

Indian Financial Markets - A Practitioner's Perspective¹

Distinguished guests, ladies, and gentlemen. A very good evening to all of you. It is my great honour to speak to this august gathering at the Forex Association of India (FAI)'s 33rd Annual Conference. I am grateful to the FAI led by Shri Rajan Kumar, Chairman for inviting me to speak at this event in this culturally rich, historically vibrant, and naturally blessed city of Prague - a magnificent exemplar of old-world charm. It is interesting to note that Prague has received several nicknames over the years such as "The Heart of Europe", "The Golden City", The Rooftop of Europe, "The City of Hundred Spires", and even "The Mother of Cities"! I am sure that the aura of Prague will provide a stimulating backdrop for the deliberations during the Conference.

2. The FAI, an organisation of treasury managers, foreign exchange dealers and brokers actively involved in foreign exchange trading and foreign exchange risk management, has played a discernible role in the Indian forex market for more than four decades. Further, the annual events organised by the FAI have facilitated unconstrained exchange of feedback, views, inputs among the foreign exchange market participants in an informal setting. I am sure the participants at this event will utilise this opportunity to the fullest extent and contribute to further improvements in our rapidly growing forex markets.

3. Keeping in view the presence of a wide spectrum of forex market participants in this conference, I have decided to dwell upon my perspectives on global as well as Indian financial markets. I will first lay my thoughts on the recurring narratives on global financial markets and subsequently highlight how India has positioned itself as a pole of economic attraction amid persistent external headwinds. Further, I will also touch upon the recent notable regulatory developments and expectations from the forex market participants in ensuring a conducive market environment which will act as a bedrock as we move towards realising the cherished goal of *Viksit Bharat*.

Global Financial Landscape - Widening Fault Lines

4. In the recent years, the global financial landscape has changed rapidly and is still navigating tectonic shifts. Geopolitical tensions, parallel wars, mounting fears of

¹ Keynote address delivered by Shri Radha Shyam Ratho, Executive Director, Reserve Bank of India in the Forex Association of India Conference at Prague on September 13, 2024. Contributions of Ajay Kumar Sinha, Atul Shakti, and Sabyasachi Sarangi are gratefully acknowledged.

trade war along with sanctions and erosion of globalisation coupled with increasing geoeconomic fragmentation have been associated with an environment of growing protectionism with several countries turning inward. This has ushered in thoughts about a structural rebalancing of the global order. On the other hand, volatility, uncertainty, and exasperation caused by unprecedented synchronous rate hikes by central banks cutting across developed markets (DM) and emerging market economies (EME), the era of quantitative easing giving way to quantitative tightening, DM and EME currencies trading southwards due to unassailable lead of US Dollar, and the partial reversal noticed recently along with bonds and equities moving in tandem have completely befuddled market participants.

5. As if these events were not enough, banking crises on both sides of the Atlantic - in US and Switzerland, continuous repricing of monetary policy expectations resulting in market ructions never seen before, sharp position unwinds, the sudden sentiment shifts between risk-off and risk-on shaping the narratives have bewildered market watchers wrong-footing the experienced traders, leave alone the fresh entrants.

6. These developments have cast a haze of uncertainty over policymaking. The disinflation trend has gained momentum in major systemic economies. As against the earlier fears of further disinflation being hampered by stubborn core and services inflation and tight labour markets, the recent data points have hinted towards inflation inching towards the target zone and labour markets exhibiting signs of softness although a sustained trend is still elusive. Though the inflation environment is getting benign with each data release, the pace of disinflation remains slow. While the US Fed is expected to pivot towards rate cuts starting September 2024, the unclear inflation trajectory is causing significant fluctuations in market expectations about the pace of monetary policy easing. In this environment, several emerging market economies have begun rate-cutting cycles with major Latin American economies such as Mexico reducing by 50 basis points, Colombia by 250 basis points, Brazil by 325 basis points and Chile by 575 basis points. Further, among the developed economies, Canada and Switzerland have already cut policy rates by 75 basis points and 50 basis points respectively.

