

Musings of a Departing Forex Market Regulator¹

Mr. Gupta, Chairman, FEDAI, Mr. Vohra, Mr. Banerjee, Vice- Chairmen, Mr. Patwardhan, CEO, my banker friends, colleagues from the RBI, ladies and gentlemen,

1. It gives me great pleasure to be here with you this morning. The Foreign Exchange Dealers' Association of India has been choosing exciting overseas locations for its annual conventions these days, and this beautiful city, with its long history and increasing pre-eminence in European and international affairs is indeed a fine choice. The Indian engagement in the neighbourhood diamond centre of Antwerp has been growing over the years and today Antwerp has perhaps the highest concentration of branches of Indian banks outside a global financial centre. I am sure the aura of Brussels will provide a stimulating backdrop for the deliberations.
2. Mulling over what I should be discussing this morning, I remembered the lines from Lewis Carroll's immortal "Through the Looking Glass".

"The time has come," the Walrus said,

"To talk of many things:

Of shoes—and ships—and sealing-wax—

Of cabbages—and kings—

And why the sea is boiling hot—

And whether pigs have wings."

3. As some of you may be aware, my association with Reserve Bank comes to an end in less than two months from today as I demit office on the last day of May this year. Although my three-and-a-half-decade long association with Reserve Bank spans a wide range of functions, I shall always value and cherish my engagement with the (foreign) exchange control and later, (foreign) exchange management functions for many reasons, the most important of which is the quantum and exciting changes in this area to which I was a ring-side spectator and in which, I too

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played a small role. As practitioners, you will appreciate that, the regulatory framework for management of the external sector is a work-in-progress and it will traverse many a winding path before it is entrusted entirely to market forces. The destination is well known, but how and when we reach there remains hazy even today. It is tempting to look back at how we reached here if for no other reason than in the hope that it would perhaps guide us in our unfinished journey and help us to chart our future course of action. That is what I intend to do and I am sure you will indulge me if sometimes my discussion is peppered with personal reminiscences.

Foreign exchange: Control to management

4. Where do we begin? A good place probably would be at the very beginning, when the exchange control itself started. In 1939, the then British Government imposed exchange control as a part of their war effort with a view to directing foreign exchange to nationally important objectives. Later, after the war was over, it was put on a statutory footing with legislation in 1947. It is instructive to note that the 1939 order and the 1947 legislation were put in place in the United Kingdom as well and it will not be until 1979 that Britain removed all exchange controls- albeit lock stock and barrel overnight by the inimitable Margaret Thatcher. It is also interesting to remember that, pegged to the pound sterling, the Indian Rupee was the legal tender in a large part of the Commonwealth, particularly in the Gulf and the Africa's during the 1950's and 1960's.
5. The seeds for a rigid exchange control, the shadow of which falls even today, were sown in the fifties. During the second five year plan, the emphasis of central planning shifted to heavy industries and there was an unintended neglect of agriculture. This and three wars in a span of a decade created an acute shortage of foreign exchange reserves the intensely of which was painfully felt because we needed foreign exchange to import basic food grains. In this background, conserving foreign exchange was considered a national priority and using this precious resource for mundane purposes was blasphemous. It is necessary to understand the traumas of those days to appreciate how a framework wrought by FERA, 1973 could come into being. Though situation improved following the success of seed-water-fertilizer technology in agriculture and the inward

remittances from Indian brain and brawn, the exchange control regime meandered through the eighties with a relaxation here and a fine-tuning there. It took another crisis in 1990 to cause a paradigm shift in our approach.

