CHAPTER 6

DEVELOPMENT OF FINANCIAL MARKETS

6.1 When there is progressive integration of the domestic economy with the global economy in a FCAC regime, the interaction of domestic markets with global markets results in enhanced cross-border capital flows with benefits of diversification and additional capital. But, it also adds to credit and market risks. The nature of the cross-border financial flows are largely determined by the stage of development of different segments of financial markets, the skill and competency levels and maturity and robustness of the regulatory and payment and settlement systems.

6.2 All financial inflows across the border have to be first handled by the foreign exchange markets and later by other segments of the financial system comprising equity market, money markets and debt markets comprising both government securities and corporate debt markets. As regards outflows, they may originate from different segments of the financial system but will finally flow through the foreign exchange markets. The quality of response of different segments of the financial markets to handle financial flows will depend on whether financial markets are sufficiently broad-based in terms of number of participants, instruments and other necessary infrastructure to process large transactions of inflows and outflows.

6.3 In a well integrated financial system close linkages develop between the money market, the Government Securities (G-sec) market, the corporate bond market, the securitised debt market, the forex market and the derivatives market. Volatility in any one of the market segments gets transmitted to other market segments, although the magnitude of the impact will depend upon the extent of integration. Interest rates prevailing in different market segments would reflect their risk-reward relationships. Exchange rates and interest rates are interlinked. In an efficient market, the forward margin on the exchange rate should normally be equal to the interest differential between the two currencies. As regards the interest rate linkages between the G-sec market and the corporate bond market, any changes in interest rate in one market should lead to corresponding changes in the rate structure of the other markets if markets are well developed and efficient. For example, the yield curves for AAA rated corporate bonds and G-sec should reflect a healthy difference (although not necessarily remaining parallel) along different maturities. If the gap/differential between the two yield curves varies excessively for different maturities it is likely because either or both of these markets are not well-developed.

6.4 Any country intending to introduce FCAC needs to ensure that different market segments are not only well developed but also that they are well integrated. Otherwise, shocks to one or more market segments would not get transmitted to other segments efficiently so that the entire

financial system is able to absorb the shocks with minimal damage. Broadly, there are three main dimensions of a well developed financial system. These are: (i) vibrancy and strength of the physical infrastructure of markets as reflected by the IT systems, communication networks, business continuity and disaster management capabilities, (ii) the skill and competency levels of people who man the offices of financial intermediaries like commercial and investment banks, institutions that manage trading platforms and clearing and settlement arrangements and market intermediaries like brokerage houses, etc. and (iii) quality of regulatory and supervisory arrangements.

Equity Market

6.5 Indian equity market consists of primary and secondary segments, both of which have evolved to world class standards in terms of trading technology, disclosure standards and price discovery processes. Infrastructure in terms of depository, clearing corporation and anonymous electronic order matching, coupled with products ranging from cash and derivatives, both on stocks and indices, provide for an integrated framework for all participants. Participants are both retail and institutional, while foreign participants are restricted to the latter. Retail participation is significant including through mutual funds and exchange traded funds. Mutual funds have seen their funds under management increase steadily. Foreign institutional holding has risen to about 10 to 15 per cent of the market capitalisation, which itself is now approaching 100 per cent of GDP. In terms of trading intensity and liquidity, Indian stock exchanges are among the world's best.

Money Market

Overnight market

6.6 There has been a pronounced policy induced shift in overnight money market in recent years from uncollateralised call money market to collateralised segments. By August 2005, all non-bank entities except primary dealers have been phased out of the call/notice money market, making the call/notice money market a pure inter-bank market. Also, in 2003, the Clearing Corporation of India Ltd. (CCIL) developed a new product, *viz*., Collateralised Borrowing and Lending Obligations (CBLO). This market is very active, with participation from banks, financial institutions, insurance companies, non-government provident funds and some corporates. CCIL provides an order matching anonymous trading screen for its CBLO product and it is transparent and on a real time basis. This has helped in making the money market efficient and rates for different products in this market get influenced by the CBLO rates which are available transparently on real time basis. A similar screen for the call/notice money market and this screen has been developed by CCIL.