7. Japan is the outlier where rates are likely to rise following a hike of 25 basis points at end-July. The global interest rates today are a stark contrast to December

2020 as the shift away from negative policy rates since July 2022 has resulted in the quantum of negative-yielding bonds globally getting extinguished after recording a peak of USD 18.4 trillion in December 2020.

8. Apart from the trends I enumerated a little earlier, one unique development that has surfaced in the recent years is about myriad forms of volatility. Well, I am sure that all of you are aware of implied volatility and historical volatility. I intend to stress upon data volatility causing narrative volatility and thus resulting in market volatility. In the earlier crises episodes we had noticed data as well as market volatility. However, in recent times, the persistent endeavour in search of a fitting narrative for the market moves, although not something new, when analysed in the context of exponential growth in the narratives glut in the recent months has made it almost painful to attempt to characterise the current market. Perhaps, the global economy could well be at one of those tricky inflection points where data becomes inherently volatile and difficult to assess, and economists are faced with an unusually wide range of plausible scenarios.² Resultantly, the spectre of narrative volatility is unlikely to fade going ahead.

9. Far away from the volatility noticed in global bonds and forex markets, global equities have charted a completely different trajectory. From New York to London to Mumbai, if there's one similarity among the world's equity markets, it's "record highs". The MSCI ACWI Index, which tracks developed and emerging markets, has been on a record-breaking run. In the US, S&P 500 is up by 15 per cent this year³ after clocking an impressive 24 per cent last year. Most of these gains were driven by the Magnificent Seven stocks⁴ which comprise around 30 per cent of the index's total weight. These stocks delivered staggering return of 107 per cent in 2023 and are already up by 32 per cent this year. This phenomenon of mega-cap crowding remains a major concern for the largest equity market in the world.

10. Before I move further, let me present my thoughts on how it has become nearly impossible to comprehend the ramifications of structurally elevated geopolitical risks

² Mohammad El Erian - Project Syndicate - "Analytical Volatility Is Worse than Market Whiplash" - August 30, 2024

³ As of September 10, 2024

⁴ Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia, and Tesla

on financial markets. Incidentally, a study carried out by BlackRock in 2019 found that “the average market response to unexpected geopolitical shocks has historically been relatively modest and short-lived”. Nevertheless, over 2000s and 2010s, geopolitics has been more or less deflationary creating a lower risk environment for capital allocation across the world. However, the recent conflicts have brought about a sea change in the approach of market participants and continue to remain major tail-risk contributors. As such, navigating the challenges in an era of a more geopolitically turbulent world warrants a profound strategical realignment. In this context, the biggest imponderable is “has the market priced these tail risks? If yes, then to what extent?”

11. An attendant development is signs of broad retreat from global rules of engagement and significant reversal of the gains from economic integration. As per the IMF, new trade restrictions have increased sharply - more than tripling since 2019 - while financial sanctions have also expanded and the geopolitical risk index has spiked in 2022 following the Ukraine conflict. The private sector concerns about fragmentation - gauged by the number of mentions in corporate earnings calls - have also surged. However, we are yet to see bigger impact of de-coupling between geopolitical rivals on global trade as the emergence of “connector”⁵ countries through the mechanism of so called near-shoring or friend-shoring has cushioned the effects.

Further enduring challenges involve unending shocks stemming from climate changes and technological over-dependence.

Climate Change: Is it slow advance of apocalypse?

12. The world is warming up. The year 2023 turned out to be the warmest one on record. Rising global temperatures and increasingly frequent and severe weather events could result in severe and irreparable climate change leading to gradual but deep impacts on global economy and financial markets. According to a recent study⁶ on the macroeconomic effects of climate change by the National Bureau of Economic Research (NBER), climate change costs the world 12% in GDP losses for every 1°C of warming. The damage caused is reportedly as much as six times larger than

⁵ IMF article dated May 07, 2024 on “Geopolitics and its Impact on Global Trade and the Dollar”

⁶ NBER Working Paper 32450: May 2024 : The macroeconomic impact of climate change : Global vs local temperature; Adrien Bilal and Diego R Kanzig

previous estimates. The World Meteorological Organisation has estimated that weather disasters cost the global economy USD 1.5 trillion in the 2010s, up nearly ten-fold from the 1970s in real terms.

