Traversing the "New Normal" in Financial Markets - Some Perspectives[1]

Distinguished speakers, esteemed panellists, office bearers of the Forex Association of India (FAI), delegates, ladies, and gentlemen. A very good morning to all of you. It gives me great pleasure to be amidst you today at the 32nd Annual forex assembly of the FAI. I deem it an honour to be addressing the thought leaders from various segments of financial markets present here.

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. I urge all of you present here to take note of this and seek your co-operation in this regard.

Is there a "New Normal"? or are there "Newer Normals"?

3. The financial world has come out of more than a decade of low inflation, low interest rates, unconventional monetary policies, and cheap money. However, since 2022, most central banks have sharply hiked interest rates. In this scenario, Econ 101 would have us expect the typical tradeoffs that result when interest rates are hiked to tame inflation. Yet, we find that economic growth remains resilient, equity markets are rallying, while bonds yields march higher - a sign of how uncertain times are!

4. To give you a flavor of this, I intend to read out a list of words and phrases which have proliferated in the financial lexicon recently. I will not explain these in detail as I am sure that most of you would already be

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[1] Keynote address delivered by Shri Radha Shyam Ratho, Executive Director, Reserve Bank of India in the Forex Association of India Conference, Hong Kong, August 13, 2023.

familiar with the same. These words and phrases exemplify how the financial and economic landscape around us has become more and more complex and uncertain. No wonder that the acronym VUCA which stands for Volatility, Uncertainty, Complexity, and Ambiguity has become so common.

First, from hard landing or soft landing earlier to crash landing and even no landing

5. Initially when the Federal Reserve embarked on the sharpest ever tightening spree in four decades, hard landing and even crash landing seemed inevitable. Recently a slowing but strong labor market, softer inflation prints and surprisingly resilient growth have led to growing optimism that the US economy may avoid a hard landing and have a soft landing. Some believe that there may be no-landing. However, because earlier hard landing or crash landing was feared, markets are very happy at the prospect of soft landing. What markets seem to be overlooking is that soft landing is also a 'landing' - meaning slow growth and rising unemployment over years.

Second, from inflation, deflation, and stagflation to now greedflation, profitflation, excuseflation, or even tomatoflation

6. Post covid, corporate profit margins have witnessed a conspicuous surge[2]. Retail prices in many advanced economies continue to remain high[3] despite a softening of commodity prices. It is believed that this is because of big corporates leveraging on their pricing power to expand profit margins by raising output prices more than input costs. This is

[2] The non-financial corporate business profit after tax is currently at the highest in the last 70 years in US – source: US Bureau of Economic analysis.

[3] EU essential food items have risen in cost by up to 55% in the past 12 months (FT and Eurostat)

"greedflation". Further, the big corporates somehow find some excuse or other to raise prces – so "excuseflation". In the Indian context, "tomatoflation" doesn't need any explaining.

Third, from recession to rolling recession, and now 'immaculate disinflation'

7. With prospects of recession in US fading, the narrative seems to have shifted to **'rolling recession'** with pockets of slowing activity rolling through the economy rather than a sharp drop in the overall economic activity all at once. Fed staff are no longer forecasting a recession in the US[4]. In fact, US employment and growth rates for 2022 have been better than that projected by the FOMC before the pandemic in December 2019. Rate hikes appear to be finally reining in headline inflation without much of a dent to the economy. Therefore, the question arises; is the US economy heading towards "Immaculate Disinflation"?

Fourth, from bank runs now to either physical or digital bank runs

8. Social media and technological advancements in banking have introduced new frontiers of vulnerability. Social media is no longer a camera of events but, perhaps, drives it as well. News of bank frailty, verified or unverified, can snowball into a digital bank run. By some estimates, around $40 billion (23% of the deposits) were withdrawn in a matter of hours during the recent run on the Silicon Valley Bank, a US regional bank. In comparison, it had taken almost nine days for depositors to withdraw $17 billion (9% of deposits) during a bank run on one of the US regional banks in 2008. Financial institutions now have to contend with a growing customer base increasingly plugged to social media feed and

[4] Fed Chair's press conference after FOMC meeting on July 26, 2023

armed with the ability to flee away with their deposits with a mere swipe in their banking apps.

