective of the Reserve Bank, as stated earlier, continues to be the maintenance of orderly

market conditions no doubt, in a regime where exchange rate is determined by demand and supply conditions. Some of the recent empirical work in the Indian context do suggest evidence of growing integration between money, debt and foreign exchange markets with relatively weak convergence of capital markets. In the aftermath of terrorist attacks in the US, the Indian financial markets have sometimes exhibited some tendency to be in tandem with the movements in global financial markets, reflective of the growing inter-linkages between domestic and international markets on the one hand and among various segments of the domestic financial market on the other, as a result of financial sector reforms and increasing globalisation led by IT.

In this context, I would like to highlight some critical data regarding the forex market. There is a widespread feeling that market volumes have dropped significantly on account of certain measures taken by the Reserve Bank in the past like withdrawing the freedom to rebook cancelled forward contracts, placing restrictions on swaps etc. But the data collected by the Reserve Bank belie this belief. The average monthly turn over in the merchant segment of the forex market increased from US$ 20 billion in 1999-2000 to US$ 23 billion during 2000-01. The average monthly turn over in the inter bank foreign exchange market has also increased to US$ 90 billion in 2000-01. A recent survey of the foreign exchange market turn over during April 2001, in which 43 countries including India participated by the BIS reveals the interesting fact that while forex turnover world over has declined considerably as compared to 1998, India bucks this trend by showing an increased turnover.

Let me now turn to the specific issues relating to the Indian forex market that would need to be addressed. The market is skewed with a handful of public sector banks accounting for the major share of the merchant transactions and a private and foreign banks having a greater share of inter-bank business. It is conducive for healthy market development to have much larger number of players active in the market with enhanced volumes of business. The presence of increased number of players and larger volumes alone lend certainly greater depth to the forex market leading to a more efficient functioning.

Forex derivatives have not picked up sufficiently. The development of a vibrant derivatives market in India would critically depend on the growth in the rupee-based derivative products, which in turn depends on a well developed and liquid forward dollar-rupee market. This would in turn require development of a deep and liquid inter-bank term money market. In this regard, making tax laws pertaining to derivatives unambiguous and liberal will go a long way in the development of an active derivative market. In our market in its present stage, the focus of reforms should be the growth of rupee-based derivatives. The Reserve Bank took a major step in this context by putting in place an Asset-Liability Management (ALM) system for the banks. But any attempt at making ALM a catalyst for the development of more vibrant and integrated financial markets would need to recognise the following characteristics of the Indian financial system.

1) Retail nature of the Indian banking system that makes it difficult to get real time information. The answer lies in spreading technology-based solutions.
2) Absence of a clear cut transfer pricing system, firstly on account of lack of centralisation of treasury operations and secondly on account of the absence of a rupee yield curve across maturities. A recent article by Zagorski in the Capital Markets News published by the

Federal Reserve Bank of Chicago highlights the importance transfer pricing system. To quote "without a well-implemented funds transfer pricing system the impact of interest rate risk is buried within the results of the other operating units. Thus a bank would not be able to accurately measure the profitability of either its treasury unit or its business units, and would not precisely understand the volatility of its net interest margin".

3) Absence of adequate instruments to hedge interest rate risks.

There is also a need to put comprehensive risk management system in place. Risk management concepts, such as, value at risk (VaR) need to be developed and implemented in the Indian market. Technological upgradation in forex transactions, clearing and settlement is a pre-requisite for developing a proper risk management system. The setting up of Clearing Corporation of India is a step in this direction. The Clearing Corporation of India, in addition to government securities, will also handle inter-bank forex settlements, which will go a long way in enhancing the efficiency and security of our settlement system for government and forex securities. The objectives of the forex clearing arrangement is to provide market infrastructure to mitigate and manage settlement risks while also reducing the costs associated with these transactions. The Corporation which is planning to act as a central counterparty for effecting clearing and settlement through *de facto* multilateral netting is in an advanced stage of operationalisation. It is in the interest of the Authorised Dealers that they become members of the Clearing Corporation at the earliest and undertake the changes required in regard to their back office software systems to get them integrated with the Clearing Corporation of India Limited (CCIL) system. I understand that shortly Foreign Exchange Dealers Association of India (FEDAI) will be organising a Seminar to help its members expedite the formalities of taking up membership of Clearing Corporation to hasten the process of implementation of the project. The Reserve Bank attaches considerable significance to an early operationalisation of the forex clearing system.