13. Moving from the impact on the economy to equity prices, a new study⁷ estimates market losses to the tune of 50 per cent if climate change tipping points such as Amazon-rainforest dieback⁸ or gas leak from melting permafrost are accounted for. The losses can be minimised to just 5 to 10 per cent if mitigating steps are undertaken to limit warming to two degrees Celsius above pre-industrial averages. It is noteworthy to highlight that these losses will not be a one-off event and there may not be any reversion to the mean. It may be a long journey through the wilderness like Japan's Lost Decades. Now digressing a little from the economic impact and coming to the impact on the scarce human capital, Antonio Guterres, Secretary General, United Nations⁹ has noted that heat stress is the leading cause of weather-related deaths and estimates show that approximately 4,89,000 heat-related deaths occurred each year between 2000 and 2019.

14. Therefore, it's a no-brainer that the climate change related risks continue to dominate policy discourses worldwide. Climate action is an urgent global imperative, presenting policymakers with a fundamental trilemma¹⁰ between achieving climate goals, fiscal sustainability, and the political feasibility. Prolonging the business-as-usual path and taking only moderate action will not contain global warming, leaving the world vulnerable to potential catastrophic consequences.

Technological Challenges

15. I am sure all of you are aware of one of the largest **IT outages** in history that occurred on July 19, 2024 (*Microsoft outage due to CrowdStrike patch*), which

⁷ By the École Des Hautes Études Commerciales du Nord (EDHEC) - Risk Climate Impact Institute

⁸ Amazon dieback is defined as the process by which the Amazon basin loses biomass density as a consequence of changes in climate. Although there is no consensus definition on how to characterize forest dieback, for purposes of analysis reductions in biomass carbon resulting from climate impacts, which would exceed 25 per cent of the standing stock of carbon, are considered to be an indication of dieback. [World Bank Study on "assessment of the risk of Amazon Dieback"]

⁹ WHO press release dated July 25, 2024

¹⁰ IMF publication: Climate Crossroads: Fiscal Policies in a warming world: October 2023

disrupted businesses and governments around the world. The incident led to widespread disruption of airlines, banks, healthcare providers, and other critical service providers. This outage was a stark reminder of the importance of cyber resilience in an increasingly digital and networked world. Crashes, hacks, and data breaches are a mounting threat as the global economy becomes more digitalised and interconnected. The concentration of software and hardware in the hands of a few mega companies makes matters worse. Accordingly, it is imperative to bear in mind that whether caused by the intentional actions of an adversary or the innocent mistakes of well-intentioned actors, the stakeholders need to be resilient to cyberattacks and other cyber failures that can lead to major disruptions of business processes.

Amidst this challenging global economic climate, the Indian economy stands resilient and stable, bolstered by robust macroeconomic fundamentals and financial stability.

India - a pole of economic attraction

16. India has ascended as the fastest-growing major economy globally and a pivotal contributor to global growth. Inflationary pressures are receding, driven by steady core disinflation and declining fuel prices. However, food inflation remains susceptible to recurring supply shocks, hindering a swift alignment of headline inflation with the target. The external sector is gaining strength, evidenced by a narrowing current account deficit and foreign exchange reserves reaching all-time highs. The financial sector is sound and dynamic, fostering double-digit credit growth, supported by high capital adequacy, solid earnings, and enhanced asset quality.

Indian Financial Markets – Resilient

17. The domestic financial markets have weathered the recent global shocks with resolute confidence and evolved in an orderly manner drawing strength from resilient economic activity and strengthening macroeconomic fundamentals.

