Recent Regulatory Developments in Financial Markets - Challenges and Opportunities[1]

Smt. Indrani Banerjee, Additional Director, Shri Pramod Kumar Panda, Senior Program Director, CAFRAL, CEOs and top executives, independent directors of banks and financial institutions, and guest speakers. A very good morning to everyone. At the outset, let me thank CAFRAL for hosting this program of contemporary relevance and inviting me to deliver the keynote address. I deem it an honour to be addressing the distinguished participants present in this virtual conference.

2. Let me emphasize here that the views expressed in this speech are my own and do not, I repeat do not, represent the views of the Reserve Bank of India. The opinions and commentaries mentioned at various places in this speech are aimed at stimulating an intellectual discussion. I urge all of you to take note of this throughout this event and seek your co-operation on the same.

A. Challenges facing global markets and spill-over to Indian markets

3. In recent years, a confluence of black swan events exerting continued unparalleled and mutually reinforcing shocks have left policy makers globally facing a delicate balancing act. The 'polycrisis'[2] on a global scale is acting as disruption multipliers and causing heightened volatility amid uncertain times.

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[1] Keynote address delivered by Shri Radha Shyam Ratho, Executive Director, Reserve Bank of India in the CAFRAL virtual conference on Financial Markets in India, October 19, 2022. The contribution of Sabyasachi Sarangi, AGM, is gratefully acknowledged.

[2] This term was made famous by Jean-Claude Juncker, a former President of the European Commission, in the context of the European crises of the past decade. Adam Tooze, an English historian and professor at Columbia University recently noted that a polycrisis is not just a situation where you face multiple crises. Rather, it is a situation like that mapped in the risk matrix, where the whole is even more dangerous than the sum of the parts.

4. At the beginning of this decade, the COVID-19 **pandemic** broke out and the resultant unprecedented mobility restrictions led to a cratering of economic output in countries across the world. Supply-chain snarls caused multi-decade high inflation that mutated from a 'transitory' narrative to "deeply entrenched". While the swift vaccination drive along with humongous monetary and fiscal policy loosening induced resilience, more infectious new variants came storming back derailing the recovery momentum.

5. The nascent economic recovery in countries, *albeit* at a varying pace, was thwarted by the **Russia - Ukraine conflict** in February 2022 giving rise to geopolitical upheaval. The resultant global commodity shock further provided impetus to rising inflation. Elevated food prices owing to the conflict, restricted trade and climate risk continue to pose a global huger threat and may transform into a full-fledged catastrophe. Freezing of Russian foreign exchange reserves and disallowing Russian banks from SWIFT triggered calls for US dollar decoupling measures. As such "friend-shoring" / "near-shoring" has become the buzz word and the decades-long endeavour for globalization face existential risk. If a country's US dollar holdings in its foreign exchange reserves can be frozen, then the holdings in other hard currencies can also see the similar fate. Then what do countries, particularly EMEs who require these reserves to defend their currencies, do?

6. Under the backdrop of mounting concerns over fragmentation in the world order giving rise to a debate on "***whither globalisation***", Dani Rodrik, professor of International Political Economy at Harvard University's John F. Kennedy School of Government, recently opined that the Covid pandemic and Ukraine conflict have brought to the fore food and energy security, public health, and national security as areas of national priorities where countries

will no longer rely on global markets. He further believes that globalisation will be restricted to areas other than those crucial areas which countries view as too important to be left to the forces of globalisation.

7. Central banks across the world have embarked upon an **aggressive front-loaded rate hike spree** to excoriate the inflationary headwinds. Such entrenched, widespread Inflation had not been witnessed by market participants and policy makers in the last four decades. Likewise, the synchronous rate action by central banks had not been seen in the last four decades. The abrupt regime-change from Quantitative Easing (QE) to Quantitative Tightening (QT) has amplified uncertainty. The most striking aspect is that the above developments are happening in a compressed timeframe triggering increased risk of accidents and multi-year high volatility in financial markets, along with a pace of asset repricings unseen in previous crisis episodes. The Federal Reserve, after hiking policy rate at its sharpest pace since the early 1980s, seems willing to push the US economy into recession. Financial conditions have tightened and stagflationary concerns abound. The transition from a period of “great moderation” to “great exasperation” has bewildered and wrong-footed market participants.