6. What was the foreign exchange market like those days? The market participants today would hardly see any similarity between the market today and the market then. There are many reasons for the primitive nature of the market in the decades preceding the 1990's. Firstly, the markets globally were characterised by the post Bretton Woods tranquillity of a fixed exchange rate regime. Though the Breton Woods arrangement broke down in the early 1970's, we in India continued with a variant of fixed-exchange rate regime for two more decades. Secondly, the external sector engagement was trade-dominated. International capital flows were rather thin. The license-permit regime made foreign exchange transactions rather straightforward in the sense that every transaction had to be backed by a license or a permit. Thirdly, the technology was pretty primitive. It is hardly believable today that when the Rupee was devalued on June 6, 1966, the forex markets were shut down for two days so that banks and firms could recalculate the impact.
7. Talking about the devaluation of 1966 brings to my mind an observation, which though a digression, is too important to pass. You see, we have had two devaluations: the one I spoke about just now by a massive 57.4% and then again in 1991 when within a year the Rupee had dropped by 59%. On both occasions, the devaluations were sharply criticised. The arguments spanned the entire spectrum: from surrendering Indian sovereignty to external pressure to textured cynicism as to why devaluation will not be effective in narrowing the trade deficit because of the structural inflexibilities of the Indian exports and imports. Yet, statistics shows that on both occasions, the impact of the devaluation on trade deficit was phenomenal. The point that I wish you to ponder over is that devaluation, or depreciation in a flexible exchange rate regime, may be bad politics but often is good economics. The reason I ascribe great importance to this is that our approach to greater capital account openness in large measure will be tempered by our tolerance of exchange rate volatility and particularly, weakening of the Rupee.

8. Even in a rather passive and archaic market those days, the banks showed great hesitation in participation. Till 1950s, only foreign banks were allowed to undertake foreign exchange transactions. With the gradual entry of Indian banks, the FEDAI was formed in 1956 basically to evolve uniform practices for interbank transactions as well as banks' transactions with the public. Its functions have also evolved over the years and I would particularly like to mention the role it played countrywide during the transition phases involving both fixed to floating rates and from FERA to FEMA in facilitating the change. It played an important role as an educator as well as norm-setter. In mentioning this, I am anticipating the far greater role, from a self regulatory perspective, that awaits it, in the time to come.
9. Now we come to the momentous changes that the 1990s decade brought about. The events leading to the onset of economic reforms and the course and content of the reforms have been commented upon extensively and it has been so deeply accepted and absorbed in our collective discourse that any discussion is superfluous. What made the change possible? We can take a cue from the words of Victor Hugo that Dr. Manmohan Singh quoted in his first budget speech: "*no power on earth can stop an idea whose time has come.*" Dr. Singh had applied these words to the vision of emergence of India as an economic power. To me, these words apply with as much aptness to the concept of 'free markets'. In a recent speech, Governor Rajan has eloquently dealt with the issue and I will strongly urge the audience to reflect on his discussion as well as the works he bases his discussion on. The reforms in the 1990's in India and elsewhere were facilitated by the dismantling of the Soviet Russia and the Eastern Bloc countries and triumph of the free market over central planning and control.
10. A critical component of the reform process was introduction of flexible exchange rate. It started with exchange rate adjustments in July 1991, continued with the introduction of Liberalised Exchange Rate Management System in March 1992 and by March 1993 we had put in place a completely market determined exchange rate system. This was a critical step indeed. I still recall the trepidation that prevailed when RBI took this step which involved the central bank stopping the announcement of buying and selling rate every morning. Everyone waited with

bated breath as to how market will open on day one. It did and the rest as they say is history. As I mentioned earlier, the move did have a salutary effect on the trade deficit and by 1994, the trade deficit had shrunk to one-sixth of what it was in 1991. More importantly, it paved the way for greater openness not only in the current account which was achieved as early as 1994, but also in the capital account by removing one of the three constraints of the impossible trinity: the fixed exchange rate.

11. Once the flexible exchange rate regime was put in place, the next step was the development of the forex market. It was not smooth in the beginning. The market participants were as hesitant as a bird that had been released from its cage after an age and often reluctant in offering two way quotes. Besides, they also probably did not have as much regulatory freedom as a market-maker would require. In 1994, an Expert Group (Sodhani Committee) went into this issue in great depth and detail and came out with a large number of recommendations, a majority of which was implemented. Implementation of these recommendations gave the banks as well as business firms a great deal of freedom to conduct their forex business in an efficient and cost-effective manner. The ones that were not considered immediately have either been implemented over the years (e.g. forex clearing, offshore banking units, etc) or have become superfluous (e.g. authorised dealer license to DFIs).
12. The two decades of flexible exchange rate regime has been marked by several episodes of disturbances emanating from external sources. The Asian crisis of 1997, the post-Pokhran II sanctions, the unprecedented capital inflows of 2007-08, the post Lehman seizure of 2009, the Euro-Zone crisis, the US debt problem and the so called taper-fear have all affected the exchange rate and elicited, amongst others, response that constrained the market and market participants at least temporarily. You will also notice that we are relatively more affected by external turbulence now-a-days as compared to the past, which is quite intuitive in view of the increasing openness of our external sector in trade as well as financial channels. The future course of market development has to recognise this fact and develop an immune system, as it were, to deal with the onslaught and the fortitude not to fall off the cliff every time there is heightened volatility in the exchange rate.

