*India's Growing Significance in Global Arena. Is it Sustainable? Are We Ready for it?**

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It is a great pleasure to be amidst you today and I wish to thank foreign exchange dealers' association of India (FEDAI) and the organisers of this conference for the privilege to speak to you. FEDAI has been playing a seminal role in steering the cross-border transactions of the members of public as well as interbank transactions in the foreign exchange market for more than six decades now. It may be recalled that FEDAI was formed to secularise foreign exchange transactions in the early days when only select branches of foreign banks were conducting these transactions. Over time, the statutory framework enjoined upon the foreign exchange dealers an additional role as authorised dealers – a role so comprehensive that they share the responsibility for administering the regulatory regime. FEDAI, as organisation of authorised(forex) dealers has played its role remarkably well and if we are expanding the set of players in the foreign exchange market today, a part of the credit goes to FEDAI in creating the necessary skill abundantly and widely in dealing with foreign exchange. I am sure it will continue to play a constructive role and help market participants grapple with the challenges that a market as prone to volatility and uncertainty as the foreign exchange market will spring from time to time.

These annual conferences since 2006 have been an important event, or should I say, the most important event that the participants in the foreign exchange market look forward to. It provides an opportunity for networking and exchange of ideas for the market participants. It also provides a welcome respite from the heat and dust of the marketplace. I cannot but commend the choice of the venue this year, particularly with a view on the theme of this year's event. China and India have been comrades-at-arms for millennia's, sharing their journeys in multiple dimensions: commercial as well as civilisational. Angus Maddison[1] estimates that India and China were the world's two largest economies until the early 18th century. China is the world's largest economy today on PPP basis and India is the third largest. If you add the exports and imports, China is India's largest trading partner (2017-18 data). Among the fastest growing economies, the engagement between the two countries can be expected to see phenomenal growth in the times to come.

The theme chosen for this conference is: India's growing significance in international arena: Is it sustainable? Are we ready for it? These are interesting and important issues and as we shall see, quite relevant to our common functional domain. Now, importance in the international sphere has many dimensions: cultural, military, moral, strategic to name a few but the dimension that underpins all others is economic. If you look at the history of mankind, it is economic prosperity that has always dictated the importance of a nation. Whether we look at the Italian city states of the 15th/16th century – many of Shakespeare's plays were situated in these places Verona to Venice – and one wonders whether the renaissance would have been possible but for the wealth and backing of the Medicci's and others, or the British of the 18th/19th century – Britain became the dominant global power for two centuries, and English became the *lingua franca*, it is the economic prosperity that made the nations internationally important. The pre-eminence of China today is to a great extent due to its phenomenal economic success.

We also must notice that economic prosperity has almost always been inextricably linked with

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[1] Maddison, Angus, 'The World Economy: Historical Statistics', 2003

international trade and commerce (capital movements are recent phenomenon). The need for free trade and commerce became important as the industrial revolution greatly increased productivity. Of course, it was not in the sense we now understand. Till middle of the nineteenth century, mercantilism was the dominant policy driver in Europe. Essentially, while it favoured exports of all commodities except gold, it sought to discourage imports through tariffs. Ultimately, with repeal of the (British) Corn Laws in 1846, the case for free trade had been decisively established. The doctrine that free trade enhances welfare has been further strengthened by subsequent research at least on a theoretical plane. Despite the fact that global economic growth and growth in global trade have moved in tandem over the past two centuries, arguments in favour of import substitution, selective protection, subsidies abound. One can perhaps reasonably conclude that while the global objective will continue to be less restrictive trade, local variations will have to be considered keeping in view other macroeconomic factors like fiscal policy, exchange rate policy, employment policy, and so on.

