Is China or India more Financially Open?

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The views expressed are my own and should not be attributed to the Board, Management or Staff of the IMF.
This paper is an embarrassment!

• Not to the authors
• It’s an excellent paper
• We are the ones who should be embarrassed
Why be embarrassed?

• All of us have studied financial openness

• We’ve all used Chinn-Ito index as our measure

• Have we actually crossed-checked the index, to see if it really makes sense?
The problem
The Ma-McCauley solution

• They examine a variety of measures of financial openness, both price-based and quantity-based

• Measures are straightforward – methodology is perfectly sound

• They conclude that India is more financially open than China

• Very emotionally satisfying conclusion for an Indian government conference!
India won!
But this is not the Asian Games

• It’s not enough to know that “India won”

• Need to examine the implications

• Issues are: what did India win, why, and where do we go from here?

• Put another way: how should we think about India’s financial openness?
First issue: what?

• Not enough simply to compare India with China

• Cannot tell whether India’s “win” means it is financially open, or whether both economies are actually closed, with India being marginally less closed

• This is a critical question – central to the way we think about how economic policy should be conducted
Is India an open economy?

• If India’s capital account is closed, then the RBI can target interest rates and the exchange rate. But if it is open, the RBI can only choose one of these instruments

• To decide this issue, we need a standard of openness -- India needs to be compared to countries that we know are open
  – As a cross-check, use a variety of standards: advanced countries, other Asian countries, the average EME

• Then, need a way to evaluate the gap between India and the standard
  – Is a differential of 0.41 percent for the onshore-offshore forward premia a large number, or a small one?

• Issue with huge policy implications: if the gap is “small”, we should think of India as an open economy

• Conjecture: capital inflows of around 10 percent of GDP in 2006/07 suggests that India’s capital account is indeed very open
Second issue: why?

- Why did India win?
- Both countries have similar de jure measures of openness. So why is India more open, de facto?

- Two possible explanations (not mutually exclusive):
  - Official side: China enforces its controls more rigorously
  - Business side: Indian firms are better at evasion

- Again, a critical issue
  - If the first explanation is true, then openness is a policy choice (could end lax administration)
  - If the second, government needs to accept openness as a fact, focus more on rationalizing the system

- Paper implicitly supports the second explanation
  - Highlights the larger presence of foreign banks, giving greater scope for international arbitrage
  - But anecdotally, the arbitrage is actually done by non-financial firms -- Indian multinationals buying assets where they are cheaper

- Conjecture: second explanation holds, but because Indian businessmen have honed skills for honoring letter of law while evading its intent
Third issue: what next?

• Key aspect of methodology: comparison based on 10-year averages

• But a decade is a long time, particularly in dynamic countries such as India and China

• Are we missing something by using 10-year averages?

• Can use the charts to examine recent trends
Forward exchange rate differentials

Sources: Bloomberg; CEIC.
Money market differentials

[Graph showing money market differentials over time for China]
Bond yield differentials

1 Three-year maturity.
Source: Bloomberg.
Offshore RMB/Rs debt

In billions of US dollars

Source: Dealogic; Euroclear; Thomson Reuters;
Assessment

• Hard to escape conclusion that China is catching up fast, may soon overtake India
  – Trends show narrowing differentials
  – Could be temporary, but more likely the impact of reforms

• While India has had little recent capital account reform, China has launched program to internationalize RMB. Allowed:
  – 2004: offshore RMB deposits (for trade)
  – 2005: “panda bonds”, foreign companies issuing onshore in RMB
  – 2007: “dim sum” bonds, local companies issuing offshore in RMB
  – 2009: RMB trade settlement
  – 2010: offshore RMB deposits (for financial activities)
  – 2011: R-QFII program for investing offshore RMB in domestic bond market
  – 2012: R-QFII limits increased nearly fourfold to Rmb 270 billion ($43 billion)
Summary: suggestions to authors

• Extend measures to other countries, so India can be compared to a global standard, not just China

• Extend analysis beyond 10-year averages, to consider dynamics and recent trends

• Explain why *de facto* measures paint a completely different picture from the *de jure* measures

• Draw clear implications for the usefulness of the Chinn-Ito measure
  – Are these two cases flukes or is there a more serious problem?
Summary: policy implications

• Paper raises some deep policy questions:

  – Is India is an open economy?

  – If so, how does economic policy need to be adjusted?

  – Why has China begun to shift away from their successful development model, and started to open the capital account?

  – What are the lessons for India’s capital account liberalization strategy?
Thank You!