18. Domestic Government security yields have exhibited signs of decoupling with the global yields highlighting inherent stability. The rangebound movement in G-sec yields despite sharp gyrations in emerging market peers and major countries' yields (upheaval in the global bond markets) has fostered a conducive atmosphere for

attracting foreign capital. While India's inclusion in the JP Morgan's Government Bond Index - Emerging Markets (GBI-EM) has become a reality, the increasing interest of foreign participants is reflected through significant net FPI inflows amounting to around USD 16 billion in the debt segment so far this year.

19. As regards the Indian Rupee, it's a *tale of two eras* - one related to the Taper Tantrum in 2013 when India was infamously dubbed as one among the "Fragile Five" as the Rupee depreciated significantly against the US Dollar, and the present times - a period of broader stability covering various asset classes engendering congenial market conditions. Despite broad gains in the Dollar Index, the Rupee has exhibited range-bound trend aided by improved macro-economic fundamentals, narrowing of current account deficit, strong portfolio flows and robust forex reserves. Rupee's historical volatility remained the lowest amongst major currencies in CY 2023 as well as CY 2024. This low volatility coupled with high carry (interest rate differential) has resulted in steady inflows.

India's External Position

20. India's external sector vulnerability indicators remain robust and much better as compared to earlier stress periods. India is currently having the fourth largest foreign exchange reserves in the world with the latest data coming at a record US\$ 682 billion as on August 23, 2024. India's foreign exchange reserves has increased by US\$ 61 billion during 2024 so far (as on August 30), the highest rise among major foreign exchange reserves holding countries. The ratio of short-term debt (original maturity) to foreign exchange reserves stood at 19 per cent at end-March 2024 as against 34 and 26 per cent at the time of two earlier stress periods i.e., end-June 2013 and end-September 2018 respectively. The ratio of foreign exchange reserves to external debt was comfortably placed at 97 per cent as against 70 per cent and 79 per cent during the above periods. Import cover was at 11 months at early-August 2024¹¹ as against 9.5 months and 6.7 months during the above periods.

Recent changes in the regulatory framework for foreign exchange market

21. In recent years, the regulatory framework for the foreign exchange market has gone through significant transformation with changes aimed at simplifying regulations

¹¹ RBI Bulletin – August 2024: State of the Economy

and improving accessibility; fostering greater flexibility and encouraging innovation; enhancing transparency and ensuring fair market practices; protecting the interests of less-sophisticated customers; and positioning India as the hub for the price discovery of INR products.

22. A new principle-based regulatory regime has been introduced which provides market participants greater freedom to manage their foreign exchange risks effectively. The market-maker base has been broadened, with standalone primary dealers now authorized to operate on par with Authorised Dealer banks. The regulations governing access to onshore markets have been harmonised, allowing non-residents to access the onshore market under the same terms as residents.

23. Recent regulatory changes have also provided market-makers with the flexibility to innovate and offer bespoke or custom-made products to sophisticated users to enhance efficiency in hedging, provided they have adequate risk management capabilities. While the access of retail users remains limited to simple products, with clear disclosures on prevailing market rates, retail users with sufficient risk management capabilities have now been given the flexibility to get classified as non-retail users and access more complex derivative products. It is crucial that market-makers exercise necessary due diligence when offering complex products and conduct derivatives business in a transparent, responsible, and ethical manner.

24. Pursuant to the aforesaid changes in the regulatory framework, it is observed that several derivative products, including structured products are being offered to customers by market-makers. It is critical here that users are made sufficiently aware of all possible risks / payout scenarios associated with the products. Important in this context is that RBI's regulatory framework, which sets out the conduct framework for market makers for offering OTC derivatives to users, explicitly mandates market makers to include a comprehensive scenario analysis covering key upside and downside risks on the pay-off profile in the risk disclosure statement that they are required to provide to the users for each derivative transaction. It is expected that market makers scrupulously comply with these regulations in letter and spirit. In particular, market makers may exercise additional caution while offering structured products with asymmetric pay-offs to their clients.