Unlike trade in goods and services, the case for capital flows has not been clear. We must appreciate that restrictions on capital flows were enshrined in the Bretton Woods system. However, after the breakdown of the Bretton Woods system in the early seventies, a set of strong arguments emerged in favour of free capital flows and was endorsed by the IMF. In the wake of the far eastern crisis of the late 1990's, the debate about its desirability was revived. The debate again came to life after the global financial crisis and there has been a general agreement since that – and I quote the words of Harry Dexter White, one of the principal architects of the Bretton Woods, – 'the desirability of encouraging the flow of productive capital to areas where it can be most profitably employed needs no emphasis, but there are periods when failure to manage flows have led to serious economic disruption.' Keynes was in agreement.

The reason I have dealt with the propositions relating to trade and capital flows is to bring out the point that there is no universally acceptable policy prescription relating to either. Both theory and empirics accommodate the possibility of specific sets of policy appropriate to a country's idiosyncratic requirements and it is in this backdrop that we shall consider our policies in respect of cross-border transactions, past and present.

There are several dimensions of the regime for cross border transactions: but what we shall be concerned with in this discussion is that relating to exchange control or rather foreign exchange management. The foreign exchange management policy ultimately hinges on two factors: the quantity of foreign exchange available and the exchange rate. This has guided the evolution of the exchange control regime in India, and indeed elsewhere in the world.

The war-time exchange control through administrative fiat was converted to a statutory regime in 1947 through the foreign exchange regulation act (FERA), 1947. The acute shortage of foreign exchange in the 1960's and various other factors such as food shortage, wars, *etc.*, led to a more stringent regime through the FERA, 1973. Foreign exchange *per se* was considered important and the policy regime comprised rules to grudgingly allocate foreign exchange to various demands. Import control and promotion of import substitution provided complimentary policy instruments. Beginning mid-seventies (soon after the enactment of FERA,1973 but not necessarily because of it), the situation relating to the external sector started improving primarily because of increasing remittances from Indian diaspora and impact of green revolution. Thus, through the 1980's, there was progressive and incremental liberalisation in cross border transactions, *albeit,* within the same paradigm. Two observations are in order here. First, the liberalisation in exchange control regime was not accompanied by any significant changes in other economic policies. Second, although the Bretton-

Woods regime broke down in early 1970's and many currencies started floating, the rupee continued to be in a pegged exchange-rate system, first to pound sterling and then to a basket of currencies. Thus, the foreign exchange crisis once again surfaced in early nineties. The policy response in the aftermath of the crisis this time was a comprehensive reform. As far as regulating cross border transactions are concerned, I would like to mention three landmarks: (a) adoption of a market determined exchange rate system in 1993, (b) Commitment to conform to Article 8 of the IMF charter – current account convertibility – in 1994 and (c) Enactment of foreign exchange management act (FEMA) in 1999 – removing the shackles of a repressive regime. It was a new paradigm.

We have lived through this paradigm for nigh two and a half decades now. There have been cadences in the policy regime from time to time, but the basic tenets remain the same and will continue to guide the evolution of policy framework in future. Let me draw your attention to the preamble of the FEMA, 1999 which very aptly summarises the philosophy behind how we regulate the cross border transactions. It goes: 'An Act to consolidate and amend the law relating to foreign exchange with the objective of **facilitating external trade and payments** and for promoting the **orderly development and maintenance of foreign exchange market** in India.'

As far as current account is concerned, the statute mandates that there shall be no restrictions except such that are placed by the Central Government in consultation with the Reserve Bank. The restrictions that figure in the rule-book mostly relate to some (socially undesirable) non-priority activities like gambling, transactions that can be used to dress capital accounts transactions as current account transactions, and some with strategic implications. There is also some asymmetry, in practice if not in precept, between the current account transactions that involve an outward remittance and those that involve an inward one. The regulatory framework for current account transactions has been pretty stable; I may mention in passing that transaction in services has been growing steadily in keeping with India's reputation as an outsourcing hub. While a comprehensive system for collection of aggregate statistics for compilation of the balance of payment is in place, perhaps we need to develop a system to capture transaction level data similar to that for merchandise trade to improve our understanding and guide policy action, wherever necessary.

