*Goa to Goa – Changed contours of the Indian Forex Markets – New realities and Priorities**

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It is indeed an honour to once again address the top professionals in the Indian forex market. It is exactly 15 years since Dr Y V Reddy, the then RBI Deputy Governor, heralded the beginning of a true forex market in India in this city through what has become famous as the 'Goa Speech'. Clearly the attempt of Dr Reddy that day, and I was present in the front row of the audience, was to drive home some rationale and sanity into the participating audience. The market took the cue and rest as they say is history. Today, we are back to the same position but exactly on the opposite side. But what is needed to calm the market is the same- may be more sophisticated- levels of sanity and rationality. Let me attempt to set out some issues and priorities in this endeavour.

2. An old adage, purportedly an old Chinese proverb and curse, that has been fashionable in the post Global Financial Crisis discourse, goes: 'May you live in interesting times'. To see it as a curse is a bit of an irony; after all, interesting times are what one hopes for and looks forward to. Yet, on reflection, it is easy to see what the Chinese sages would have meant. After all, the only thing that is interesting is uncertainty, and therefore, interesting times may be enjoyable for the bystander; but for those who are in the thick of it, those who are to take various decisions and whose livelihood depended on it, it surely is a challenge, to say the least. But the question that I am going to examine today is different. Do economic agents, who have a significant exposure to forex risk in their balance sheet deem this phase of uncertainty and volatility as a challenge or do they consider this as a royal pathway to boom? I will try finding some answers to this question but with a warning – the word 'boom' is not too different from the word 'doom' both in terms of intonation and reality. In the same vein,another question. What is the difference between personality and character? To put it simply, while personality reveals external qualities which often can be put on, character is a measure of internal strength of a person. While character traits are objective, personality traits can often be subjective. In markets such as today, we need participants with character rather than personality if we are to tide over these difficult times.

3. The Global Financial Crisis has had severe fall out for the economies worldwide. Almost every single economy now faces deceleration of varying magnitude in economic growth, increased unemployment, increased fiscal burden, heightened currency volatility and so on. The real sector developments are gloomy and challenging; but evolution of the price process in the financial markets worldwide during this period is truly interesting. Let us recall that prior to the onset of the financial crisis, there was optimism all around; risks were underpriced and prices of all assets were moving heavenwards. As soon as the crisis broke out, markets crashed and prices bottomed out. The response of the monetary and fiscal authorities worldwide was swift and overwhelming. Consequently, the markets recovered sooner than expected, which however was short-lived as the Euro problem – the root of which lie partly in inherent structural problems of the union but also partly in the post-crisis fiscal response, threw the market into fresh turmoil that is yet to be resolved.

4. Asset prices in the financial markets have been on an uncertain roller-coaster ride for the past few years. Let me mention a few. The DJIA moved from the pre crisis peak of 14164 (Oct 07) to post crisis low of 6547 (March 09) to 11204 (April 10) to 9686 (July 10) 12811

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(April 11) to 10655 (Oct 11) to 13279 (May 12). The US 10-year yield, moved from 4.27 per cent in June 2008 to 2.05 (Dec 2008), 4 per cent (Apr 10) and historical low of 1.3910 in July this year. USD/EUR, the current flavour, was at 1.60 in April 2008. Since then it has seen 1.24 in Nov 08, 1.51 in Nov 09, 1.19 in June 10, 1.48 in May 11 and the recent low of 1.2036 in July this year. The figures I have mentioned only points to a few peaks and troughs, but there is whole lot of details in the charts that tell the same story : The markets have been highly volatile.

The Rupee story

5. Let us now look at the Rupee. Around the onset of the crisis, we were inundated with capital flows and the Rupee had appreciated. It had touched a high of 39.27 in Nov 2007. As the crisis unfolded, the trend reversed and Rupee started depreciating and reached 52.06 in March 2009. The Rupee started correcting soon and for almost two years between Nov 2009 and Aug 2011, remained range-bound at 44-47 levels. The sharp decline seen since September last year (with a significant correction in Jan 2012) is too recent to need recounting.