6.7 Although CBLO is a highly versatile product and meets the objectives of a repo deal, some market players still find repo to be a useful instrument and there is, therefore, a need to develop a repo order matching screen for increasing level of transparency and providing real time rate information to the entire market. The repo facility is yet to be effectively opened up to corporates and other players to manage their liquidity through repo operations. Since entities, other than banks, Primary Dealers (PDs) and mutual funds cannot enter into repo transactions with a maturity of less than one week, this market has not yet taken off. Again, corporate bonds are not eligible for repo purposes.

Term money market

6.8 One of the major gaps in the structure of the money market is the absence of a term money market and, therefore, a money market yield curve. There are no reliable interest rate quotes for fortnight/one month/three months/six months/nine months/364 day duration transactions despite availability of Treasury Bills of varying maturities. Until this segment of the market develops, it will be difficult to develop proper/meaningful linkages between the forex and domestic currency markets. The derivative market is also at a disadvantage when meaningful term money market benchmarks do not exist. Despite several efforts made, the term money market has not developed due to poor treasury skills as also lack of incentives to borrow or lend term money in certain segments of the banking sector. This is a hurdle in the development of not only the term market but also other important segments of the financial markets, *viz.,* forex, G-sec, corporate bond markets as also the derivative markets. Human Resources Development (HRD) policies/practices followed by a large part of the banking sector have to be significantly changed so that suitable staff is recruited and posted on a long-term basis and allowed to develop high quality skills/expertise in treasury operations including foreign exchange dealings.

Certificates of Deposit (CD) & Commercial Paper (CP) Markets

6.9 There has been a significant growth in the CD market in recent years and CPs also remain a popular instrument in the money market. The fact that CDs can be traded makes them attractive for investors like mutual funds, which seek liquid investments.

6.10 The CP market is also expanding over time. More importantly, the nature of the CP market has changed significantly in recent times. Leasing and Finance Companies accounted for nearly three-fourths of the total outstanding as at end-March 2006, while there has been a secular decline in the amount of CPs being issued by 'Manufacturing and other companies'.

Rupee Interest Rate Derivatives

6.11 Presently, Forward Rate Agreements (FRAs), Interest Rate Swaps (IRS) and interest rate futures are permitted in the Indian money market. The volumes of swaps FRAs have increased

substantially both in terms of outstanding notional principal amounts and the number of contracts. Some foreign banks, private sector banks, PDs and large corporates are the major participants. Though certain steps have been taken to shore up the monitoring and regulatory aspects of risks related to derivatives, there are certain other areas requiring immediate strengthening. Interest rate futures, though permitted, have not become popular.

6.12 Since FCAC would mean that market participants would be increasingly enabled to take on or transfer risk across markets, further expansion of hedging instruments such as interest rate futures are necessary. For effective risk management of G-Sec portfolios, participants will also need access to a liquid interest rate futures market, and eventually to an interest rate options market, which in turn would increase liquidity in the G-Sec market.

6.13 In the interest rate swap market, apart from increase in volumes, the market also witnessed emergence of interest rate benchmarks like Mumbai Inter-Bank Offer Rate (MIBOR), the Mumbai Inter-Bank Forward Offer Rate (MIFOR) (which is a combination of the MIBOR and forward premium) and other multiple benchmarks which essentially had linkages to the movement in overseas interest rates.

6.14 While an interest rate futures market nominally exists, there are no transactions, mainly because banks can use it only for hedging exposures. Since they are all long in fixed interest securities, there is lack of counterparty on the other side. First, banks should be allowed to trade in interest rate futures, subject to prudential market risk management. In principle, if they can trade in interest rate swaps, the logical extension is that they should be allowed to trade in futures as well. Secondly, FIIs in the debt market should also be permitted in all the derivatives markets.