Fifth, from political refugees to climate refugees, and global warming to "heat domes"

9. In July 2023, with average temperatures already at least 1.1 degree celsius hotter globally than pre-industrial levels, swaths of US, Europe and Asia sweltered under "heat domes." Scientists are clear that extreme weather events, including heatwaves, will become more frequent and intense with every fraction of a degree of warming.

10. According to the United Nations High Commissioner for Refugees (UNHCR), an annual average of 21.5 million people were forcibly displaced each year by weather-related events between 2008 and 2016. They are the so-called "climate refugees". This climate migration is expected to surge in coming decades with forecasts predicting that 1.2 billion people could be displaced globally by 2050. Further, a study published by academics at Dartmouth last year found that heatwaves cost the global economy an estimated $16 trillion over a 21-year period from the 1990s. Are the markets prepared for "higher food inflation for longer"? Climateflation?

Sixth, from TINA to BARBIE

11. Katie Martin of the Financial Times had recently penned an insightful article highlighting "The golden age of doing nothing"[5]. The world has moved into a new era where interest rates are expected to remain higher for longer. Earlier, over a decade of low interest rates and cheap money together with central bank put had encouraged chasing of equities leading

[5] An article published on Financial Times dated July 29, 2023

to high valuations. Investors believed in TINA, i.e. There is No Alternative to equities. Now, the higher for longer interest rates are expected to damage equity valuations. In contrast, simply holding cash or government bonds and doing nothing will yield a decent return. So, **BARBIE**, i.e., “**Bonds Are Really Back in Earnest**” may well be in vogue for several years to come.

Last, from globalisation and, in hindsight, hyperglobalisation to deglobalisation and now slowbalisation

12. Post the second world war, there was increasing globalisation until the pandemic broke out. In hindsight, the last decade is now dubbed as a period of hyper-globalisation. Supply chains became so diffused that the manufacture of a finished product, say a car, involved processes spread over around a hundred countries. The pandemic dealt a death blow to such hyper-globalisation. Although covid is now a thing of the past, the war in Europe and continuing geopolitical tensions are resulting in deglobalisation. Recently, the realization that globalisation is not easy to reverse has now given rise to a belief in slowbalisation. As near-shoring and friend-shoring become widespread, we are probably headed for a prolonged period of slowbalisation.

All the above show that we don’t know much about where the world is headed. There are new challenges with every passing month, if not day. One such challenge is an inexorable drift towards a multipolar currency regime.

13. In the aftermath of the Ukraine war, the freezing of Russian foreign exchange reserves and the banning of Russian banks from international payment systems like SWIFT have triggered efforts by countries to move

away from the US dollar dominated payment and settlement systems. If a country's US dollar holdings can be frozen, then the holdings in other hard currencies may also see a similar fate. Then what do countries, particularly EMEs who are holding hard currency reserves, do?

India - metamorphosing into a key global player

14. India is now the fifth largest economy of the world in terms of market exchange rates and the third largest in terms of purchasing power parity (PPP). India remains a bright spot in an otherwise grim world economic scenario. Therefore, **INR internationalisation is the natural step forward.**

15. As you are aware, the RBI has recently released the report of the Inter-Departmental Group constituted in December 2021 to examine issues related to internationalisation of INR and suggest a way forward. The Group comprising departmental heads looking after critical area of forex reserves, financial market operations and regulations, banking regulations, and payments and settlements deliberated on all relevant aspects. I had the opportunity to contribute to the Report as the Chair of the Group.

16. I need not elaborate on the benefits of INR internationalisation which all of you are familiar with. The benefits include, *inter alia*, (i) reducing exchange rate risk, (ii) lower cost of capital due to better access to international financial markets, (iii) seigniorage benefits, and (iv) reduced requirement of forex reserves. Some concerns have also been expressed and I am going to address them.

17. The Group recommended various short term, medium term, and long-term policy measures. One of the first recommendations is a Local Currency Settlement (LCS) system with other countries.

Local Currency Settlement (LCS) System - An enabler

18. The LCS system basically involves use of national currencies, establishment of correspondent banking relationships in national currencies, use of national payment systems, and a bilateral currency swap between the two central banks. Recently RBI and the Central Bank of UAE (CBUAE) signed a MoU for establishing a LCS system to promote the use of local currencies, viz. the INR and the UAE Dirham (AED), for cross-border transactions.

