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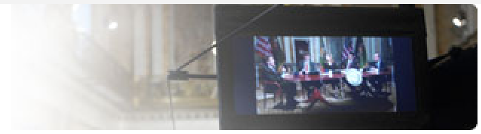

Press Center

Remarks by Assistant Secretary Ramin Toloui at the USIBC Welcome Dinner

11/2/2015

MUMBAI -Thank you for welcoming me to Mumbai. I would like to thank the U.S.-India Business Council for arranging this evening's event and for leading the delegation of private sector participants here in India this week.

I am pleased to be in India for the U.S.-India Investment Initiative, one of the pillars of the Economic and Financial Partnership between India and the United States. This partnership began in 2010 to facilitate deeper bilateral cooperation on economic and financial sector policy issues. In the spirit of this dialogue, the Ministry of Finance and the U.S. Department of the Treasury launched this Initiative in January 2015 to share ideas and enhance cooperation between our two countries with the goal of promoting investment into India. I think it is appropriate for this year's Investment Initiative to be taking place right around Diwali, since the goal of this dialogue is to promote actions aimed at building greater wealth and prosperity—an outcome that benefits all of us.

A central focus of our discussions has been how to finance India's huge needs for infrastructure investment so that it can achieve higher economic growth and meet key social objectives. The need for infrastructure is not India's alone, nor is the conclusion that public sector funds are insufficient to meet the large needs for investment. For infrastructure and other critical investments, capital market development has a critical role to play in mobilizing private capital from both domestic and foreign investors to reach the government's goals. In my remarks today, I would like to discuss the importance of deepening India's capital markets to support its goals to build infrastructure and create jobs through manufacturing. I would also like to offer ideas on how the Treasury can provide support for these efforts.

India's Growth Story and Private Sector Investment

I first visited India ten years ago. Even within that period of time, the change in the character of its economy and, in turn, the expectations for the future, are remarkable. The change over a longer timeframe is even more striking. With the decisive shift in course over two decades ago, India's leaders embarked upon a reform path to achieve faster growth and raise incomes for its citizens. These reforms were premised on the idea that achieving higher economic growth and social goals required steps aimed at, one, unleashing India's domestic economy from the burdens of over-regulation and, two, better integrating India into the global economy. The Indian government abolished quotas and licenses that restricted production of goods, opened the country's borders to foreign goods and investment, and allowed the rupee to adjust.

These reform initiatives have produced remarkable changes—the rise of the middle class, the development of world-class sectors in information technology and pharmaceuticals, and a growing role in the global economy. Today, India stands as one of the fastest-growing economies in the world, and foreign direct investment (FDI) in India rebounded last year, even as FDI flows have stalled in the rest of the world. Per capita income is five times higher today than it was in 1991 in U.S. dollar terms, helping reduce poverty and building one of the world's largest consumer markets.

Prime Minister Modi's election in 2014 reinvigorated this commitment to economic reform. His government has already taken steps to reduce uncertainty and allow greater competition in select sectors, create an e-business portal, and lay out a program for major reform of tax and bankruptcy laws. India has also taken steps to allow and encourage greater foreign investment.

Looking ahead, Prime Minister Modi is rightly committed to linking every corner of this country through infrastructure and to expanding India's manufacturing base. These two priorities are critical to putting India to work by creating jobs, and improving the quality of life for millions of Indians.

A key question is: how to mobilize the volumes of private capital needed to finance these priorities? Identifying the steps that will enable India to mobilize private capital is at the heart of the U.S.-India Investment Initiative. To help answer this question, a key component of the Initiative is dialogue with a broad range of investors to identify specific policies that India can implement to mobilize capital. These discussions have already come up with a robust list of ideas, including streamlining licensing requirements, developing a strong bankruptcy code, resolving tax disputes, and easing restrictions on foreign portfolio investment.