6.15 With the large market for Over the Counter (OTC) swaps, which is expected to grow fast with more open markets, a safe and efficient settlement system for such swaps is necessary. A netting legislation needs to be in place to ensure legality of such a clearing and settlement system. The proposed Payment and Settlement Bill does incorporate provisions in this regard.

6.16 As interest rate derivatives grow, an area which requires urgent attention relate to accounting and disclosures. The current standards in respect of these are not comprehensive enough, do not prescribe mandatory uniform accounting policies, and in some respects are not aligned to international standards. Institute of Chartered Accountants of India (ICAI) is in the process of evolving an Indian standard for this purpose in line with IAS 39, the relevant international standard.

6.17 There is a general concern about the complexity with which the swaps/ options are being structured and marketed to corporates. Many complex products involve multiple benchmarks and

writing of options by corporates. An issue is whether these products are appropriate as hedging instruments and whether the risks are understood by the corporates and/or made known to them by the banks.

6.18 The Committee's recommendations relating to development of the money market are as follows:

(i) Policy initiatives should be taken to facilitate development of different financial markets to encourage capital inflows. During this process, prudential regulations on inflows of foreign capital, segment-wise would be desirable.

(ii) In cases where the regulatory purview extends beyond one regulator, one of the regulators should be designated as the lead regulator so that necessary coordination is ensured.

(iii) Suitable regulatory changes need to be progressively introduced to enable more players to have access to the repo market.

(iv) The CBLO and repo markets could be expanded in scope to cover corporate debt instruments.

(v) Considerable staff-skill up-gradation programmes in banks have to be undertaken to develop the inter-bank term money market. Staff compensation levels have to be different depending on the area of activity.

(vi) Since CP and CD are short-term instruments, any unlimited opening up could have implications for short-term flows. Limits from prudential angle may have to be considered even in an environment of FCAC.

(vii) There is a need to set up a dedicated cell within the RBI for tighter monitoring of all derivatives. This would be specially important as demand for derivatives could increase manifold to meet larger hedging requirements in the context of FCAC.

(viii) Banks should have well laid down 'appropriateness policy' before complex structured derivatives are marketed to their clients.

(ix) Efforts may be made to activate the market in interest rate futures to all participants including foreign investors. Permitted derivatives should include interest rate options, initially OTC and subsequently exchange traded.

(x) Enactment of the Payment and Settlement legislation, followed by a swap clearing arrangement, with provisions for netting will need to be completed before opening up swap markets.

(xi) Development of accounting standards for derivatives in line with international standards should be a priority.

(xii) Liberalised and open markets require strong regulation. It is also necessary to have transparency with respect to market related information such as the volumes transacted, etc. Towards this end Fixed Income Money Market and Derivatives Association (FIMMDA) may be suitably empowered to act as a self regulatory organisation to develop market ethics, trading standards and also undertake regulation of participants besides disseminating information.

Government Securities Market

6.19 While the outstanding stock of government securities of both the Central and State Governments has grown to the size of more than Rs.12 lakh crore, this market is yet to emerge

as a deep and liquid market across different maturities so that the market is able to throw up a meaningful yield curve. Markets in financial derivatives will emerge effectively only if the yield curve can be accessed based on actual traded prices in a wide range of maturities. Most of the trading now is concentrated on Central Government stocks and that too in the ten-year maturity which accounts for, on an average, 50 per cent of the daily trading volume. Lack of liquidity in most of the other stocks is attributable *inter alia,* to the Held to Maturity (HTM) facility available to the banks.

6.20 Participant base in the G-Sec markets in India is currently dominated by mandated holders like banks, insurance companies and retirement funds. To improve depth and liquidity of the G-Sec market, particularly in an environment of freer capital flows, as well as to improve price discovery, it is necessary that the non-mandated investor base, in particular, the retail investor base expands. The retail segment could be encouraged through direct retail investment in G-secs or via gilt mutual funds and suitable incentives provided for such investments.

6.21 The high SLR level is one of the major constraints restricting the incentive for banks to reshuffle their investment portfolio in response to changing market conditions. The eventual objective should be to do away with any stipulations for statutory/regulatory preemptions; but this would be contingent on the fisc achieving a significant improvement thereby enabling a moderation in the size of the gross borrowing programme of the government.