Some reflections

13. The foreign exchange market today is fairly well developed. The liquidity as gauged in terms of turnover and bid-ask spread is quite impressive. There is a wide range of products available for firms engaged in international trade and commerce to hedge their foreign currency risks. There is both an OTC as well an exchange-traded segment. But I do not intend here to patronisingly pat ourselves on what we have achieved in developing the market but rather reflect on what we haven't and what lies ahead.
14. As we have seen earlier, free market process is the best way of organising economic activity. Why then should this principle not extend to the foreign exchange markets and why should there be any regulation at all? It is well known that markets have limits and there are market failures. I am not talking about the moral limits of markets but limits coming from factors such as monopoly or non-competitive markets, externality, information asymmetry, etc. And then there are financial and macro-economic stability issues, which have come to the fore post the turbulence of past seven-eight years. Foreign exchange has of late come to emerge as an asset class by itself. It is common today to see currencies being described as 'best performing', 'under-performing' etc. There are currency trading desks with performance assessment, strategies and so on. Several banks and other financial institutions have brochures promoting investment in currencies as an asset class. Not only are currencies seen as assets, but as a Financial Times caption once brought out, it is an asset class that thrives on volatility. Currencies as assets generate a dynamics of their own. Currency flows are no longer adjunct to trade and investment, they exist for their own sake. But it has to be appreciated that currencies as assets, like fire, cannot exist on their own; just as fire needs a fuel, currencies require other assets classes –bank deposits, bills, notes or bonds and so on, and thus impact other markets as well.
15. Most of the regulatory constraint in the Indian forex markets relate to the foreign exchange derivatives both in terms of who can participate and what are the conditions for participation. Derivatives essentially facilitate inter-temporal transfer of demand and supply and therefore serve to express future expectations or views

as traders call it. Moreover, the views can be expressed rather cheaply inasmuch as one does not have to finance a speculative inventory. This, in conjunction with what I have discussed a little earlier brings us to the inference that an unrestricted currency market can lead to volatility in exchange rate as well as currency inflows and outflows.

16. The question that then arises is this. If we are to allow unfettered currency trading, are we prepared for the consequences? The first of these is volatility in the currency. The exchange rate is an important macro-economic variable that impacts a country's trade and investment directly and the entire macro-economic condition indirectly. I do not intend to venture into the debatable territory of the magnitude, direction and exact nature of the impact of exchange rate movements: notice the debate on the impacts of a weak Euro or a strong Dollar. But that there is an impact is undeniable. Equally important is the impact on the sentiments which often drive reactions in the public, the press and even among those who are supposed to know better.
17. This brings us to the other impact, that is, on the monetary management of the economy. The Mundell-Fleming 'Trilemma' is well known. If, with an open capital account – which is what a free foreign exchange market shall mean – you intend to interfere with the market determined exchange rate, you will have to sacrifice your freedom to set the interest rate. Obviously this is not a viable choice. So what is a workable compromise? Some restriction on capital account which translates to the restrictions on the foreign exchange market seems the easiest of choices which several countries including India adopted.
18. Let me now come to the derivatives in the Indian forex market. As I mentioned, there are three sets of restrictions: on products, on participants and on participation. Let me comment on these aspects in reverse order. The access to the derivative markets is basically available for hedging. All economic agents – residents or non-residents - who have an exposure arising out of any permitted transaction have access to the derivative market – both OTC as well as exchange traded – on the strength of such underlying exposure. Over the years, we have made this

operationally as easy as possible and continue to smoothen the creases. We are aware of the expanding Rupee derivatives market – necessarily cash settled – in overseas locations and have been trying to provide easy access to the overseas entities that have a Rupee exposure to the entire derivative markets onshore. Short of completely delinking the access to derivative markets from underlying exposure, our efforts to facilitate operationally easy and economically efficient hedging shall continue.