8. Emerging Markets (EMs) have been subjected to a dilemma of either opting for aggressive rate hikes at the risk of stymying their nascent economic recovery or drawing down their foreign exchange reserves accumulated over the decades to defend their currencies. The unabated rise of US dollar shows no signs of weakening in its upward momentum. The **HFL moment** has arrived indicating that global rates are going **H**igher, getting there **F**aster and staying there **L**onger. Massive “terms-of-trade” shock stemming from the Ukraine conflict and prospects of a terminal US interest

rate of 4.5 - 5.0% continue to support Dollar amid calls for a Plaza Accord-II. Undoubtedly, EMs have resiliently weathered the current rate hike-stoked-anxiety because of their decent growth and sizeable foreign exchange reserves. However, concerns remain on the ability of EMs to sustain the ongoing **reverse currency wars** as their reserves deplete at a swifter pace.

9. In addition to the above factors, tepid growth in China has further **stunted global growth** prospects**.** Relentless pursuit of zero-Covid policy along with crack-down on tech giants and the real estate sector have weighed on sentiments. Further, the property sector downturn deepening a sharp decline in home sales has exacerbated the liquidity stress of property developers, with heightened risk of spillovers to the banking, corporate, and local government sectors, thereby raising concerns about broader solvency risks.

10. Heighted uncertainty and amplified volatility have kept the currency markets on razor’s edge. The relentless strength in US dollar has reverberated across DM as well EM currencies. Recessionary fears amid the worsening energy crisis and sharp rate hike by ECB pulling rates out from negative territory have resulted in Euro breaching parity with US dollar. Trapped in a vortex of volatility stemming from uncertain outlook over the recent fiscal measures and cost of living crisis, the British Pound has a distant threat of parity looming over it. The Japanese Yen has depreciated the most among G-10 currencies, exacerbated by a widening interest rate differential with the US as a result of monetary policy divergence and continuation of Yield Curve Control (YCC) policy.

11. Despite the unfavourable external environment coupled with challenging domestic circumstances amid record FPI outflows in the equity segment, the Indian Rupee (INR) has performed much better than major currencies and most of the Asian peer currencies. The Rupee has been aided by timely interventions by the Reserve Bank in the currency market keeping the expectations anchored and volatility low. The demand for US dollar continues to be very high and RBI seems to be the lone supplier in the market. However, the rapid decline in foreign exchange reserves is a cause for concern. Indian G-sec yields have hardened to a lesser extent as compared to peers indicating improved supply-demand balance. Market borrowing programme of the Government has been orderly and instances of devolvements have diminished. It is pertinent to note that higher G-sec yields have deleterious impact on fiscal position of the Government as well as corporate margins owing to higher borrowing cost.

12. The IMF Managing Director recently noted that "India deserves to be called a bright spot on this otherwise dark horizon because it has been a fast-growing economy, even during these difficult times, but most importantly, this growth is underpinned by structural reforms". In its recently published World Economic Outlook (WEO), the IMF projected a growth of 6.8 per cent in 2022, making India the fastest growing major economy in the world.

B. Financial market reforms

13. The Reserve Bank's continuous endeavour in market regulation has been aimed at modernisation of the domestic financial markets. Principles based regime has been implemented in place of prescriptive regulations

keeping in mind the important role of ease of operations for market participants to embrace the regulatory intent.

14. Orderly development of the sovereign yield curve has been accorded primacy by introducing issuances of new benchmarks to impart market liquidity at important tenor points. A “retail direct” scheme was formulated in November 2021 as a one-step solution to facilitate investment in Government Securities by individual investors. Introduced with an objective of increasing retail participation, the Scheme also sought to widen the investor base for Government securities, thereby democratizing the G-sec market.