6.22 For a deep and liquid market in G-secs, a process of consolidation should be taken up to reduce the number of floating stocks so that each series has at least Rs 25,000 crore of stock in the market. The RBI has adopted a process of passive consolidation by resorting to reissues. But, the difficulty with this process is that it is very slow in building up liquid stocks. Hence, a more rapid consolidation should be considered.

6.23 The present FII limit for investment of US $ 2 billion in G-secs (Centre and States) as a percentage of total gross issuances of Centre and States for 2005-06 amounts to only 4.8 per cent. The Committee suggests that rather than an *ad hoc* fixation of ceiling, the ceiling should be calibrated as a percentage of annual gross issuance and this ceiling should be gradually raised.

6.24 The Committee's recommendations for further development of the government securities market are as follows:

(i) Over time, it would be preferable to progressively increase the share of mark-to-market category.

(ii) Promoting a two-way market movement would require permitting participants to freely undertake short-selling. Currently, only intra-day short-selling is permitted.

This would need to be extended to short-selling across settlement cycles; this would, however, require adequate regulatory/supervisory safeguards.

(iii) To stimulate retail investments in gilts, either directly or through gilt mutual funds, the gilt funds should be exempted from the dividend distribution tax and income up to a limit from direct investment in gilts could be exempted from tax.

(iv) In line with advanced financial markets, the introduction of Separate Trading of Registered Interest and Principal of Securities (STRIPS) in G-secs should be expedited.

(v) Expanding investor base would be strengthened by allowing, *inter alia,* entry to non-resident investors, especially longer term investors like foreign central banks, endowment funds, retirement funds, etc.

(vi) To impart liquidity to government stocks, the class of holders of G-secs needs to be widened and repo facility allowed to all market players without any restrictions on the minimum duration of the

repo; this would, however, necessitate adequate regulatory/ supervisory safeguards. This will improve the incentive for a wide range of economic agents to hold G-secs for managing their liquidity needs through repos.

(vii) A rapid debt consolidation process that is tax neutral, by exempting the gains arising from exchange of securities from all taxes, may be taken up. If necessary, a condition may be stipulated that gains arising from such an operation cannot be distributed to the shareholders.

(viii) The limit for FII investment in G-secs could be fixed at 6 per cent of total gross issuances by the Centre and States during 2006-07 and gradually raised to 8 per cent of gross issuance between 2007-08 and 2008-09, and to 10 per cent between 2009-10 and 2010-11. The limits could be linked to the gross issuance in the previous year to which the limit relates. The allocation by Securities and Exchange Board of India (SEBI) of the limits between 100 per cent debt funds and other FIIs should be discontinued.

Corporate Bond Market

6.25 The corporate bond market in India has not matured in tandem with the government securities market. Bank funding and internal resources are the predominant means of corporate funding. As the corporate sector expands and Indian financial markets get progressively integrated with the rest of the world, there is a need for a well developed corporate bond market.

6.26 As of now, the corporate bond market is the least transparent and totally illiquid segment of the financial market. The market does not follow any of the well established practices that are needed to create a healthy primary and secondary market segments in bonds issued by both public and private sectors. Currently, both the issuers and the investors have adopted practices that do not distinguish corporate bonds from the typical loan instruments. With fiscal consolidation and progressive reduction in fiscal deficit and also public debt levels in relation to GDP, the corporate bond market should be geared to crowd in financial savings for promoting long-term investment in industry and infrastructure.

6.27 As regards corporate debt, figures on outstanding stock are not readily available. The High-Level Expert Committee on Corporate Bond Market (Chairman: Dr. R.H. Patil) has provided data on resources raised by the corporate sector by way of debt, both through public issues and private placements for the period 1995-96 to 2004-05. The annual issuance since 1999-2000 is in the range of Rs.50,000 to Rs.60,000 crore. Assuming an average of 5-7 year maturities, the outstanding stock can be roughly placed at around Rs.3 lakh crore.