6. There are two issues involved here – depreciation and volatility. As far as depreciation is concerned, the facts are well known. India has always had current account deficit which has increased significantly during the past few years in view of strong petroleum prices, increased gold imports coupled with strong gold prices and deceleration in the growth of exports on the back of faltering or even falling growth in most of the developing/developed countries which also happen to be the major trading partners. On the other hand, autonomous capital flows also seem to have slowed down because of several factors including global risk aversion, slowdown of investment in the Indian economy and several structural issues including inadequate infrastructure. In such a situation Rupee exhibiting a depreciating bias is no surprise. A depreciating currency is often seen to act as an instrument for correction of imbalances in the BoP. However, a sharp depreciation within a short period of time has a destabilising impact inasmuch as it provokes panic reaction amongst market participants which apart from leading to sub-optimal economic decision making further accentuates the price process. While the policy response to structural as well as exogenous factors that lead to mismatch between inflows and outflows and consequent depreciation (or appreciation) of the currency take time to yield results, Reserve Bank has a mandate to maintain orderliness in the foreign exchange market.

7. Now let us turn to volatility. Volatility essentially means unpredictability. Unpredictability not only of the extent of change over any given time period but also the direction of change. It affects all of us because we are required to take decisions today that will fructify at a future point in time. Because all financial prices are inherently forward looking in the sense that they incorporate the participants' future view, it is no wonder that volatility is their most important attribute. It is further complicated by the fact that usually our future view is informed by our past experience. It may be interesting to recall that in 2007-08 when Rupee was at 39 levels, informed participants were forecasting 35-36 levels by the end of 2008 and very recently, during end-June this year, when Rupee reached 57, market was looking at 58-60 or even 60-65 as inevitable. What I wish to emphasise is that when economic agents take decision based on such a view of the future, it certainly does not bode well either for them or for the economy as a whole. This raises a related issue. If we accept that market makers/analysts who often are in a position to influence the market sentiment tend to be either euphoric or despondent, what is the accountability if their forecasts turn out to be widely wrong but meanwhile some participants in the market do get taken in by these forecasts and their decisions then turn out to be sub-optimal or inappropriate?

8. Thus, it needs to be recognised that increased volatility in the financial markets has become a way of life- a kind of new normal-and it has to be accepted as such. Capital account liberalisation during last few decades and enormous increase in the scale and variety of cross border financial transactions has increased the magnitude of exchange rate movements, particularly in the emerging market economies. Of course, volatility may be moderate for some stretch of time – recall that

in 2006 people were seeking explanations for low volatility in the forex market[1] – and heightened at other times, as now. The question that I will now seek to address is: What should be our response to volatility? For ease of exposition, I shall mainly discuss the issue in the context of two sets of market participants. The real sector agents – exporters, importers, foreign currency borrowers and so on and the banks or authorised dealers.

Real Sector or Real Culprits?

9. First, the real sector. In view of the extant capital account restrictions, exposure of residents to assets denominated in foreign currency (other than overseas direct investment) is marginal and therefore I exclude this from my discussion. Whenever a contract is denominated in a foreign currency, the contracting party faces uncertainty in its cost or revenue and ultimately profit on account of fluctuations in the exchange rate. I would like to particularly emphasise the case of exporters, who in the face of stiff global competition and absence of any significant pricing power, have to reckon with rather thin margins which can be easily eroded because of fall in the value of the foreign currency before the payment is received. The same applies to importers as well when they are handicapped by incomplete pass-through of the increase in their input cost. The foreign currency borrower, who has to carry the exposure for a much longer period than the exporter or the importer, can find his cash flows and the bottom line seriously impaired because of depreciation of the home currency. You will be aware that one of the Maharatna companies declared a 18 per cent drop in Q-1 profit and a loss in excess of Rs 250 crore reportedly ascribed to foreign currency debt[2].

10. How do the corporates manage this risk? There are basically two routes available: non-hedging techniques and hedging techniques. Non-hedging techniques include:

a. Settlement of transaction through advance payment, which though beneficial for an exporter, carries a cost for the importer and is impossible for a borrower. Even for the exporter, it is doubtful, in how many cases in our context an exporter can demand and obtain advance payment without the risk of losing the order.

b. Invoicing in the home currency has been discussed a great deal in recent times, which, however is quite sometime away before it can be effectively implemented. In the current state of global slow-down declining exports, our exporters simply are not in a position to dictate terms.