19. The MoU covers all current account and permissible capital account transactions. Illustratively, an Indian importer and a UAE exporter would mutually decide to use either INR or AED for settlement of a trade transaction. If INR is the preferred invoicing and settlement currency, the UAE exporter will have an option to gainfully deploy his INR funds in permissible financial instruments in India. Similarly, an Indian exporter who prefers to invoice and settle his exports with a UAE importer in AED will have opportunities to make investments in UAE. Thus, the principle of reciprocity is adhered to. However, at the aggregate level, India runs a trade deficit with UAE. So, the CBUAE will accumulate INR. It can either invest the INR in India or choose to repatriate in a hard currency or do a combination of both.

20. Several questions arise. **Should India have LCS agreement only with countries with whom we have a trade deficit?** The problem is that by definition in a LCS agreement with India the other country will have a trade surplus with us and will not be interested because that country would

accumulate INR which is not a reserve currency and will have to invest in INR assets. Besides, it is also possible that our trade deficit turns into a surplus with the passage of time.

21. If we enter into LCS with countries with which we have a trade surplus, we will **accumulate non-reserve currencies** instead of USD as part of our forex reserves. This seems to be a disadvantage. However, if we think deeply, reserve currencies are held by central banks ultimately to pay for imports and service debts. If the so-called non-reserve currencies can perform the above two functions, then there is no disadvantage in holding non-reserve currencies in our forex reserves.

22. Another concern that is expressed is that **exchange rate volatility** may increase if INR becomes internationalised. However, the liquidity and depth of Indian financial markets has increased manifold over the years. All through the recent years when the markets have been hit by covid, war and interest rate hikes, INR has, barring brief periods, largely traded in a range-bound manner and has been among the less volatile currencies in the world. Further, continuing capital inflows and our forex reserves of over US$ 600 billion is likely to keep INR fairly stable going ahead.

23. A third concern is that currency internationalisation often comes in conflict with domestic monetary policies. A vigilant approach will be required to contain the spillover of shocks given the open flow of funds into and out of the country, and conversion from INR to other currencies and vice versa. However, we must remember that internationalisation is a long-term process involving a decade or more. The formulation, adoption, and implementation of a wide array of policies as elaborated in the Inter-Departmental Group Report require a long timeframe. As we go down the path of INR internationalisation, implementing one measure after another,

monetary policy issues and concerns may gradually emerge. However as more and more INR liquidity is provided outside India over the years to further internationalisation, the domestic economy is also very likely to have become stronger and more resilient with the passage of time. As a result, domestic monetary policy would be able to manage the trade-offs arising from increased holding and trading of INR overseas.

Let me give a few examples of how gradually changes are to be brought about to our financial architecture in the pursuit of the eventual goal of INR internationalisation.

24. The Report has envisaged that at first, LCS will be introduced for trade transactions. This may be followed soon by non-trade transactions. Capital account transactions of various types would follow in due course one after another. Similarly, so far as opening of INR accounts for non-residents is concerned, initially, Special Non-Resident Rupee (SNRR) accounts may be allowed to be opened for all purposes. Thereafter, opening of INR accounts abroad for non-residents by branches of AD category 1 Indian banks may be allowed. Finally, foreign banks would be permitted to open INR accounts for non-residents abroad.

25. In fact, the final phase of internationalisation will be in the form of a non-resident being able to open an INR denominated account to be used for all capital and current account transactions with a foreign bank abroad. The final phase will also see a Chilean exporter and a Norwegian importer settle their trade in INR. Another manifestation may be a Portuguese bank accepting INR deposits from a South African citizen.

Conclusion

26. In the ultimate analysis, the internationalisation of a currency is closely dependent on the nation's economic progress and geopolitical significance. On both counts, India is making rapid strides. As we celebrate our 77th Independence Day just a day after, our vision should include the ambition of an internationalised INR. This would signal that India has arrived on the world stage. The current global milieu provides us an excellent opportunity to pursue internationalisation of INR. All it requires is an adventurous mindset.

In the end, I am reminded of the unforgettable words of Sir Edmund Hillary, who along with Tenzing Norgay set foot on the summit of Mount Everest for the first time ever seven decades ago, and I quote

"It is not the mountain we conquer, but ourselves."

I wish the conference all success. Namaskar.