6.28 The present FIIs' limit for investment in corporate bonds of US$ 1.50 billion would work out to an estimated 11 per cent of the gross issuance in 2004-05. The present limits allowed for corporate debt seems to be far more liberal than the limits allowed for G-Secs and the present absolute limit could be retained for 2006-07; thereafter, the limit could be fixed as a percent of gross issuance in the previous year.

6.29 The Committee notes that issues relating to the corporate bond market have been recently addressed comprehensively by a High-Level Expert Committee on Corporate Bond Market, which has made wide-ranging recommendations for the advancement of the corporate bond market. If corporate bonds have to become really tradable instruments like G-secs or equities, an elevated and significant level of reforms will be needed on the basis of recommendations of the High Level Committee.

6.30 The corporate bond market is essentially an institutional market. During the past decade, commercial banks in India have been investing in corporate bonds in a big way. Some of the private sector banks' portfolio of corporate bonds is almost equivalent to that of G-sec investments. Retail interest in corporate bonds continues to be relatively small in India. Given the institutional character of the corporate bond market, it would be desirable to adopt a flexible approach that allows development of institutional trading and settlement arrangements, so long as there is transparency in primary issuances and safe trading and settlement mechanisms, besides development of stock exchange platforms.

6.31 The Committee's recommendations for the development of the corporate bond and securitised debt market are:

(i) GOI, RBI and SEBI should be able to evolve a concerted approach to deal with the complex issues identified by the High Level Committee on Corporate Bond Market.

(ii) Institutional trading and settlement arrangements need to be put in place and investors should have the freedom to join any of the trading and settlement platforms they find to be convenient.

(iii) The issuance guidelines have to be changed so as to recognise the institutional character of the market. Since issuers may like to tap the bond market more frequently than the equity market and since subscribers are mainly institutional investors, issuance and listing mechanisms in respect of instruments being

placed with institutional investors should be simplified by relying more on the assessment of a recognised rating agency rather than on voluminous and tedious disclosures as required by the public issues of equities.

(iv) Until transparent trading platforms become more popular, reliable trade reporting systems should be made mandatory. Clearing and settlement arrangements like those offered by CCIL in the case of G-secs should be in place to ensure guaranteed settlement.

(v) Stamp duty at the time of bond issues as also on securitised debt should be abolished by all the state governments.

(vi) The FII ceiling for investments in corporate bonds of US$ 1.50 billion should in future be linked to fresh issuances and the present absolute limit should be retained for the year 2006-07 and be fixed at 15 per cent of fresh issuances between 2007-08 and 2008-09 and at 25 per cent between 2009-10 and 2010-11. The allocation by SEBI of the limits between 100 per cent debt funds and other FIIs should be discontinued.

(vii) Corporate bonds may be permitted as eligible securities for repo transactions subject to strengthening of regulatory and supervisory policies.

(viii) In the case of the securitised debt market, the tax treatment of special vehicles that float the securitised debt has to be materially different. Government should provide an explicit tax pass-through treatment to securitisation Special Purpose Vehicles (SPVs) on par with tax pass through treatment granted to SEBI-registered venture capital funds.

(ix) Securitised debt should be recognised under the Securities Contract and Regulation Act (SCRA), 1956 as tradable debt.

(x) The limitations on FIIs to invest in securities issued by Asset Reconstruction Companies should be on par with their investments in listed debt securities.

Foreign Exchange Market

6.32 Liberalisation would lead to increased volume and liquidity in the spot and derivatives segments of the forex market. In order to increase the size of the forex market to enable it to handle larger flows, more Authorised Dealers (ADs) should be encouraged to participate in market making. The number of participants who can give two way quotes needs to be increased. It is, also, imperative that appropriate instruments and efficient markets are available to Indian corporates to manage their forex risk. The ICAI should extend the coverage of their comments on internal controls, to include market risks. Failure to properly hedge risks could pose serious difficulties, which could be transmitted across financial markets.