This is a particularly interesting discussion for me because, before joining Treasury last year, I was one of these investors as a portfolio manager in a global bond firm. It was an experience that shed light on how government policy, market structure, macroeconomic fundamentals, and regulation intersect to shape the practical decisions in investment committee conference rooms that ultimately guide the allocation of capital.

Nurturing the Capital Markets Tree

I was in Washington's National Arboretum last weekend before leaving for this trip. In a specially designated section, they had given permission for a number of weekend enthusiasts to climb some of the trees in the Arboretum.

What is the process for climbing a tree? First it is important to gain a familiarity and comfort with the trunk. It is the first part that you have to scale to reach any of the branches. It is important that it is sturdy, or the tree won't be stable as you ascend. Once you climb the trunk, you start to contemplate the branches. Some may look interesting, offering a pathway to enjoy unique foliage or fine vistas, but can they bear the weight? Perhaps you test them with a few footsteps before committing.

There are similarities between that tree climbing and portfolio investment in the bond market. If we think about a country's fixed-income capital markets as a tree, government debt is the trunk. It provides the supporting pillar from which other things can grow. If nurtured and allowed to develop ring after ring, the trunk will serve as the base for a healthy tree that can bear the diverse branches with fruits of different varieties.

From my experience, to tap the scale of capital that India seeks from the large institutions around the world that deploy that capital, portfolio investors need to first be comfortable with climbing the tree trunk—sovereign risk—before climbing further up into the thinner branches—corporate debt, sector-specific investments, and longer-term infrastructure bonds. Let me describe two reasons why.

First, the sovereign bond market fulfills a specific quantitative and technical function across the financial sector in that it is the "risk-free rate" foundation off of which all other assets are priced. A transparent yield curve develops a strong base for the valuation of corporate debt markets, as well as more complex debt instruments, ranging from municipal bonds, to asset backed securities, to infrastructure debt. The introduction of these other forms of financing can help ease the burden on banks, and improve financial stability by reducing maturity mismatch.

Second, the sovereign bond market is the starting point for the accretion of investor experience and comfort that is the prerequisite for portfolio investment in more specialized sectors. When a portfolio manager is contemplating any investment, the key questions are: what are the potential returns, and what are the potential risks? The due diligence on risks is particularly important when investors are entering new countries.

The more specialized the investment, the longer and more idiosyncratic the list of risks, and the more information a portfolio manager will need to feel confident before deploying his or her clients' capital. The list of risks is shorter with investments in government bonds, which is why the government bond market is a key platform for gaining familiarity with the basics of politics, economics, and market structure that become the basis for accepting other more sectoral and idiosyncratic risks related to specific corporations or projects. Absent that familiarity, a substantial portion of portfolio capital may either not come, or will demand higher compensation—i.e., higher interest rates paid by Indian borrowers—to accept those risks.

For this reason, the sovereign debt market is the experiential springboard for future investments in a country. Step-by-step, as investors become comfortable with the sovereign debt market, and obtain a feel for the unique nuances of how a specific country's capital markets function, they will eventually expand to more specialized investments in companies and other sectors, such as infrastructure. In order for investors to move further along the credit spectrum and move into specialized targeted investments, they need to first develop confidence in the basic architecture of a new market by accessing and trading a country's government bonds.

For these reasons, a bold agenda for facilitating access to the government bond market is critical to cultivating the broader development of India's fixed-income markets. Market impediments stunt the growth of this market or twist it in undesirable ways. By phasing out limitations on government bond access, ownership, and trading—and by simplifying procedures for investing in India's markets—there are enormous gains to be had from global investment funds interested in exploring opportunities in India's markets. Policymakers have an important role to play in this effort.

Developing Tools to Manage Risk

I focused in the previous section on the aspects of investment related to identifying, assessing, and understanding risk. There is also a dimension related to isolating and managing risks.

Let me return to the Arboretum. The climbers were not simply climbing up the trees unadorned. Many were strapped into harnesses and attached to ropes that would catch them if they fell. This was particularly important for the climbers intent on reaching the highest and most remote branches. The capital tree can also benefit from some harnesses and ropes, which enable investors to mitigate certain kinds of risk to enable them to focus on those kinds of risk where their specialized expertise can unlock special value.