In the context of integration of Indian financial market with international markets, the move towards capital account convertibility, which has an important bearing on our forex market, assumes paramount significance. Some of the preconditions/signposts for capital account convertibility, as mentioned in the CAC Committee Report, such as, fiscal consolidation, mandated inflation rate, consolidation of the financial sector, adequacy of foreign exchange reserves, sound BoP situation etc. need to be adhered to properly before rupee is made fully convertible on capital account. As CAC integrates both the real as well as the financial sectors with the international economy, the impact of external impulses would be felt more strongly, which makes it imperative to have the preconditions in place before full capital account convertibility is allowed.

In the present context, the major thrust of RBI's policies would continue to focus on the development of deep, liquid and integrated financial markets. The importance attached to the forex market would be evident from preamble to the newly enacted Foreign Exchange Management Act (FEMA). One of the main objectives of the FEMA is to promote the orderly development of the foreign exchange market in India.

In this context let us identify issues that are of immediate concern both to the market and the regulator.

The first issue that would need to be addressed relates to depth and liquidity in the market particularly in the forward segment. It is well known that barring well developed markets, forward markets are rather shallow in many of the emerging countries. Why? Given the constraints in such emerging markets are there any solutions?

In most of the developing markets, liquidity is not there for maturities or are not available beyond one year period. I believe that this would be the case in most of the markets where there are restrictions on capital movements. In other words, in markets dominated by trade related flows and which are not financially driven, where capital controls exist, liquidity across the spectrum as seen in the developed markets, may prove to be difficult at least in the early stages of development of the market. The question that we would need to address is within these constraints, how can the liquidity improve? Indian experience suggests that there could be two impending factors in this regard. First is the absence of a well-developed local money market and second, more important is the reluctance of larger public sector banks who handle a major portion of the export-import transactions to assume the mantle "market makers". While the solution to the first problem partly lies with the Reserve Bank and there have been many initiatives in this regard, as I had stated earlier, it is entirely up to the bank managements to make their banks more pro-active in the market and realise that forex dealing rooms could be an important profit centre, provided proper risk management systems are in place. You may have a point of view that liquidity has come down after the imposition of restrictions on re-booking of cancelled contracts. While this kind of liquidity in an emerging market, which often tends to get one sided, is a debatable issue, absence of this freedom is more acceptable than wide swings in policy prescriptions whenever volatility erupts.

In the developing markets where volumes are not large, it has to be remembered that the positioning of the markets, types of players allowed entry into the market, the amount of unhedged position, all could prove crucial when turbulence erupts. The last mentioned issue that of unhedged positions of the corporates is curently attracting the attention world over. The Reserve Bank would welcome and support efforts of the banks in monitoring such positions on an ongoing basis since this is closely linked to the issue of credit risk as well.

A major issue that has attracted sustained debate among the forex market participants during the last one year, has been the issue of longterm rupee – foreign currency swap. This was permitted in 1997 as a hedging mechanism for corporates who run longterm foreign currency exposures. When instances of use of this product to merely take a view on the currency movements and putting in place structures that would be tantamount to corporates effecting pre-payment of the foreign currency loan were noticed, banks were advised last year to put through transactions only on a fully matched basis. The matter has since been reviewed and the banks have been accorded limited freedom to run a swap book. We are aware that banks have been raising a few issues in this regard and demanding greater freedom to make this product a genuine hedging tool. Reserve Bank would continue to monitor transactions in this area and take pro-active decisions with a view to offering further relaxations wherever warranted.

There have been demands from the market players to be accorded greater freedom in the investment of foreign currency funds and using new products like the options to better manage

their balance sheet and proprietary trading positions. Given the fact that FCNR (B) deposits are presently accepted for maturity ranging upto three years, there is justifiable demand for permitting longer tenor investment out of these funds. The Reserve Bank is actively reviewing the current restrictions in this regard. Although options could be very useful for any managing risk positions, particularly at the Treasurer level, there has been very limited demands from the market for using this product. The Reserve Bank is open to the suggestions from the banks for using new products to help them in better managing risks.

Finally, The Reserve Bank is alive to the developments around us, with its epicenter in the US that could have a bearing on the Indian economy and the financial markets. Several groups within the Reserve Bank are reviewing the position in its various dimensions on an ongoing basis. Options are considered as developments unfold and expectations are formed. Actions are explored as appropriate to meet the dynamic situation. Our actions since September 11, 2001 in regard to various financial markets testify to alertness and promptness of the RBI, whenever considered necessary.

With these observations, I have great pleasure in inaugurating this Conference and wish your deliberations all success.

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[*] **Keynote address delivered by Shri Vepa Kamesam, Deputy Governor, Reserve Bank of India at the inauguration of the 12th National Forex Assembly organised by the Forex Association of India at Goa on October 26, 2001.**