Inter-bank and Retail Market - Infrastructure

6.33 The major part of the foreign exchange market is the wholesale inter-bank market where the price discovery of different foreign currencies *vis-à-vis* the rupee takes place. The other component of the foreign exchange market is the retail market where some of the large

corporate entities are at times able to negotiate more favourable rates by seeking quotations from different authorised dealers, whereas a large number of others, especially small and medium enterprises (SMEs) who do not have strong bargaining power end up dealing at rates which often may not be the most favourable. There is a strong case to delink forex transactions from the underlying credit facilities and provide a transparent infrastructure even for the smaller entities.

6.34 A price discovery model could be introduced that is similar to exchange trading. Under such an arrangement, an authorised dealer will fix certain limits for its clients for trading in forex, based on a credit assessment of each client or deposit funds or designated securities as collateral. A number of small foreign exchange brokers could also be given access to the forex trading screen by the authorised dealers. The buy/sell order for forex of an authorised dealer's client first flows from the client's terminal to that of the authorised dealers' dealing system. If the client's order is within the exposure limit, the dealing system will automatically route the order to the central matching system. After the order gets matched, the relevant details of the matched order would be routed to the client's terminal through the trading system of the authorised dealer.

6.35 In the case of large sized deals, the authorised dealers prefer to resort to a negotiation mode on the screen. The authorised dealers will continue to be responsible for delivery of rupee or foreign exchange on their own behalf as also on behalf of their clients to CCIL for settlement of the transactions concluded on the screen. The proposed new arrangement will help in making foreign exchange market highly competitive, efficient, and transparent on a real time basis to all players in the system. The intervention of the RBI in the forex markets could also be through this system that will provide the desired anonymity.

Derivatives in Forex

6.36 Booking of contracts at present is conditional on having a position in the underlying. An exporter, for example, is permitted to book a forward sale of the export earnings. But, with the economy getting increasingly exposed to various types of forex/commodity risks/exposures arising out of exchange rates, their international competitive position needs to be strengthened by allowing them effective options to hedge. Presently, the domestic prices of commodities like ferrous and non-ferrous metals, basic chemicals, petro-chemicals, etc. have an import parity and given the two-way movement of the rupee against the US dollar in recent years, it is necessary for the producer/consumer of such products to hedge their economic exposures to exchange rates. The spot and forward markets should be liberalised and extended to all participants removing the constraint on past performance/underlying exposures in a phased manner. It should be noted that there are no restrictions as such on unhedged exposures.

6.37 A major structural weakness of the forex market is the absence of interest parity in the forward market, arising out of restrictions on capital flows. This has not only led to existence of arbitrage opportunities but has also abetted the development of non-deliverable forward (NDF) markets. One impediment is the lack of a liquid term inter-bank market. The second impediment is the limitation on banks' borrowings and placements in the international market. As of now, ADs have been given permission to borrow overseas up to 25 per cent of their Tier-I capital and invest up to limits approved by their respective boards. There is a need to gradually liberalise flows, to nurture interest rate parity conditions in forward markets.

6.38 The NDF market in rupees is a symptom of growing international interest in the currency of a globally integrating economy with restrictions on the use of its currency by non-residents. Currently, the FIIs are not allowed to rebook contracts once cancelled. FDIs and FIIs should be permitted to cancel and rebook forward contracts. Similar facilities should also be available in relation to derivatives in general, including Rupee derivatives like MIBOR and MIFOR swaps.

6.39 A facility of guaranteed settlement of spot, cash and settlement next-day/tomorrow (TOM) transactions in the forex market is being offered by CCIL to all the authorised dealers during the past three years. Similar facility for forwards trades needs to be made available.

Derivatives Market

6.40 There is a general concern about the kind of complex derivatives being marketed to Indian corporates. Many complex products under the nomenclature of 'swaps' involve the corporate in writing options which it is unable to price or hedge. In the process, the stipulation that derivatives should be used by corporates only for hedging exposures, seem to be ignored and contravened. It is understood that FIMMDA is preparing a model code of conduct on the subject which should duly take into account these concerns. The RBI also needs to consider adequate risk management systems and appropriate standards for derivatives transactions, especially with end-users. Banks should be allowed to hedge currency swaps by buying and selling without any monetary limits in the forward market.