To illustrate, let me tell a story that remarkably also involves trees. When I was returning recently from a business trip to Latin America, I was seated next to an executive from a company contemplating an investment in the timber sector of a country in the region. Now this was not a portfolio investment, but rather a direct investment in which the international firm would be bringing its best practices to the logging sector of the recipient country. This executive was asking me for my opinion about the currency of the country in question—did I think it would go up or down? After prefacing with a caveat that I didn't offer investment advice, I suggested that perhaps the best thing he could do was find a way to make it irrelevant to his investment decision whether the currency went up or down—that is, hedge out the currency risk so that he could focus on what his company did best, namely, bringing efficiency and value to the business of timber. This was one of those rare times when it is best to advise someone to focus on the trees, not the forest.

There are investors who have an expertise in a particular industry or product, but who do not want to take the time to worry about non-sector specific risks. Be it healthcare, roads, or information technology, specialized sector investors bring a wealth of knowledge, and increase the chance of success of their projects. However, these investors, can be distracted from their core specialty, or at worst deterred from entering the market, in the face of macro risks, such as currency and exchange rate risks. Investors in infrastructure or manufacturing projects, in particular, face a high degree of uncertainty and risk because of the long horizon of these investments.

The creation of instruments that hedge risks helps create an environment where real sector investors can focus on what they know best. Currency risk is at the top of this list, because it is both pervasive and complex. The variety of factors affecting currency valuations is staggering, such that even experts who focus on such things are caught wrong-footed on numerous occasions. So asking those without macro-financial expertise—but who could add substantial value in specific sectors—to bear those risks is highly inefficient.

While in most major economies, investors can hedge their currency risk through the capital markets by executing onshore currency spot, forward, and derivative trades, the same opportunities are not available in India's capital markets. This is largely due to limitations on rupee trading.

I appreciate the arguments against a more liberal trading regime. It is true that liberalized markets with free trading regimes can often encounter greater volatility. But it is also true that such trading regimes encourage development of the kind of hedge instruments, as well of an investor base that is willing to assume the risk of currency volatility that cushions the impact of such volatility on actors in the real economy. The long-term benefit of a more open market is the ability to mobilize a greater flow of inward capital, as investors are able to access the hedges they need to protect their investments. With greater involvement and participation of investors, not only will this support India's overall balance of payments, but capital markets will deepen, providing natural buffers to market volatility.

Building infrastructure in India is not just about laying down roads and building up ports. It is also about policies that deepen India's bond, currency, and equity markets. A deep capital market not only helps finance growth but also provides a long-term defense against volatility.

Role of the U.S.-India Investment Initiative

The United States is eager to forge an even closer partnership with the government of India, and we look forward to deepening our engagement with the Ministry of Finance and the Reserve Bank of India to facilitate our shared goals.

As I mentioned, I am here in India this week to discuss in more detail these issues with my government counterparts and the private sector, with the goal of identifying policies that can mobilize more private sector capital into India. Included in these discussions are private sector investors, so that we can hear directly from them on what policy actions can best catalyze larger flows of investment in India.

Furthermore, technical experts from Treasury will be accompanying me to identify areas of collaboration between our two governments to catalyze greater capital flows, particularly towards infrastructure and manufacturing development in India. This week we will also be sharing the lessons that the United States has learned in building up our own capital markets, including a robust corporate bond and municipal debt market.

Earlier, I mentioned the India of yesterday. In contrast, the India of today is far more open to investors, and growing at an impressive rate. Actions by policymakers have created the conditions for India to prosper, and have brought millions of citizens into the middle class. The India of tomorrow has the potential for even faster and more inclusive growth supported by a robust capital market capable of mobilizing and channeling the investment flows critical to India's future.

Thank you once again for the opportunity to speak before you today.

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