15. Rationalization of the regulatory framework for forex, credit and interest rate derivative markets has been pursued. Under the overarching framework of product simplicity for retail users, the market makers are mandated to adhere to a set of product due diligence measures in order to shield their clients from undue risk. More complex derivatives are allowed only to institutional and non-resident investors who are otherwise classified as ‘non-retail’ users. Access to non-residents in these markets has been eased.

16. Concerted efforts have been made over the last few years aimed at integration of domestic and offshore INR markets. In order to remove segmentation between the two markets and improve efficiency of price discovery, Indian banks with operational IFSC banking units have been permitted to participate in NDF markets. With 17 banks operational in the INR NDF market, daily turnover has steadily increased from less than US$ 1 billion in the initial days to about US$ 4 billion in the recent period. Further, the price differential between onshore and offshore rates has narrowed.

Similar measures have also been undertaken to facilitate integration of offshore and onshore OIS markets.

17. The recent announcement on issuance of sovereign green bonds worth ₹16,000 crore as part of the H2:FY 2022-23 borrowing programme is poised to give the required fillip to the local green bond market creation and set a benchmark by adhering to international best practice.

C. Opportunities and way forward

18. As India prepares to grow to a five trillion-dollar economy in a least disruptive manner, our financial markets need to be well equipped to facilitate the same. Aimed at this endeavour, let me emphasize some ideas and thoughts which will continue to support the journey.

Stable and developed financial markets

19. Amid clamour for various regulatory curbs and monetary tightening to aid the USD-INR exchange rate, forex intervention still emerges as the most potent tool to contain undue volatility. The market may continue to debate as to whether *"82 is the new 80"*. However, the Reserve Bank has no level or range in mind and will continue to intervene to ensure orderly conditions in the forex market. A less-volatile currency helps in lowering the country risk premium and ensures more stable capital flows.

20. While many steps have been taken in the recent past to persevere with the market reforms agenda, more needs to be done to further strengthen it. Calibrated opening of India's capital account has facilitated the regime for FPI investment in debt. In order to streamline the various investment

channels at the disposal of the FPIs in debt segment, recalibration of various channels such as Medium-Term Framework (MTF), Voluntary Retention Route (VRR) and Fully Accessible Route (FAR) based on the experiences gained is the need of the hour to ensure further optimizing ease of access for FPIs.

21. In the corporate bond market segment, among various measures, the recent policy decision to notify Credit Default Swaps (CDS) as qualified financial contracts for netting, and expansion of issuer and participant base for the instruments have the potential to provide the necessary enabler for improved interest in the market.

Bond index inclusion

22. Developments related to the inclusion of India in global bond indices have been a topic of keen interest by market participants and policy makers in recent times. India is the notable exception amongst major emerging markets that does not feature in global bond indices. Market estimates indicate inflows of around $30 billion in the ensuing years if index inclusion materializes. The major index providers such as JP Morgan Global Bond Index - Emerging Markets and FTSE Emerging Markets Global Bond Index continue to keep India under watchlist. The inclusion will also further diversify the investor base for the government's market borrowing programme. Moreover, the stable passive flows associated with index investing will likely have potential long-term benefits such as steady annual inflows, flattening of G-sec yield curve, upside bias in INR, reduction of overall borrowing costs with tightening of bid-ask spreads, improvement in foreign flows to corporate bonds, among others.

INR as a global currency

23. RBI recently announced arrangements for invoicing, payment, and settlement of exports/imports in INR to encourage exports from India. It has paved the path for reinforcing the interest of traders across the globe laying the launchpad for catapulting INR as a global currency. From a cross-country perspective, it has been seen that bilateral trade agreements involving currency swaps for trade, investment and remittances have been successful. The swap provides a liquidity backstop support and obviates the need for large foreign exchange reserves in the long run. Further, these agreements also boost the development of the domestic financial markets and support the economic growth of the participating countries.