25. As a significant step towards promoting India as the hub for INR transactions, Authorised Dealer banks with IFSC Banking Units have been allowed to participate in the offshore INR market. The move aims to encourage non-residents to access the onshore market, thereby enhancing liquidity and market efficiency. To further promote onshore market participation, non-residents have been allowed to access onshore pricing and liquidity through their overseas bankers. This approach enables non-residents to leverage their existing banking relationships abroad while benefiting from the advantages of the onshore market. AD banks have also been permitted to provide pricing to non-resident clients beyond onshore market hours thereby facilitating transactions within the clients' own time zones. Further, INR derivatives settled in foreign currency have also been permitted in GIFT City, both through OTC markets and on the exchanges. These initiatives aim to bridge the gap between offshore and onshore markets, fostering a more integrated and accessible onshore forex market for global participants.

Transparency and fairness in FX transactions

26. The current legislative and regulatory environment requires that users / clients need to meet their FX needs (cash as well as derivative products for hedging) only through authorised dealers. Banks, especially, scheduled banks, account for the vast majority for authorised dealers for this purpose. In particular, such banks, as a group, are the sole providers of FX hedging facilities to users / clients – residents as well as non-residents – in the economy.

27. This privileged position enjoins upon banks a fiduciary responsibility to act in a fair and transparent manner when dealing in FX products with users / clients especially the smaller users. The Reserve Bank is, however, in receipt of formal and informal feedback that individuals and smaller firms (especially MSMEs) continue to be discriminated against in FX markets when it comes to pricing and transparency considerations. Divergence in pricing in FX markets for the small and large customers are wider than what can be justified by operational considerations. Efforts to bring about greater transparency and fairness in the FX market for retail / smaller customers through the introduction of FX-Retail - an electronic trading platform launched by the Clearing Corporation of India Limited in 2019 - have also not been able to achieve the desired results given lack of efforts made by banks in facilitating their customers to

onboard the platform. Data about the rejections of the on-boarding requests by customers, unavailability of transacting limits for approved customers and undue delays in processing of on-boarding requests on the platform are disquieting.

28. Reserve Bank's regulatory framework also sets out provisions which are aimed at ensuring that users are offered FX derivatives products at a fair price and in a transparent manner. Separately, RBI's overall requirements in the area of customer service also require banks to ensure that no customer is discriminated against merely on the basis of size of transaction. Banks are required to follow these instructions in letter and in spirit. Greater efforts and pro-active steps to create awareness about the FX Retail platform and facilitate seamless on-boarding and participation of customers on the platform are also necessary.

Broker complaints

29. In recent months, we have been in receipt of several complaints about the practices followed in broker deals in the inter-bank FX market. The complaints allege restricted practices, lack of transparency and collusions. Since this is a forum where both bankers and brokers are present, this is an appropriate platform for me to re-emphasize the need for utmost transparency and the highest level of ethical standards in all dealings in the financial markets in general and in the FX markets in particular. Strict adherence to the regulatory guidance set out in the Internal Control Guidelines issued by RBI needs to be mandatorily ensured in this context.

The Need for Diversified Use of Electronic Trading Platforms

30. Amidst the backdrop of technological challenges as elaborated earlier, associated with excessive reliance on few mega companies, it is germane to highlight the relevance of diversified usage of electronic trading platforms to minimise undesirable operational shocks which can unleash undue volatility in the price action. In the FX markets, the use for technology for achieving greater efficiency is not new. The electronification of the global FX trading with the emergence of multi-bank platforms over two decades ago has transformed the execution of trade and price discovery. Recent changes in electronification, particularly the emergence of single-bank platforms, have further altered the market structure. Some of these changes can be seen even in the onshore Indian Rupee (INR) market.