19. This brings me to the next question: what derivative products are necessary to ensure efficient hedging? Ordinarily, as long as access is based on the principle I mentioned earlier, there should not be any restriction on the products that participants can transact. It is well known that a wider range of products helps market participants hedge their risk better. The problem arises from the complexity of the products and the questions as to whether those who use them fully understand their risk consequence and whether the products are appropriate for their risk profile and risk appetite. Memories of the Global Financial Crisis are too fresh to over-emphasise this aspect. Abuse of complex foreign exchange derivatives has happened in our markets as well and I am sure some of you present here will testify to this. Before we proceed further in our efforts to enrich the derivative products allowed, banks will have to put in place a framework for testing the appropriateness of the product used for their clients. FEDAI has an important role to play in this. The idea must be to prevent mis-selling rather than penalise such actions. Recently, it came as a great shock for me to learn that some of our exchanges do not have systems to upfront prevent self trades. They rather believed in tracking and penalising self trades. This to my mind is an inefficient approach to the issue. At least in the markets that RBI regulates, the principle shall be prevention is better than penalising.

Unfinished agenda

20. Let me now turn little futuristic. What is that needs to be done in proximate future? You may call it my perception of the unfinished agenda. Firstly, the scope of option products that market participants can contract needs to be expanded beyond the plain vanilla now available. The motivation for this is that there is a growing concern these days about the risk of unhedged forex exposure in the books of

corporates. At a micro level, individual entities may well be able to tide over any exchange rate shock, but at a macro level when everybody scurries for cover, the market impact may be unsettling. Now, what is the incentive for hedging? We must consider the facts that roughly, the Rupee has been depreciating at about 5% per year whereas the cost of a swap today is about 6-7%. This surely acts as a disincentive. There is a need to align individual incentives with that of the system. Use of options and what is called option trading strategies can contribute in this and therefore, the regime has to consider permitting this. Two specific enablements that we are actively considering in this direction are permitting covered option writing and relaxing the net worth criteria for using option strategies to hedge exposures.

21. Secondly, the scope of participation based on economic rather than contractual hedging needs to be expanded. Here we are on a more difficult territory. With increased integration of the Indian economy with the rest of the world, economic exposure affects virtually everybody in the tradable sectors and also outside. Today, even a banana grower from Nagercoil can complain that her business is affected by an appreciating Rupee. To some extent, this gets addressed by the no-underlying-required-hedging that has been enabled both on the OTC as well on the exchange-traded segments. But there is also a need to take a re-look at the issues and widen the scope of the present regime and perhaps bring clarity into it. For instance, can we think of permitting corporates to access forex markets upto a multiple of exposures to be contracted during any year without any documentation being insisted upon subject to necessary checks and balances to prevent outright punting? Can we redefine "exposure" to mean net exposure, i.e., net of payables and receivables for permitting outright purchase or sale with the temporal mismatches being managed through swaps? I would invite extensive debate on these issues.
22. Another issue that I would like to flag is the need to rethink on the entities to participate in the forex market. Has the Indian forex market become a closed club where the behaviour of the market participants is getting too predictable? Do we then allow new category of members as market makers, for example, the stand-alone primary dealers or select non-bank finance companies? Are we prepared for an open minded debate?