24. Additionally, a Local Currency Settlement (LCS) framework obviates the need for hard currencies. It stabilises the local currency and provides a natural hedge for the business community to protect against hard currency risk exposure, reduces transaction costs through more efficient direct exchange rates, and facilitates faster transfers. Hence, facilitating LCS framework for bilateral transactions in local currencies with INR on one side, backed by bilateral swap arrangements with the counterpart countries can give a fillip to the long-term goal of INR internationalisation.

Internationalisation of payment systems

25. Availability of a robust INR-denominated payment mechanism for cross-border transactions and providing timely inter-bank transfers and settlement is an important step towards promoting INR as a global currency. The availability of such payment infrastructure ensures a seamless flow of

cross-border transactions in local currencies. This, apart from a reduction in transaction cost, will also reduce our dependence on international payment systems based on the SWIFT messaging system. While the potential of India's advanced payment systems like Real Time Gross Settlement (RTGS), National Electronic Funds Transfer (NEFT) and Unified Payments Interface (UPI) has been recognised globally, leveraging the same for cross-border trade transactions can be a complimentary step to internationalising INR. Following the announcement of the Reserve Bank and the Monetary Authority of Singapore (MAS) to link their fast payment systems UPI and PayNow in September 2021, NPCI's international arm NPCI International Payments Ltd (NIPL) has recently partnered with France-based digital payment company Worldline to launch UPI and RuPay payments in Europe. Progress in such global arrangements is a harbinger of scaled up payment internationalisation going ahead.

KYC reforms

26. A vibrant financial market should ensure smooth client on-boarding and simplified KYC procedures to help attract foreign investors and enhance the ease of doing business. Investors and custodians have been indicating in various fora that Indian KYC regulations are relatively more stringent compared to international financial centres. As such review of the KYC norms applicable for foreign investors and removal of the frictions impeding their access to INR assets under the overarching framework of the applicable statute shall facilitate smoother on-boarding of foreign investors without compromising on the compliance with the Anti Money Laundering (AML) standards. A high-level committee with representations from the concerned stakeholders is currently looking into the broader aspect of KYC reforms.

Acquiring strategic assets abroad through market mechanism

27. G-7 countries' holding of gold in their reserves stood at 41 per cent as per the latest data with countries like United States (68 per cent), Germany (67 per cent), Italy (64 per cent) and France (59 per cent) preferring for much higher share. Amid the growing unease over hard currencies getting frozen and thereby putting the hard-earned foreign exchange reserves under sanction, thoughts of acquiring strategic assets in commodities either directly or through market mechanism such as futures and options, and in countries immune from probable sanctions are coming to the fore. While these require detailed deliberations, the essence of the same has never been more relevant after freezing of Russian foreign exchange reserves by the western countries.

Change of mindset

28. As we move further towards exploring bilateral swaps with trade partners, the possibility of onboarding their currencies, which are not reserve currencies, in our Foreign Currency Assets (FCA) will manifest. The decades-long approach of accumulating foreign exchange reserves in hard currencies goes against the prospects of soft currencies gradually claiming an increasing share in the FCAs. However, it is pertinent to note that a change of mindset is the need of the hour if we are to reduce our dependence on US dollar. Acquiring strategic assets abroad will also call for an adventurous mindset. Internationalising INR will need more relaxations in the remaining capital controls.

Conclusion

29. As I come to the end of my address, I am reminded of Michael Lewis, the celebrated author of books such as “The Big Short: Inside the Doomsday Machine”, and “Liar’s Poker”. At a time when it appeared imminent that the common currency bloc, viz. the Eurozone, would break up, with Greece being forced to abandon the Euro, he wrote the following last sentence in his book “Boomerang: Travels in the New Third World”, and I quote,

“As idiotic as optimism can sometimes seem, it has a weird habit of paying off”

30. This quote does not need any further emphasis amidst the ongoing uncertain times and volatile markets. These trying circumstances too shall pass. Ultimately, we will be judged by history in terms of our response as well as reaction to these unprecedented events.

Thank you very much for the patient listening. Stay safe. Namaskar!