International Monetary Fund

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.

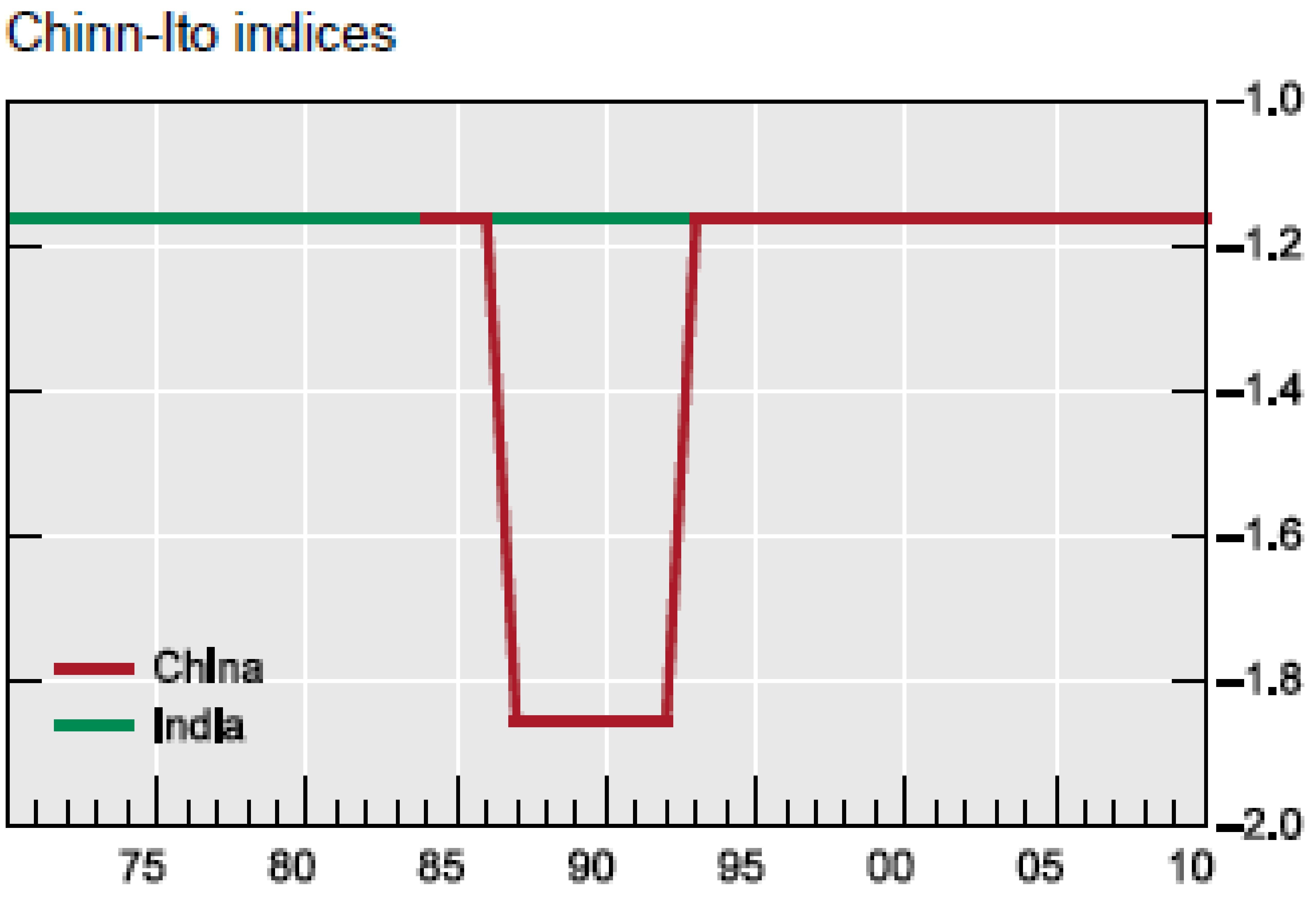
This paper is an embarrassment!