Let me now turn to the capital account transactions. The statute provides that the Reserve Bank (and when the 2015 amendment to FEMA, 1999 is notified, the Central Government in some classes of transactions) will regulate which capital account transactions are permitted and to what extent and subject to what conditions. Partly because of this construct of the statutory provisions but mostly because of the evolving macroeconomic conditions during the past two decades, majority of the policy actions have related to the capital account.

As I mentioned earlier, starting the 1970's, and through the 1980's and well into the 1990's there was a strong advocacy of full capital account convertibility by the free market proponents. This culminated in the 1994 Madrid Declaration of the IMF to encourage the member countries to remove impediments to capital flows. However, subsequent global economic developments have modified the stance and it is now admitted that capital controls can indeed be used as an instrument for macroeconomic and financial stability. The goalpost has now shifted from convertibility, an event to capital account liberalisation, a process. This raises issues about the pace and composition of the liberalisation the drivers of which are eclectic and country specific rather than based on universal principles. Broadly, three determining factors are important: (a) the pre-conditions for opening up of capital account; (b) the cost and effectiveness of capital account restrictions; and (c) monetary policy implications of an increasingly open capital account.

Of course, the stability and orderly conditions in the forex market remains the proximate determinant of the policies relating to capital flows. In our case, while capital inflows serve the twin purposes of bridging the export-import gap and the savings-investment gap, the above considerations will determine the approach to regulation.

There are usually three preconditions for capital account liberalisation discussed: price stability, fiscal stability and stability of the financial institutions and markets. As we speak to day, achievements in respect of the stated parameters vary. The fiscal deficit at the General Government level needs consolidation. It is desirable that growth along with low inflation and fiscal prudence become well entrenched before we take quantum steps towards a more open capital account. Besides, there are signs of global headwinds, though in the distant horizons.

While the nuances of capital account liberalisation is a matter of detail, some broad policy prerogatives relating to the hierarchy of capital flows can be mentioned. First, capital flows particularly for the real sector will always have priority over flows into the financial sector. Second, equity related capital inflows will have preference over debt inflows. Within the equity flows, direct investment flows will be preferred to portfolio flows and in so far as debt flows are concerned, preference for long term debt and rupee-denominated debt – whether bilaterally contracted or through marketable securities – shall continue. You are aware of the policy changes in recent times in respect of foreign direct investment, external commercial borrowing, trade credit, *etc.* However, the changes constitute mostly rationalisation and consolidation rather than any significant change in stance.

The investment requirement of the Indian economy is and will continue to be quite large. Apart from the usual ICOR (incremental capital output ratio)-driven investment to support the desired growth, huge investments are also required for the physical and social infrastructure sector. These latter investments have their own challenges in terms of long and uncertain execution period, long payback period, *etc.* The world today is flush with long-term savings in the nature of pension funds and corpus of insurance companies, our policy regime need to be nimble and accomodative enough to direct these to productive ventures in India. We are working towards this.

Talking of the need of infrastructure sectors, we cannot help notice the emergence of a new class of investors: venture capital and private equity funds. Anecdotal reports seem to suggest that in the last few years, investment by these funds constitute about 35-40 per cent of the foreign direct investment (FDI) inflows. Important as the role of venture capital (VC) and private equity (PE) funds is as the mediator between long term investors like pension funds, insurance companies, sovereign funds, trusts, endowments *etc.*, on the one hand and potential growth industries on the other, these investments have different structural and behavioural characteristics. The current regime permits wide latitude of freedom to VC investors in select sectors perceived to be economically important but risky for normal FDI. Perhaps there is a need to consider private equity investment in its totality and see if a modulation of policy regime is warranted, including wider and innovative debt funding, hybrid instruments, *etc.* particularly in so far as they relate to priority areas such as infrastructure, non-conventional energy, health, education and other social impact areas. This is engaging our attention.