6.41 One of the objectives of setting up domestic interest rate futures market is to provide market participants and the public with more instruments for price-risk hedging, risk transfer, price discovery, liquidity and standardisation. Internationally, many investors use futures rather than the cash market to manage the duration of their portfolio or asset allocation because of the low upfront payments and quick transactions. Entities also trade in futures with the hope of making profit out of speculation or arbitrage opportunity between the futures market and the underlying market. By having widespread membership and bringing together a large number of interested parties, the market provides liquidity, making quick transactions possible and providing immediate

information on prices. Since futures, like any other derivatives, are linked to the underlying cash market, its availability improves trading volumes in the cash market as it provides an arrangement for handling risk. Speculative activity also tends to shift risk to a more controlled and organised market, away from the underlying cash market.

6.42 For the development of the forex market, the Committee recommends the following:

(i) The spot and forward markets should be liberalised and extended to all participants, removing the constraint on past performance/underlying exposures.

(ii) Similar to the attention shown in protecting the interest of bank customers in terms of transparency of charges etc., the authorities need to be equally concerned about bank margins on forex transactions of smaller customers. The best way to reduce margins would be first to separate forex business from lending transactions and second to introduce an electronic trading platform on which forex transactions could take place, the customer having the choice of trading with the bank quoting the best price. For very large trades, a screen negotiated deal system is proposed. It is desirable that the RBI's intervention in the forex market should be through the anonymous order matching system.

(iii) An important step that can be taken to nurture interest rate parity in forward markets, is to allow more flexibility for banks to borrow and lend overseas both on short-term and long-term and increase the limits that are prescribed now to promote more interest parity with international markets. To ensure that weak banks are not exposed to additional risks, as a result of having access to foreign markets, banks may continue to be allowed to access the market depending upon the strength of their balance sheet.

(iv) To minimise the influence of NDF markets abroad, the FIIs may be provided with the facility of cancelling and rebooking forward contracts and other derivatives booked to hedge rupee exposures.

(v) Currency futures may be introduced subject to risks being contained through proper trading mechanism, structure of contracts and regulatory environment.

(vi) The existing guaranteed settlement platform of CCIL needs to be extended to the forwards market.

(vii) Banking should be allowed to hedge currency swaps by buying and selling without any monetary limits.

Gold Market

6.43 As the largest consumer of gold in the world, India has the potential to develop into an international centre for bullion trade. The gold prices in India respond to global markets and the price differential has narrowed to thin margins after liberalisation measures. As the country moves to FCAC, further steps need to be taken to promote an orderly and well-regulated gold market in the country. Towards this end, the Committee recommends the following:

(i) It is an opportune time to liberalise import of gold by all entities. There are advantages in promoting a vibrant market in both physical gold and financial products based on gold.

(ii) It is necessary to establish an inter-bank spot/cash market in gold which will activate inter-bank borrowing and lending in gold. The setting up/developing of existing gold

exchanges, both for physical and financial products, should be pursued further. A proper regulatory framework has to be put in place for the same.

(iii) Banks may be encouraged to lend to traders/jewellers in the gold industry, against primary gold with a view to preventing hoarding and speculation. This will facilitate the transition of gold from being considered as a commodity to a financial asset.

(iv) A gold deposit scheme introduced in 1999-2000 has not taken off. Alternatives, where depositors are offered the facility of investing in gold by depositing the rupees repayable in gold or equivalent rupees or gold certificate, have also been proposed. As such schemes will play a key role in weaning the investor away from physical gold holdings to financial assets in gold, they need to be promoted and widely publicised.