- 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


Chinn-Ito indices
China
India
-1.0
-1.2
-1.4
-1.6
-1.8
-2.0
75
80
85
90
95
00
05
10

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 diferential 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

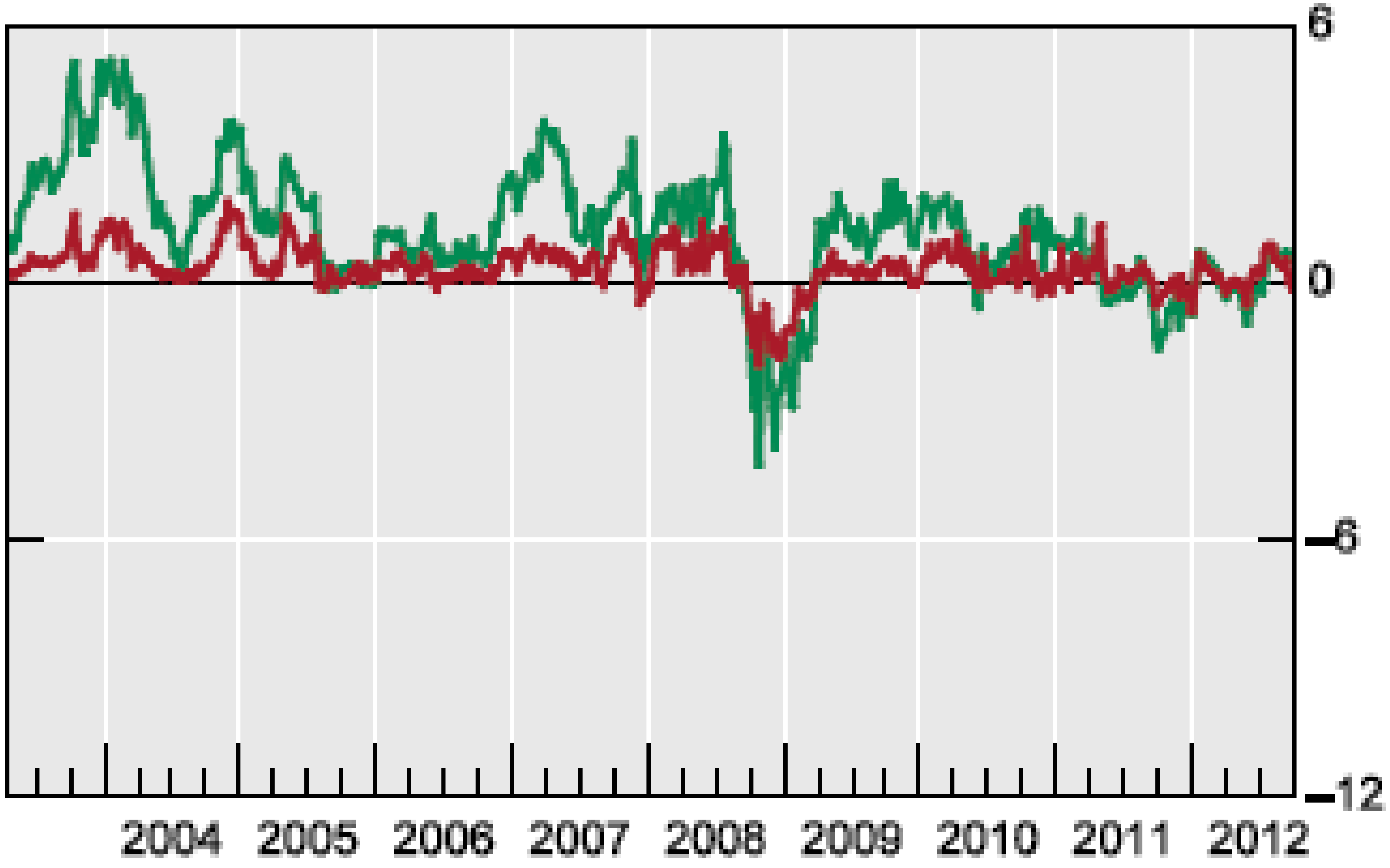
- Conjecture: second explanation holds, but because Indian businessmen have honed skills for honoring letter of law while evading its intent

