

Ruminations on Markets¹ - Provoking Thoughts Amid VUCA² Times

Distinguished speakers, esteemed panellists, office bearers of FIMMDA and PDAI, delegates, ladies, and gentlemen. At the outset, it gives me great pleasure to be amidst you today at the 22nd Annual Conference of FIMMDA jointly organised with the PDAI. I deem it an honour to be addressing the thought leaders from various segments of financial markets present here. Both FIMMDA and PDAI have worked with RBI in tandem for transforming our markets into vibrant ones, which have withstood crisis after crisis with enviable resilience.

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. The opinions and commentaries mentioned at various places in this speech are basically aimed at stimulating an intellectual discussion.

A. 2022 - A year of reckoning for global markets!

3. In recent years, financial markets are navigating through an era of “megathreats”³ amid unprecedented uncertainty not seen in many decades. Regardless of the long experience of many market veterans present here, and the young participants who may still be trying to acclimatize to the volatile dealing room environment, I must say that the current macro-

¹ Address delivered by Shri Radha Shyam Ratho, Executive Director, Reserve Bank of India in the 22nd FIMMDA – PDAI Annual Conference 2023 held in Dubai on January 27, 2023. The contributions of Shri Rakesh Tripathy, Chief General Manager and Shri Sabyasachi Sarangi, Assistant General Manager are gratefully acknowledged.

² An acronym coined in 1987 based on leadership theories of Professor Warren Bennis and Burt Nanus. It was subsequently introduced by the U.S. Army War College to describe the more Volatile, Uncertain, Complex, and Ambiguous multilateral world.

³ An article dated Jan 18, 2023 by Nouriel Roubini - “Sleepwalking on Megathreat Mountain” on Project Syndicate

financial setting is completely different from what we have seen earlier. This ‘polycrisis’⁴ on a global scale refuses to abate and continues to act as disruption multiplier causing a VUCA environment.

4. The three major contributors to the broader gloom and doom need no elaboration. Firstly, at the beginning of this decade, the COVID-19 pandemic broke out and secondly, the resultant lock-downs and supply-chain snarls caused multi-decade high inflation, which mutated from a ‘transitory’ narrative to “deeply entrenched”. Thirdly, the Ukraine conflict fuelled the global commodity shock and provided further impetus to soaring inflation worldwide. Aiming to tame the inflationary headwinds, central banks across the world embarked upon an aggressive and synchronous front-loaded rate hike spree, not seen in the last four decades. The transition from a period of “**great moderation**” to “**great exasperation**” has confounded and wrong-footed market participants.

B. Whither global economy? Hard or Soft landing!

5. There is a growing disconnect between market expectations of a decline in inflation and central banks more determined to stay the course. While market participants know that the “central bank put” is long dead, there is still a growing hope about improved probability of **soft landing** in 2023. Well, central banks cannot hike policy rates endlessly and each hiking cycle must peak somewhere. *But at which level?* The second question is for how

⁴ This term was made famous by Jean-Claude Juncker, a former President of the European Commission, in the context of the European crises. 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 a risk matrix, where the whole is even more dangerous than the sum of the parts.

long central banks will keep policy rates at the highest / terminal level before they start cutting rates. So, the ‘pivot’ has two aspects - the level of the terminal rate, and the period for which the terminal rate is maintained.

6. A pertinent point is that when inflation runs way above the target, it becomes a no-brainer for the central bank. It is only when inflation comes within one to two percentage points of the target that central banks are likely to face the dilemma of how much more to tighten policy, given that monetary policy works with a lag. During major tightening cycles earlier, usually some financial vulnerability has emerged in some unsuspected corner of the economy. Debt vulnerabilities are high today, with potential costs and risks to debtors, creditors, and, more broadly, financial stability. The upward trend in global debt to GDP ratios since the Global Financial Crisis (GFC) raises a key challenge before the stakeholders as to **“how much debt is not too much?”** To provide a perspective⁵, the total debt owed by governments, households, financial and non-financial corporates as of June 2022 stood at US\$ 300 trillion, equivalent to 349 per cent of global GDP, 71 percentage points higher than the pre-GFC position of 278 per cent. Further, we are yet to see the secondary effects of the **unusual twin sell-offs**⁶ recorded last year pop up anywhere. While well-regulated conventional markets may remain less vulnerable going ahead, the less regulated and less transparent private markets may see massive write-downs fuelling contagion risk. *Could this fear of triggering a crisis somewhere with ramifications for overall*