11. Now, when it comes to hedging , are the corporates taking a well- deliberated and calculated call? To this , 'no' would have to be the answer in most cases. The reason is obvious. The rupee was rock solid in the range of 44 to 46 for about 2 years from 2009 to 2011. That lulled the corporates into a sense of complacency that nothing can go wrong. They started believing that this is the eternal range for rupee. A good bit of sales talk from various analysts (and some bankers too) convinced then that hedging is an unwarranted cost imposed on the business when the rupee is so well-behaved. It is like saying that life insurance is of no value since you are alive today !! This is where my answer to the earlier question comes in. If India is a high inflation country in comparison to the US, then the classical theory of foreign exchange states that rupee has to depreciate against the dollar to the extent of inflation differential. But there seems to have been an optimism among the corporates that the rupee will continue to be stable even if India is a high inflation country and that the financing of the CAD will never be a problem since India will continue to attract flows!

12. Over the years, we have made available a wide range of derivative products to enable those with foreign currency exposure to effectively manage their risk. The products include forwards, options and futures. I would like to mention that one of the motivations for introduction of the products like exchange traded futures or options was to enable the small and medium enterprises to access the derivative market at competitive cost. But the use of these

[1] Dino Koos, Recent Volatility Trends in Foreign Exchange Market, FRBNY, 2006.

[2] http://www.thehindubusinessline.com/companies/article3734210.ece?homepage=true&ref=wl_home

products depends on the agents themselves.

13. But, unfortunately, even these hedging instruments have become weapons in the hands of corporates to trigger market instability. Whether it is past-performance based booking or cancellation and rebooking, or EEFC accounts, the corporate deemed these instruments as unfailing profit channels rather than flexible operational tools to manage real- life business events. These instruments have a tendency to exacerbate volatility in the markets and create a constant undercurrent of instability. That is why Reserve Bank had to step in to moderate volatility and cushion the rupee fall.

Risk Management Framework

14. What should determine the use of the derivative products by the agents? Like in case of any risk, currency risk requires identification, measurement and management. It is important therefore that a firm should have a comprehensive framework for risk management and the decision to hedge or not to hedge should flow out of a conscious assessment of risk and the costs and consequences of entering a zero, partial or full hedge. The potential downside of any hedging strategy has to be recognised. Take the case of a forward contract, the most direct and commonly used hedge. An exporter, who had sold his receivables forward at a particular level, stands to makes a notional loss in comparison with an unhedged position if the foreign currency appreciates beyond the contracted level. Similar is the case when an exporter, anticipating a fall in the value of the foreign currency, sold his receivables forward only to find the trend reverse, as happened in 2007-08. Exporters cancelling forward contracts and importers rushing to cover their exposure are a common phenomenon we see when the Rupee depreciates.

15. There is a fallacy of composition involved here. What is a good strategy for one may not remain so if everybody adopts the same strategy. After all, a forward contract in essence shifts the demand from one point in time to another. If everyone adopted hedging strategy in anticipation of Rupee decline at a future point of time, the Rupee decline will happen now and here. The point I wish to make is this: the hedging strategy should be part of a well-conceived risk management framework built around assessment of risk and risk appetite. Having bought certainty through a hedge, the agent should be free to concentrate on his chosen line of activity without bothering about the potential gain or loss on account of currency movement. Having bought a car insurance, one should not regret that no accident has taken place.

16. I am told that fear of mark-to-market losses, inhibits many firms from hedging activity that their risk assessment and appetite would warrant. I am no expert in accounting. Yet it is clear to me that the objective of accounting is to faithfully reflect the true economic essence of business affairs. On the contrary, if accounting rules stand in the way of agents' adopting a hedging strategy that economic rationale hold optimal – on the basis of information available at the time, I must qualify, and not with the twenty-twenty vision of hindsight – then perhaps there is a need to take a relook at this inconsistency.

