23rd FIMMDA-PDAI ANNUAL CONFERENCE, BARCELONA 2024

Indian Financial Markets – Enabling India's Growth Trajectory

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colleagues from the RBI, banking and primary dealers, ladies, and gentlemen.

First of all, I want to commend the organisers for choosing this beautiful mediterranean city of Barcelona as the venue for this gathering. As we witnessed yesterday, this Catalan city is blessed with beautiful architecture designed by Antoni Gaudi, with as many as 9 UNESCO world heritage sites, of which 7 were designed by Gaudi. And of course, for the football fans, it's home to the largest football stadium in Europe, the home ground of FC Barcelona, the famous Camp Nau (under renovation till November 2024).

I also want to thank FIMMDA for inviting me to listen to Governor Das's wisdom in person, and to give me the pleasure to interact with colleagues from the fixed income, money and derivatives markets. FIMMDA, since its inception in 1998, has played a vital part in the development of Indian fixed income markets through its role as an industry interface with the regulators and its contributions through the development of valuation models for various instruments. In more recent years, it has played a leading role in the introduction of new benchmarks, new interest rate derivative products, global best practices including the code of conduct, and also as an arbitrator of disputes. Since I represent the banking sector here, I also want to thank RBI for always patiently hearing the views and concerns of the industry and incorporating those in its regulations and guidelines, wherever possible. With the great many developments happening in the Indian economy as well as in the Indian financial markets, including the introduction of new derivatives products like swaptions, the valuation and portfolio classification changes in the investment portfolio, as well as the changes in capital requirements necessitated by the implementation of Basel III norms, FIMMDA's role has never been more critical and I am confident that the association will continue rise to whatever challenges that may present themselves in the future.

Financial markets, as we understand today, consist of electronic platforms on which buyers and sellers trade various assets, like different fixed income securities, equity shares in companies, foreign exchange, commodities, etc. Till some time back, instead of these electronics platforms, most of the trading was done through "voice" i.e. through telephones. Most, though not all, of trading has now moved to electronic trading platforms. While the mode of interaction between buyers and sellers has undergone changes, the basic function of financial markets, i.e. to bring buyers and sellers together, has remained unchanged.

In modern economics, Joseph Schumpeter is often credited with first proposing a direct link between finance and economic growth through his 1911 theory of "creative destruction", which suggested innovation and entrepreneurship as the major drivers of growth, with finance playing an essential role through efficient allocation of savings and by providing risk management. Schumpeter's hypothesis has been widely debated and contested, with causality being the major cause of disagreement. While developed financial markets may not be a necessary condition for economic growth, a 1998 paper by Raghuram Rajan and Luigi Zingales proved the role of developed financial markets as that of a lubricant for economic growth by showing that industries that are more dependent on external financing (as compared to company's own resources) grew faster than others in countries with developed financial markets. There is also reason to believe that better resource allocation by efficient financial markets leads to more sustainable growth.

Efficient financial markets provide a platform for both corporates and governments to raise capital from different investors. These funds are then used to build infrastructure, build new production capacity, and generate employment, which increases demand. Financial markets can also mitigate the adverse selection problem in credit by reducing the information asymmetry. The role of financial markets in efficient allocation of capital is well established, but they also help generate wealth for individuals by providing them diverse, liquid investment options. This wealth also leads to increased demand and increased savings. And as the Rajan, Zingales paper proved, efficient financial markets allow companies to grow larger faster, helping a country grow its competitive advantage in the Ricardian[1] sense.

In India, financial liberalisation was a major component of the economic reforms in 1991, and development of financial markets has gone along with the growth of the economy. In addition to the development of electronic platforms, we have seen the rapid growth of exchanges in equity and derivatives markets, increase in the number and type of participants and growth in the sophistication of instruments and products addressing different funding, investment, and risk hedging requirements of the market participants. All of these have contributed to making the Indian financial markets more efficient.

The resilience shown by Indian financial markets during the 2008 Global Financial Crisis, and especially during the more recent Covid crisis, compared to markets in many of the advanced economies, is a testament to how far Indian markets have come, and to the sagacity of our regulators. Since Covid, India's equity market cap has risen to be the 4th largest in the world at $4.8 trillion, with majority of it coming from the increasing number of domestic investors. Indian Mutual Funds' AUM has doubled in the last four years to more than Rs. 50 trillion, while 579 companies have raised Rs 3.13 trillion through IPOs

[1] David Ricardo was a classical economist whose widely acclaimed comparative advantage theory suggests that nations can gain an international trade advantage when they focus on producing goods that produce the lowest opportunity costs as compared to other nations.

since 2020. Debt markets have also come a long way, with corporate bond market size (outstanding) growing from Rs 34 trillion in Sep-20 to Rs 45.5 trillion in Dec-23, despite disruptions from high inflation. This resilience, combined with India's strong growth potential, has resulted in the inclusion of Indian government bonds in JP Morgan and Bloomberg's EM bond indices.

While we all deserve a pat on our backs for this, I'm sure everyone will agree that we should not lose sight of the remaining challenges in our financial markets - frictions that reduce the efficiency of the lubricant for economic growth. One of the big remaining challenges, and one which both RBI and SEBI are focused on, is the lack of financial inclusion. While the JAM trinity and the various insurance schemes launched by the Government, as well as the launch of platforms like FX-Retail by RBI have dramatically improved financial inclusion in the last few years, there is still a long way to go for improving equitable access to many other financial services and products for a large part of the Indian population.

Another long-standing issue, and one which old timers in the Indian debt markets would have heard of many times, is the development of the Indian credit markets – both corporate bonds market and the credit derivatives markets. The causes and possible solutions have been discussed ad infinitum, so I will not repeat those here.

Finally, while India has become home to the world's third largest startup ecosystem, our ability to finance such startups is still lagging. The ability to properly price and finance the endeavours of entrepreneurs trying to develop new technologies, while managing the downside, is a sign of a mature financial system, and Indian financial markets will have a major role to play.

Conclusion

As the Indian economy continues to grow, hitting milestones of $5 trillion and beyond over the next few years, the complexity of the Indian economy will also increase as Indian corporates move into new sectors. This will make the efficient resource allocation and risk management roles of financial markets more critical and also more complex. As we have seen in the past, this will necessitate a growth in Indian financial markets to keep pace, and ideally to lead and contribute to growth in other segments of the economy. The financial centres in London and New York played a major role in the growth of Britain and US, developing new products and instruments, which were then themselves exported to other countries, contributing to the growth of these economies.

Walter Bagehot, banker and former editor of The Economist said in 1873 that "*In England,... capital runs as surely and instantly where it is most wanted, and where there is most to be made of it, as water runs to find its level*". It is the job of the Indian financial markets to keep the capital flowing efficiently as the Indian economy grows, and I'm certain that the members of FIMMDA - PDAI, guided by our regulators, will continue to do this job well.

Thank you.