23. Now, I come to the second theme of my discussion, that is, opening up of capital account. Having declared complete openness on the current account as early as 1994, we thought that we can soon attain capital account convertibility as well. There have been two attempts in the past at charting a path to reach full capital account convertibility: in 1997 and again in 2007. The onset of the East Asian crisis of the late 1990's and the Global Financial Crisis relegated our plans to the back burner. In the aftermath of the crisis, capital account convertibility is no longer seen as a secular objective to be pursued and capital account restrictions are, in certain situations, seen to be important policy instruments to promote financial and macroeconomic stability. Be that as it may, in the current discourse, we see opening up of the capital account as a process rather than as an event. Further, it is also recognised that unless capital account liberalisation is accompanied by achievement of certain 'thresholds' and financial and institutional developments, the costs may far outweigh the benefits.
24. Where do we stand in this regard? For the real sector, there is almost complete freedom as far as capital account transactions are concerned. In foreign direct investment, the restrictions mostly pertain to sectoral caps in a few sectors deriving more from strategic and social considerations rather than strictly economic ones. Portfolio investment is almost completely open. In fact, the unrestricted access to foreign portfolio investors has brought great buoyancy to the equity markets, but it also sometimes leads one to wonder whether we are selling our equities cheap. Overseas investment by Indian enterprise is also fairly permissive. As far as debt flows are concerned, it is true that there are various restrictions both at the aggregate levels as well as at micro level. While the regime for regulation of external debt has been progressively modified to cater to the emerging resource needs of the economy, there are still issues on which a comprehensive view needs to be taken. Let me elaborate.
25. Regulatory regimes the world over frown upon debt inflows and time and again the external sector instability has been found to be rooted in indiscriminate borrowing. In countries with relatively higher inflation and therefore higher interest rates, foreign currency borrowing in low-interest currencies appears attractive. In ideal market conditions, there should not be arbitrage opportunity between the costs of a

hedged foreign currency borrowing and an onshore domestic currency borrowing. But, given the imperfections in Indian markets, cost of the former is likely to exceed the latter. The attractiveness of and rush for foreign currency borrowing therefore can be explained only by the inclination of borrowers to remain unhedged. As I have mentioned earlier, this surely raises systemic concerns.

26. The regime for foreign currency borrowing so far has been anchored on three criteria: the use, the cost and the tenor of borrowing. These are sound principles indeed. There may be a case for doing away with the cost criterion since it is in a way superfluous in view of the other restrictions, including a loosely monitored aggregate cap. One view is that, if it is mandated that all foreign currency borrowing should be necessarily hedged, all restrictions can be dispensed with. But then, is mandatory hedging the most appropriate policy? Given the already high cost of linear hedging products like forwards and swaps which will explode if all foreign currency borrowers seek mandated hedges, there may not be any foreign currency borrowing at all. And if hedging is to include options and option-based structures, how effective will the hedging be then, given the borrowers' incentive to minimise the cost of hedging? These are questions that need to be reflected upon.
27. When the regulatory regime for external debts was born, we were all 'original sinners' of contracting debt only in a foreign currency. Of late, given the fact that India is seen as a growth hub of the future, the interest of foreign investors has turned to Rupee debts as well, as evident from the recent interest shown in government and corporate bonds. Further, foreign investors are not shy of investing in rupee debts even in overseas locations, as the experience of IFC and ADB issues last year show. There is a need to appropriately incentivise the move away from foreign currency debts to Rupee debts even as the position in respect of overall indebtedness is prudentially managed. We propose to pursue this matter further in a calibrated manner.
28. Be it investment in equity or in debt, there is a need for removing the small prints and elements of discretion in the regulatory regime. As the Finance Minister observed in his budget speech, "Capital Account Controls is a policy rather than a

regulatory matter.” It is therefore necessary to clearly enunciate the ingredients of the policy which apply secularly and uniformly to all so that the elements of ‘regulation’ are known unambiguously to all. I have spoken on this subject at length elsewhere and I do not wish to repeat them here.

29. The case for a principle based regulation is founded on the fact that the ways of doing business are forever evolving and the ways of financing are evolving even faster. This is quite evident in say, infrastructure sector and the new technology start ups. It is difficult for a rule-based regulatory framework to keep pace and consequently, it is likely to handicap many socially useful projects. Moreover, in the process, it is likely to be rendered a complex maze. But a principle based regulatory framework has certain preconditions. As Julia Black states, “PBR, both formal and substantive, and in both dyadic and poly-centric relationships, is predicated, however, on extensive trust between the actors in the regulatory regime.”² If on the other hand the actors start playing games, it leads to regulatory dialectics and an intrusive and regulatory regime. Having said this, let me state that we are almost at the end stage of rewriting FEMA regulations making them simpler and more principle based.