Role of banks

17. Now let me come to the role and response of the banks or authorised dealers in a volatile market. As I mentioned earlier, our exchange management framework places considerable restraint on residents' holding of foreign currency assets, particularly financial assets and hence, clientele of the bank comprises, exporters, importers, foreign currency borrower and overseas investors. The regime also extends differential hedging options to different classes of exposures. Without going into the rationale for the regime, let us try to see what should be the optimal role of banks in a volatile situation.

18. The banks are market makers in foreign exchange not only in the interbank market but also in relation to their clients. Obviously therefore they have to carry a position. By 'position', I mean trading position involving rupee as one of the currency. The need for this position arises from the fact that without this – inventory, as it were – banks would not be in a position to serve their clients efficiently. What should be the magnitude of this position? Naturally, this would depend upon the nature of their clientele, size of their

need and the volume of business. It is natural that like all traders, a forex dealer will also be tempted to profit from shortage by building up a hoard. Therefore, to align incentives of the forex dealers with the larger public purpose, we are constrained to impose restrictions on positions, knowing well that such restrictions may impair liquidity in the market. Let me mention another aspect in passing. Because a trading position is a risky market exposure, obviously it has to be limited by availability of commensurate capital for the purpose. But that does not mean that if you have capital, you can take as large a position as you want, irrespective of your needs as mentioned earlier. Not in the present regime, not at times of volatility.

19. We have often spoken about appropriateness and 'fit and proper test' of the products as well as the parties in conducting derivative transactions. We have also underscored the responsibility of banks in ensuring that hedging products used by clients are in consonance with the economics of their exposure as well as their risk management strategy duly incorporated into broader corporate governance framework. Let me again emphasise that the banks' responsibility to ensure appropriateness of the product for the client is not merely to satisfy a regulatory mandate nor is it motivated by altruism. Foreign exchange business in India is a part of relationship banking and it is in the banks' interest that clients do not end up taking unwarranted risk through ill-understood and inappropriate hedging products. In this context, let me flag an important issue of what I call, ensuring inclusion in forex transactions. Today, the large number of SME customers in this country are not getting fair rates for their hedging transactions. This is a serious missed opportunity in my perception and calls for some serious cooperative efforts among the banks to offer finer rates to the SME Clients who today feel that what they are faced with is a 'rip off'. You might argue that it has been the age old practice that rates are often way off the normal distribution for smaller transactions. But we can always make a sincere effort to change set thoughts and practices. I would urge some of the participants to put up their hands and take this thought process forward.

OTC vs. Futures

20. Before I close, let me flag one issue for brainstorming. The OTC forex markets and the Currency Futures are two different market segments for the same product. Both are governed by two different regulatory framework in terms of requirement of underlying, delivery and the extent of position taking by participants. We can no doubt have competing market segments as competition will bring in more efficiency. But, how can the competition be fair when the playing fields are completely asymmetric? This, in my view is an important issue warranting further public debate. But we need to underscore the fact that exchange rate is a critical macro-economic variable particularly for countries having capital controls, perhaps no less sacrosanct than the policy interest rates which are targeted by the central banks, the world over. We also need to bear in mind that excessive overshooting and volatility in such a critical variable can have adverse financial stability implications. I will leave you with the thought that there is a paramount need for aligning these market segments, perhaps with a road map over an acceptable time span.

Concluding Remarks

21. Let me now try and summarise what I have discussed. Volatility is an unavoidable feature of all financial markets and heightened volatility in the forex market that we witness today is neither unprecedented nor unexpected. All economic agents with currency risk will have to frame a conscious risk management policy to cope with the impact of the volatility on their cost, revenue and profit. Even as the Reserve Bank strives to maintain orderly conditions in the forex market, certain behavioral issues that tend to accentuate volatility have to be understood by all market participants and factored into their response and risk management strategy. I have also flagged the issues of forex inclusion for the SME sector and the need to synchronise regulations for the OTC and the Exchange traded markets.

22. Adam Smith famously said 'People of the same trade seldom meet together, even for merriment and

diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.'[3] I am sure this does not apply to the meetings of the Forex Association and I am confident that in this event, your deliberations will help to make the forex markets a place where people can trade with confidence, volatility notwithstanding.

23. I wish your deliberations over the next two days all success.

[3] Theory of Moral Sentiments