31. In fact, trading on electronic platforms is being encouraged across the world as it enhances pricing transparency through real time dissemination of prices, processing efficiency and risk control. It also enables better market surveillance and, therefore, discourages market abuse and unfair trading practices. The Reserve Bank put in place a regulatory framework for electronic trading platforms (ETPs) in 2018. The ETP regulations are being further fine-tuned in the light of the experience gained since then and in view of developments such as the increased integration of the onshore forex market with offshore markets, notable developments in the technology landscape and an increase in product diversity. The regulatory framework for ETPs is aimed at ensuring that ETPs function in a regulated space which enjoins upon the platforms to ensure fair access through transparent, safe, and efficient trading processes, robust trading infrastructures and prevent market abuse. Twelve ETPs operated by five operators have since been authorised by RBI. Of these, platforms for FX transactions are provided by seven ETPs.

32. It has been observed that while FX spot transactions are largely carried out on ETPs, FX forward and swap trades in the country today remain almost entirely voice-traded, notwithstanding the availability of ETPs for such transactions. In this context, it is important to note that ETPs offer a superior trading venue in terms of transparency, pricing efficiencies and potentially lower costs and these are aspects which the participants here may like to consider.

33. As outlined earlier, ETPs have a critical responsibility to ensure that their technology infrastructure should be robust with a high degree of reliability, availability, scalability, and security in respect of its systems, data, and network. Further, it is expected that ETPs must ensure capability to disseminate trade information on a real-time or near real-time basis. Of late we have been observing frequent incidents of outages involving extended duration of disruptions which had destabilising effects on price actions in the forex market. Under this backdrop, the ETPs being critical market infrastructures are advised to ensure apposite BCP process including contingency and disaster recovery arrangements in place. It is also the responsibility of the market participants to assess quality of ETPs on these aspects and ring-fence their internal controls.

Unauthorised forex trading

34. There has been a proliferation of unauthorised entities offering online forex trading facilities to residents without being authorised by RBI under the provisions of FEMA, 1999 or authorised to operate ETPs under RBI's ETP regulations. RBI is in receipt of many complaints of cheating and fraud by such unauthorised platforms. RBI has issued necessary cautionary advice against undertaking forex transactions on such platforms. It has also issued an alert list of entities understood to be offering or promoting unauthorised forex trading facilities.

35. While the Reserve Bank has been taking measures to create awareness against dealing on unauthorised forex trading platforms through cautionary advices and 'Alert List', it is important that banks ensure that they do not facilitate such transactions in any manner. There is also a need for all of you in the forex fraternity to specifically sensitise your customers and the broader public against the perils of dealing on unauthorised forex trading platforms.

Concluding thoughts

36. India's economy and financial markets are currently experiencing a period of significant transformation, driven by the country's unique position as the driver of global growth in the recent years. In response to these evolving dynamics, the Reserve Bank has been diligently working to simplify, liberalise, and rationalise the policies and processes related to foreign exchange regulation. These efforts aim to enhance efficiency and adaptability without compromising the stability of the financial system.

37. As a result of these reforms, market participants now enjoy a greater degree of freedom in conducting transactions than ever before. This newfound flexibility allows for more dynamic and responsive engagement with global financial markets. However, it is imperative that this freedom is exercised with a high degree of responsibility. Market players must ensure that their actions are transparent, fair, and ultimately beneficial to both their customers and the broader economy.

38. It is crucial to avoid the misuse of these flexibilities for short-term gains by a few individuals or entities, as such actions could have detrimental effects on the financial sector. Instead, the focus should be on fostering a stable and sustainable financial environment that supports long-term economic growth and development. By adhering

to these principles, our aspirations towards realising the goal of Viksit Bharat can certainly gain momentum.

39. Amidst the broader uncertain global milieu, there is a growing belief that we are witnessing an era of 'wow' moments in Indian financial markets. However, it is always prudent to shun the path of complacency and ensure that we remain committed to the overarching shared goal of securing and preserving financial stability at all times. I am reminded of the unforgettable words of Sir Edmund Hillary at this pivotal moment in the annals of Indian financial markets and I quote:

“While on top of Everest, I looked across the valley towards the great peak Makalu and mentally worked out a route about how it could be climbed. It showed me that even though I was standing on top of the world, it wasn't the end of everything.”

Thank you. Wish you all the very best for productive business sessions. Namaskar.