To conclude

30. Let me conclude. As will be seen from the foregoing, we have made considerable progress from where we were. The fixed income markets have registered good growth. In fact, we have started seeing the growth in corporate bond outstanding starting to outpace the bank credit growth. The forex market has also grown both onshore and offshore in keeping with increasing international engagement. The growth of derivative market may not have been spectacular, but the market has indeed expanded in terms of products. In the hierarchy of priorities, the foremost perhaps is the development of a bond market, for its criticality of long term financing, particularly for the infrastructure projects. Notwithstanding the

² The Rise, Fall and Fate of Principles Based Regulation -Julia Black
LSE Law, Society and Economy Working Papers 17/2010 London School of Economics and Political
Science Law Department

impressive growth over the last several years, there is a need for faster growth in issuances, increased liquidity in the secondary markets, expansion in the rating span of bond issuances and so on. The growth of this segment has been discussed a lot. To my mind, further vibrancy in this segment depends on growth in long term savings and directing the same to this segment in a framework of responsible and regulated portfolio management framework. I believe the corpus generated by the NPS will provide the necessary nudge. Directing of the foreign long term savings to domestic corporate bonds is attractive, and indeed the gates have been opened fairly wide. But, at this stage how desirable is it to allow foreign investors total freedom to access the domestic debt that is protected against credit and foreign exchange risk? Only for arbitraging on interest rates? Further, the Indian bond and currency markets are beset with many such structural frictions - large government borrowings, bank dominated financial intermediation, capital controls etc. In the face of this, wisdom lies in proceeding with caution in a non-disruptive manner. No doubt perfect and seamless integration of market segments and removal of riskless arbitrage opportunities through inter-linkages or 'nexuses' is an ideal objective but is constrained by concerns for stability in a setting of narrowing but still yawning gulf between the macroeconomic conditions of India and the financially developed, capital-surplus nations. I am reminded of what Fisher Black is reported to have once remarked, "The markets look more rational from the banks of Charles than from the banks of Hudson."

31. This brings me to my last and the most important point. The role of Authorised Dealers and FEDAI in times to come. The Authorised Dealers led a very protected life in the FERA regime and never had to apply their mind to the permissibility of a foreign exchange transaction because it had to be based on an RBI permit or some other permit, for example, an import license. Today, it is not so. When FEDAI was formed in the 1950's its role mostly evolved round computation of various forex rates and mostly interbank transactions. In the times to come, both Authorised Dealers and FEDAI will have to play an active role in ensuring that customer transactions are compliant with the regulations. The more we move towards a principle based framework, the more arduous will be the responsibility of the

Authorised Dealers. This includes the issue of fair pricing as well. Indeed, our success in moving to a principle based framework will depend on the involvement of ADs. You will have to gear up for that responsibility.

32. Finally, let me briefly recapitulate some of more important issues.
 - a. In foreign exchange market, as in any other market, freedom is the default and any restraint by way of regulation has to justify itself. The regulation has to be based on sound economic principles and not on dogmas or evangelism.
 - b. Though the superiority of free markets as a way of organising economic activity is well recognised, there are many areas where the limitations of market have been widely discussed in the literature and are well accepted. There is no accepted standard for optimum regulation which is often idiosyncratic. The regulation of forex markets has to be seen in that context. As Chesterton remarked, "Don't ever take a fence down until you know the reason it was put up."
 - c. More products go towards market completion and enable better hedging against risks, but are limited by the wisdom of the participants to use them.
 - d. Exact pace and content of capital account liberalisation will depend upon the future events, but the regulatory regime has to be clear and transparent. A regulatory regime that creates uncertainty and obfuscates imposes tremendous cost on the economy and the society.
 - e. Finally, the issue of fair pricing. Forex customers, especially from small and medium enterprises and retail segments, have approached us on several occasions highlighting "high" charges levied by Authorised Dealer banks on their forex transactions. Not only there appears to be a wide variation amongst the banks in the charges levied on the smaller customers, there appears to be a complete lack of transparency regarding the information on charges levied for such customers. I am aware that FEDAI has issued a Special Circular in this regard but I once again urge all banks assembled here to pay due attention to this aspect before calls for regulation of forex rates become more vocal.

33. I wish the conference, whatever is left of it, all success. I also wish each one of you all success in the years to come. As I leave the stage, rather than singing along with Frost that we have miles to go before sleeping, I would rather echo Tennyson's brook (read markets) that will surge along irrespective of men (like me or any other) who may come and go. I shall of course continue to watch the developments from the sidelines. Good bye.