⁵ S&P report dated January 13, 2023, based on data disseminated by the Institute of International Finance (IIF)

⁶ The Bloomberg Global Aggregate Bond Index, a broad gauge of global fixed income, sank by more than 16 per cent last year, an all-time low since the records began in 1990. Incidentally, the MSCI All Country World Index representing equity plumbed by 20 per cent recording the most correlated downward movement observed in financial markets ever.

financial stability, restrain central banks when inflation comes closer to target?

7. Second, have the recent black swan events damaged long-term productive capacity so that the low inflation of the recent decades cannot be achieved any longer? After all, the era of low inflation was due to the favourable combination of several secular global disinflationary factors that may have somewhat reversed under the impact of Covid, war and supply chain disruptions. In 2023, China's reopening, unresolved supply chain disruptions, and "green energy" costs are likely to impart an upward push to inflation. *So, are central banks going to slam the brakes until inflation falls all the way to 2 per cent? Or will a new narrative emerge? Are we about to witness central banks displaying somewhat higher inflation tolerance for the sake of a soft landing when they come close to the target?*

C. Look East

8. Analysis of any market forecasts or expectations in 2023 shall remain incomplete if the "**Look East**" factors are not carefully priced in. The global economy is likely to be stirred this year by **China's rapid reopening** after almost three years of self-isolation. While it may give a boost to commodity prices as China is the world's largest consumer of commodities, global supply chains pressures are likely to ease with China supplying 15 per cent of the world's goods exports. Apart from commodity prices and inflation, the Chinese factors will influence the trends in global macro. Further, the much-awaited policy change in **Japan** will also have significant effects. It is the sole G-10 economy having not tightened policy last year, amid 41-year high core CPI at 4.0% for December 2022. In the environment of global disinflation

spanning last three decades, Japan has emerged as the biggest creditor nation in the world with net international investment position at US\$ 3.2 trillion as of September 2022. Increase in Japanese yields will reallocate tens of billions of dollars away from global assets into Japanese assets.

D. Some untapped enablers, and other issues

Before I turn to provoking out-of-box ideas, let me highlight a few extant enablers which are yet to be fully embraced, and some issues of contemporary concern.

9. As all of you are aware, the **Retail Direct scheme** launched in November 2021 is very useful for retail investors. The Reserve Bank has undertaken several publicity and investor awareness programmes across the country. The user interface of the portal has been improved with suitable technological upgrades. I urge all of you to promote this scheme. Another issue, we have recently observed instances of few banks and primary dealers entering into **call market deals** post the permissible trading hours in contravention of regulatory guidelines. I urge the market participants to ensure scrupulous compliance with the regulatory guidelines both in letter and spirit.

10. In the area of climate risk and sustainable finance, the Sovereign Green Bonds (SGrBs) issued day before yesterday will help development of a “**Green Yield Curve**”, facilitating other entities to effectively price their thematic lending/borrowing. Further, issuance of the SGrBs is expected to help India in tapping the global funds with ESG mandate and in broadening the investor base of G-Secs.

11. The Reserve Bank has already permitted the Authorised Dealers to undertake customer and inter-bank transactions beyond the onshore market hours since January 2020. This policy measure was aimed at allowing domestic banks to freely offer foreign exchange prices to users at all times. However, despite passage of more than three years, our market is yet to witness regular trading, sans some sporadic event driven volumes.

E. Ideas for the future

12. As the world economy slows, our exports will most probably remain sluggish. Meanwhile imports are likely to increase as the economy grows, and due to firm prices. As the natural demand for US dollar rises, the local currency tends to depreciate over time requiring deployment of precious foreign exchange reserves to stem the depreciation. If policy measures can be channelized towards increasing the demand for Rupee in international transactions, the concerns on the current account front would abate.

13. After the freezing of Russian foreign exchange reserves, countries have started exploring alternatives to the dollar. In this context it will be pragmatic to endeavour for INR internationalisation by encouraging bilateral **local currency settlement (LCS)**. With countries gravitating towards “**friend-shoring**” / “**near-shoring**” and the decades-long progress towards globalization taking a back step, it will be worthwhile for us to take steps to increase the international usage of INR.