The issues relating to start-ups are extremely important. Business has evolved in ways that could not have been foreseen a short while ago. It has become a cliché to cite the examples of the largest transportation company that does not own a cab, the largest retail company that does not own a store and so on. Technology and internet have and are continuing to revolutionise the service industry. Most of the start-ups have immensely contributed

to employment generation. (Should we create a preferential FDI regime for activities with large employment potential, given the importance of employment in the economy?) The start-ups have great appetite for funds in their growing phase and lion's share of the funding has been coming through foreign investment, mostly venture capital or private equity funds. We have taken some steps in the past to facilitate fund raising by start-ups, but we will remain alive towards their evolving needs including easing the compliance burden.

What should our approach be as far as capital outflows are concerned? So far it has been almost entirely for direct investment. Moreover, there is no differentiated policy for equity and debt outflows. The policy perspective forged during the FERA days had many negative vibes. Why should capital deficit countries export capital? Shouldn't overseas investment be considered on the basis of the returns it generates? Perhaps a time has come to take relook at it. Creation of overseas assets by resident Indians goes as a credit entry in the international investment position. Therefore, rather than looking at dividend earning, there is a need to look at value enhancement. Secondly, acquisition of strategic and economic assets, eg., coalfields, oilfields, *etc.*, is a long-term priority. Thirdly, overseas investment can perhaps be seen as export, not of capital but of entrepreneurship. Lastly, overseas investment is also an important phenomenon associated with start-ups. Several start-ups, including individual entrepreneurs invest in India through a holding company overseas primarily because of the ease of raising capital in a foreign jurisdiction, whereas the economic activity is located in India, generating employment, revenue and economic value. We, along with the government of India (GoI), shall take a relook at any misgivings about regulatory regime in this regard and take necessary corrective action.

Now I come to the foreign exchange markets. I am aware that treasury professionals dealing with the forex market constitute a large part of this gathering and this is a theme with which you are closely involved. As I mentioned earlier, an orderly forex market is an important objective and also a precondition driving the evolution of the foreign exchange management regime. We have come a long way from the days of 'RBI's middle rate'. Today, the Indian forex market is pretty well developed in terms of daily turnover as well as the range of products available. Yet, it continues to be a regulated market and let us now turn to the motivation for and the future of the regulatory regime.

The forex market determines the exchange rate, an important macro-variable with implications for balance of payments, monetary policy, capital flows, and several other derived issues. Now, it is well known that in the long run the exchange rate depends on economic fundamentals like inflation, interest rates, balance of payment position, *etc.*, but in the short run there can be significant deviations in the exchange rate from the value dictated by the fundamentals. Though the exchange rate can be measured in several ways such as real effective exchange rate (REER), nominal effective exchange rate (NEER) with different combinations of currencies and different weighing schemes, my discussion will be centred around the headline INR-USD rate, which drives sentiments and decisions. The fluctuations in the exchange rate are caused by sentiments and perceptions of a host of events, some domestic and some global. As you dealers say, 'Buy the rumour, Sell the news'. We have had many such episodes. During the last one year or so the Rupee saw levels of 64 to a dollar in March 2018, depreciated to near-75 levels in October 2018 and again appreciated to 68+ levels by March, 2019 and has been trading almost flat since then. During this one year, there has not been any change in the fundamentals of the Indian economy, nor any dramatic change in the global conditions either. The cause mostly has been surge or ebb in capital flows, driven by perceptions and risk aversion or appetite. However, understanding these gyrations

in the exchange rate does not provide any solace to the policy maker: there is a response necessary lest the expectation turn to panic and bring a great deal of disorderliness in the market in its wake. The first line of defence is market interventions. But then the impossible trinity comes into play: the interventions affect the rupee liquidity and may lead to a conflict with the monetary policy stance. Sterilisation carries a cost. And sometimes, particularly when the Rupee depreciates, there is a limitation to the extent of intervention, rendering intervention strategically ineffective. The second line of defence is resorting to modulating the capital control regime: diluting or strengthening restrictions depending on whether the Rupee is appreciating or depreciating. This must be a last resort though: because while the forex market conditions can quickly reverse, the control regime must have a longer lifetime, lest decision making by economic agents is adversely affected.