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

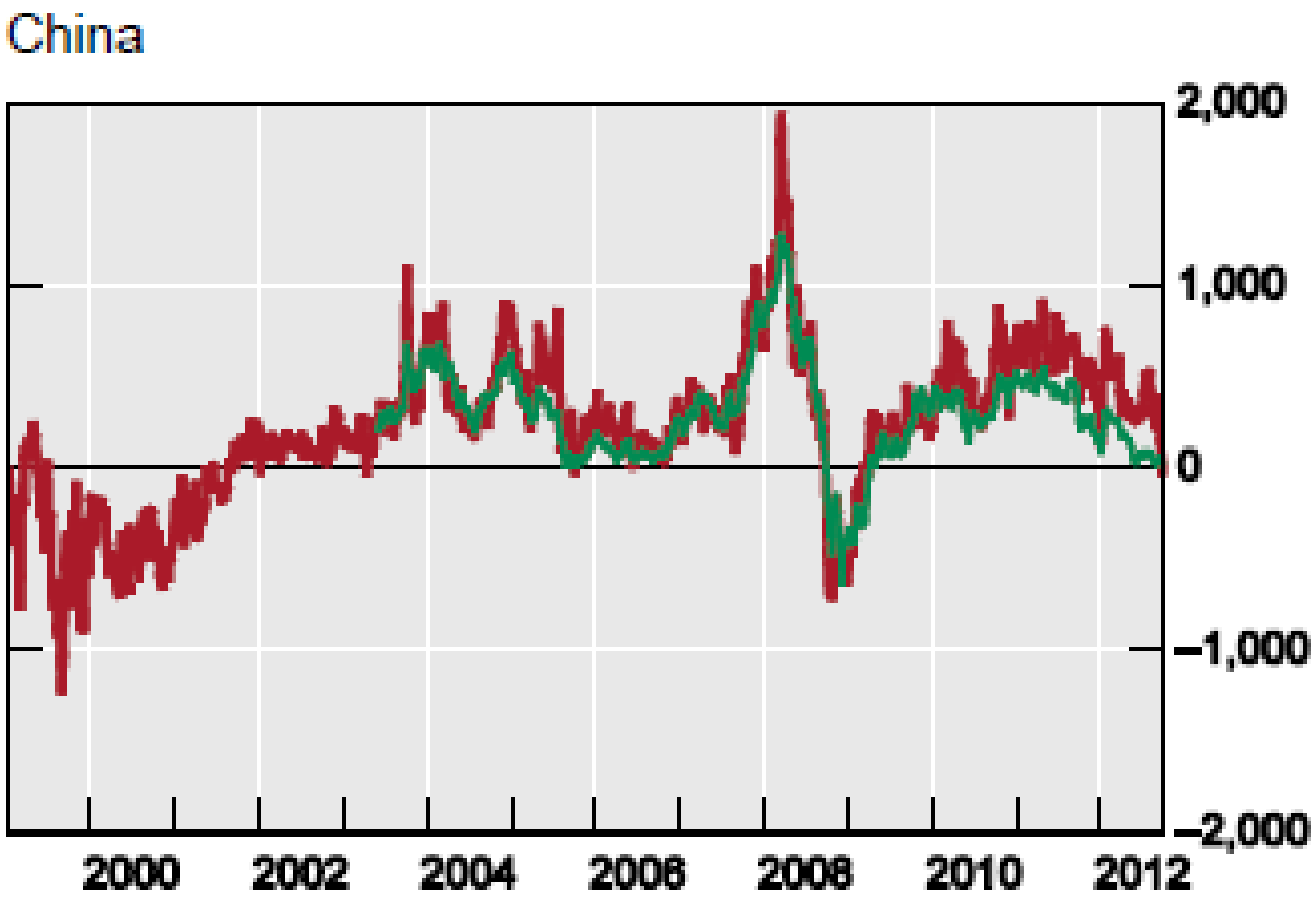
Forward exchange rate differentials

China



Sources: Bloomberg; CEIC.