14. RBI recently announced arrangements for invoicing, payment, and settlement of exports/imports in INR to encourage exports from India. Going forward, a LCS framework with other countries could reduce the need for

hard currencies. It would stabilise the local currencies, provide a natural hedge for the business community and protect against currency risk exposure, reduce transaction costs through more efficient direct exchange rates, and facilitate faster transfers. 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 and obviates the need for large foreign exchange reserves in the long run. Further, such agreements also boost the development of the domestic financial markets and support the economic growth of the participating countries.

15. The **use of national currencies** is being explored by the member countries of the Asian Clearing Union (ACU). Further, a few countries have recently evinced interest to work with us in setting out the modalities of a LCS framework. Interestingly, Brazil and Argentina are preparing to work on a common unit of account to promote their bilateral trade⁷.

16. Attempts to increase the international usage of INR should be simultaneously accompanied by measures to develop our financial markets, develop robust cross border payment and settlement based on domestic currencies, and simplify the KYC regime. The various investment channels for FPIs in the debt segment such as Medium-Term Framework (MTF), Voluntary Retention Route (VRR) and Fully Accessible Route (FAR) can be recalibrated. Further, strengthening of financial markets can be pursued by fostering a global 24 x 5 INR market, and promoting India as the hub for INR transactions and price discovery. This can be facilitated by permitting (a) AD

⁷ Bloomberg article dated January 24, 2023

Cat -1 banks to undertake interbank forex transactions through overseas branches / subsidiaries, (b) resident users and AD Cat -1 banks (not having IBUs in IFSC) to freely access non-deliverable INR derivatives, and (c) all participants to freely access onshore forex derivatives market without need for underlying exposure in a gradual manner.

17. Availability of a robust **INR-denominated payment mechanism** for cross-border transactions and settlement would reduce transaction costs. 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 very useful complimentary step to internationalising INR.

18. 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. As such a **review of the KYC norms applicable for foreign investors** and removal of the frictions impeding their access to INR assets shall facilitate their smoother on-boarding, without compromising with the Anti Money Laundering (AML) standards.

19. One issue that will arise as we progress towards greater INR internationalisation is the accumulation of **non-reserve currencies** in our Foreign Currency Assets (FCA). This is inevitable as reciprocal acceptance of national currencies is the basic principle behind LCS arrangements. These non-reserve currencies will not be recognised as per IMF definition as part of our foreign exchange reserves. But they will serve most of the purposes for which reserve currencies are held. After all, reserve currencies are held

to weather economic shocks, pay for imports, and service debts. I can imagine a future in which the so called “non-reserve” currencies of today, by and large, perform the above role played by hard currencies.

20. Another issue that will arise is that the non-reserve currencies that we accumulate will have to be invested. If suitable financial instruments are not available in those countries, we may have to turn towards **strategic assets**. Already countries are leaning in this direction. Geo-strategic investments in allies and neighbours can be another option. All these will call for an **adventurous mindset**.

F. Conclusion

21. It is not uncommon to hear that the developments in financial markets and the re-wiring of inter-dependent economies are becoming more inscrutable day-by-day amidst the ongoing uncertain times. These trying circumstances too shall pass. Ultimately, we will be judged by history in terms of our response to these unprecedented events and our willingness to explore the unexplored. As we enter the ‘Amrit Kaal’ to the centenary of our independence, our pursuit of **“INR internationalisation”** as a **public good** will, I believe, keep us in good stead, when we look back in 2047. In this context, I am reminded of Victor Hugo, one of the greatest French writers of all time, who had famously said that:

“Nothing is more powerful than an idea whose time has come”

For the young dealers here, I wish to quote the last sentence penned by Michael Lewis⁸ in his book *“Boomerang: Travels in the New Third World”*:

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

For the rest of us, seniors, and market veterans, it is apt to quote Mark Twain.

*“It ain’t what you don’t know that gets you into trouble.
It’s what you know for sure that just ain’t so.”*

Finally, I wish this Conference all success and hope we have fruitful deliberations going ahead.

Thank you.

⁸ 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, i.e. Eurozone, would break up, with Greece being forced to abandon the Euro, he predicted that the Eurozone would survive.