The second theme I want to talk about relates to derivatives in the forex market. Derivatives evoke extreme reaction – from 'the most significant event in finance' (Greenspan) to 'weapons of mass destruction' (Buffet) or 'license to kill' (Soros). The primary purpose of derivatives is to hedge against future uncertainties. Thus, they perform economically a useful function in enabling agents to make better inter-temporal decisions. But on the other hand, they can also be used as instruments of speculation and can obfuscate risk allocation. As Garber notes, 'The problems associated with rise of derivatives stem partly from the same source as the benefits: the increased ability to separate and market risks means that some counterparties can assume riskier positions more readily than in the past.' The other part of the source of the problem with derivatives is that they can be incomprehensively complex making the risk implications opaque. In our markets, we have both linear (forwards and futures) as well as non-linear (options, exchange traded as well as OTC-over-the-counter) varieties. The later is mostly plain vanilla. For some time, complex derivatives not involving Rupee were allowed, but it led to assumption of risks not understood epitomised in the Rajashree Sugar case. Another facet of the problem is unhedged exposure. Hedging has a cost. It is the price an agent pays to convert an uncertainty to a certainty. Thus, there may be a tendency to remain unhedged and leave events in the lap of gods. Should the market conditions turn hostile, there is a mad scramble to cut loss which exacerbates the market further. Our approach has been and will continue to be to provide an agent who has exposure to the Rupee – resident or non-resident - with a range of derivative products to enable them to hedge their foreign exchange risks but expanding the range of products has to be gradual.

The discussion of foreign exchange market will not be complete without the issue of internationalisation of the Rupee. A currency is international or a reserve currency when it is held widely by non-residents and used to settle international transactions. Internationalisation of a currency has certain advantages and disadvantages as well. The main advantage lies in getting rid of the 'original sin' of inability to borrow in one's own currency which is at the root of currency crises. The disadvantage comes from the obligation of a country whose currency serves as global reserve currency to supply it to meet the global demand which may come to conflict with its domestic policies. Over the years, global investors have shown increasing interest in Rupee denominated assets – both equity and debt - traded in on-shore markets. Rupee denominated bonds, the so-called masala bonds, have also found investor appetite in off-shore markets. When Rupee assets are widely held by global investors, there will be need for rupee derivatives to hedge currency, interest rate and credit risks. It is therefore natural that there will be a need for such markets in offshore financial centres. The challenge that these markets pose is that while the on-shore derivatives market is tightly

regulated, offshore markets are beyond regulatory reach, which can lead to domestic market being affected through arbitrage during turbulent episodes. The regulatory framework will continue to strive to make the on-shore derivative markets accessible to all non-residents with a Rupee exposure.

Let me now conclude. India is among the world's fastest growing countries and is the world's third largest economy today in PPP terms. It is among the global investors' preferred destination. The Indian economy has also shown remarkable resilience against adverse global developments, if not completely decoupled from it. With increasing sustained economic growth and macro-economic stability, favourable demography and a large market, India is an important player in the global economic arena. The sustainability of its global role will depend on the sustainability of the growth momentum and stability. While this would require continuing policy response to emerging challenges in many spheres, integration with global economy will be an important factor in sustaining the growth momentum. We have to be alive to the challenges of both growth and stability and steer the policy regime relating to cross border transactions in tandem with the needs of the economy. Foreign exchange dealers or rather authorised dealers, in so far as they provide the primary interface with the customers and give shape to the developments in the forex market, will continue to play an important role.

I am sure your deliberations and discussions will be rich and fruitful. I also wish you happy vistas of this ancient yet modern city.