(v) The government has announced the introduction of Gold Exchange Traded Funds (GETF) with gold as the underlying asset, in order to enable any household to buy and sell gold in units for as little as Rs.100. Based on recommendations of a SEBI-appointed Committee, SEBI has notified a scheme enabling mutual funds to introduce GETF schemes with gold as the underlying asset.

(vi) Launching of GETFs by Mutual Funds will generate demand for custodial services. Banks should be encouraged to provide such custodial services.

(vii) Although, certain banks are authorised by Reserve Bank of India to import gold for sale to the public, the general public have no facility to store the gold in demat form and are constrained to hold the gold in physical form with attendant risks. There is thus, a need to provide this facility to the public.

Dollarisation and Internationalisation of the Indian Rupee

Dollarisation

6.44 Dollarisation refers to the use of foreign currency in domestic transactions. “Financial dollarisation” develops when residents hold financial assets or liabilities in foreign currency denominated instruments or linked to foreign interest rates. “Payments dollarisation” refers to the use of foreign currency for retail or wholesale transactions. “Real dollarisation” occurs when domestic prices and wages are indexed to the exchange rate though settled in the local currency. Partial dollarisation occurs when residents hold portion of their financial wealth in foreign assets. Official or full dollarisation occurs when foreign currency acquires status as a full legal tender. While there are only a few fully dollarised countries, most economies are partially dollarised.

6.45 The level of dollarisation in India, measured by the ratio of foreign currency deposits to broad money aggregate is negligible. As the degree of dollarisation grows, so do the risks in terms of greater exchange rate volatility, reduced independence of monetary policy and greater vulnerability of the financial and banking systems. In a liberalised capital account framework, therefore, a stable macroeconomic and fiscal environment with adherence to FRBM Act/Rules is of prime importance in controlling potential dollarisation of the economy and in managing the possible risks arising from such dollarisation.

Internationalisation of the Indian rupee

6.46 An "international currency" is a currency that is widely used for international transactions, such as the US dollar, Euro, British Pound, Swiss Franc and Japanese Yen. The "internationalisation" of a currency is an expression of its external credibility as the economy integrates globally. In practical terms, it would mean the use of the currency for invoicing and settlement of cross-border transactions, freedom for non-residents to hold financial assets/liabilities in that currency and freedom for non-residents to hold tradable balances in that currency at offshore locations. Some degree of internationalisation can coexist with capital controls.

6.47 The first and immediate impact of the internationalisation of a currency is the potential increase in volatility of its exchange rate. It also has implications for the conduct of monetary policy. When a currency starts getting used outside national territories, there would be some kind of economic integration with areas where it is actively traded, which in turn stimulates better growth.

6.48 When an economy is globally integrating, differences in tax rates and restrictions on use of its currency by non-residents result in development of off-shore non-deliverable forward markets for the currency. An NDF contract is essentially a outright forward contract in differences which is cash settled. The market expectations of the exchange and interest rates of the underlying currency form the basis for arbitrage and/or pressure on domestic markets. The Korean won, Taiwanese dollar and Chinese yuan are reportedly the most-traded Asian currencies in the NDF market.

6.49 By several indications, a cash market for the Indian rupee exists outside the country, e.g., in the Middle East and in South East Asia. The Rupee NDF market apparently is not very large or liquid. The size of Rupee NDF market is placed around US$ 100 million per day, with higher volumes occasionally. Although export of Indian Rupee currency notes beyond a very modest sum is not permitted, the fact is that a significant amount of Rupees in currency form is held outside the country, particularly in places where there are sizeable expatriate Indian population. This is perhaps some indication of the growing acceptability of the Rupee outside the shores of the country.

6.50 A matter of concern is that internationalisation of a currency can greatly accentuate an external shock, given the larger channels and independence to the residents and non-residents with respect to the flow of funds in and out of the country and from one currency to another. When non-residents hold significant balances of the domestic currency, particularly at offshore locations, any expectation that the country is vulnerable due to weak fundamentals or a contagion

would lead to a sell-off resulting in a sharp fall in the currency. Withdrawal of short-term funds and portfolio investments by non-residents can be a major potential risk of internationalisation.