Money market differentials

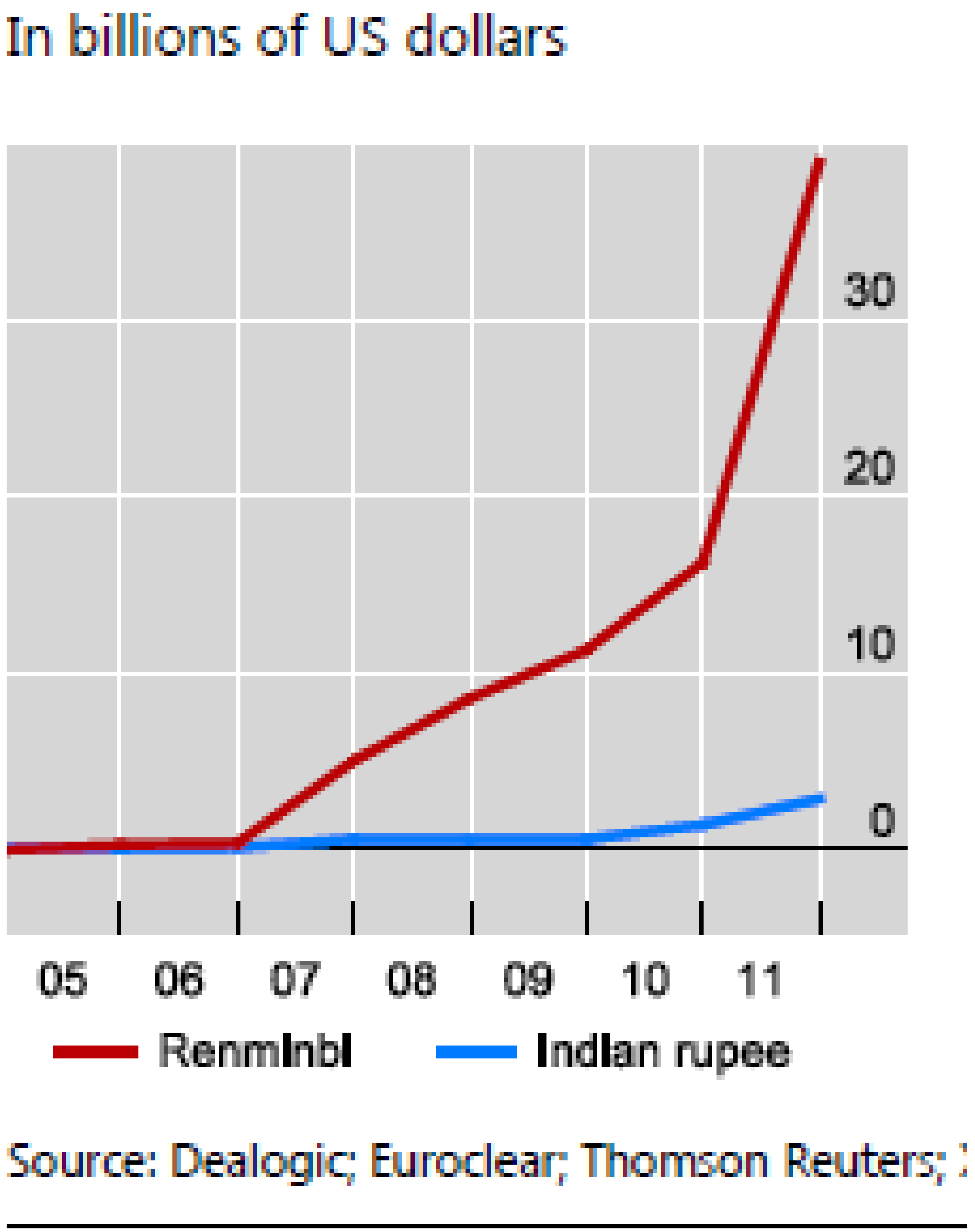


Bond yield differentials

[1] Three-year maturity.

Source: Bloomberg.

Offshore RMB/Rs debt



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!