FUNG GLOBAL INSTITUTE

Asian Perspectives Global Issues

Financial openness of China & India:

implications for capital account liberalization

Guonan Ma
Senior Fellow
Fung Global Institute

NIPFP-DEA conference
India, March 2015

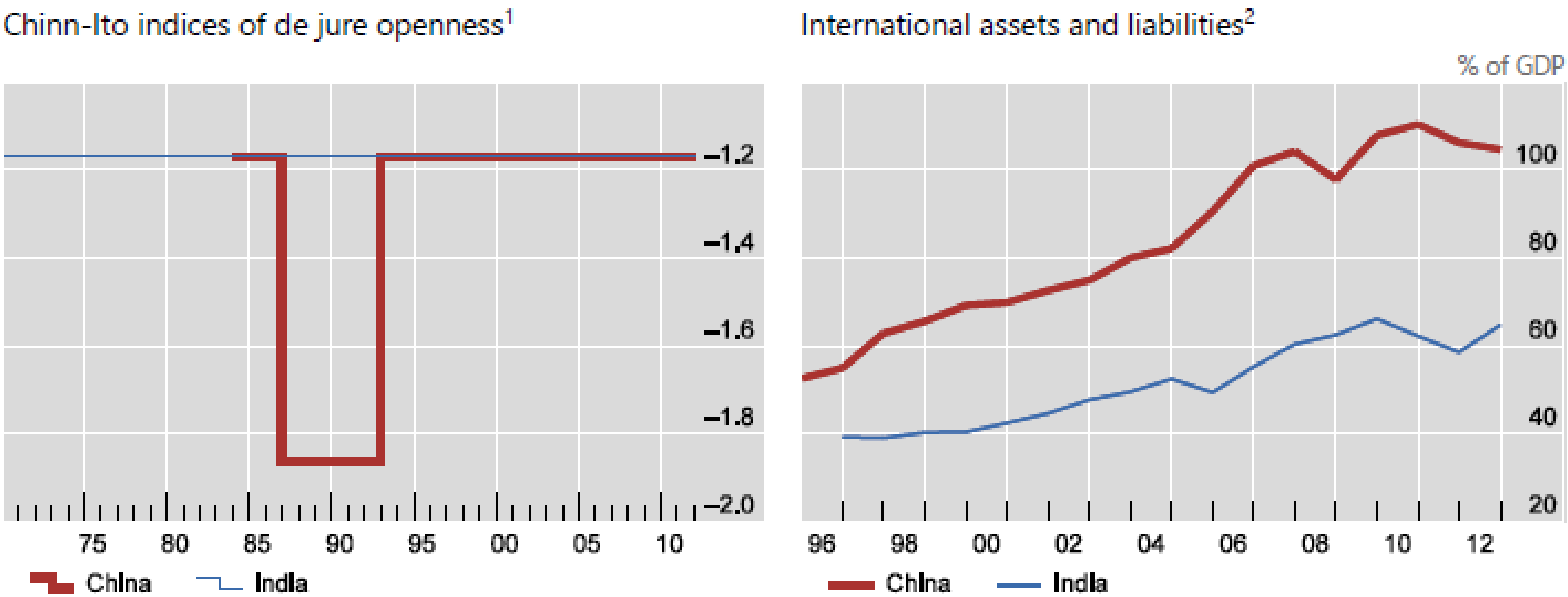
Roadmap and takeways

1. Is China or India more financially open?
   - We update our evidence to end-2013 on three price measures
2. Do our previous findings hold?
   - India is still more open on average, but China is catching up fast
3. What are the implications for China's capital opening?
   - Direct, portfolio and bank flows
4. Why the latest RMB weakness vis-à-vis US$?
   - Currency expectations, rate differentials and FX volatility

Our 2012 paper questions two most popular measures of capital account openness

- De jure and de facto
- Big questions about changes over time and relative positioning

Capital account openness of China and India: de jure and de facto measures Graph 1



Three price-based measures to update de facto financial openness

- Previous work based on eight indicators of capital account openness
  - 4 price measures and 4 non-price measures, with a focus on 2003-2012
  - Now we have updated 3 price measures to end 2013

- On/offshore deviations from the law of one price
  - ✓Smaller gap indicates less market segmentation
  - ✓A positive value of the gap suggests the underlying financial contract is priced cheaper onshore

- Cross-border price gaps for three financial markets
  - ✓FX forward market: (F-NDF)/S
  - ✓Money market: (i – r)
  - ✓Equity market: log(H/A), or log(ADR/M)

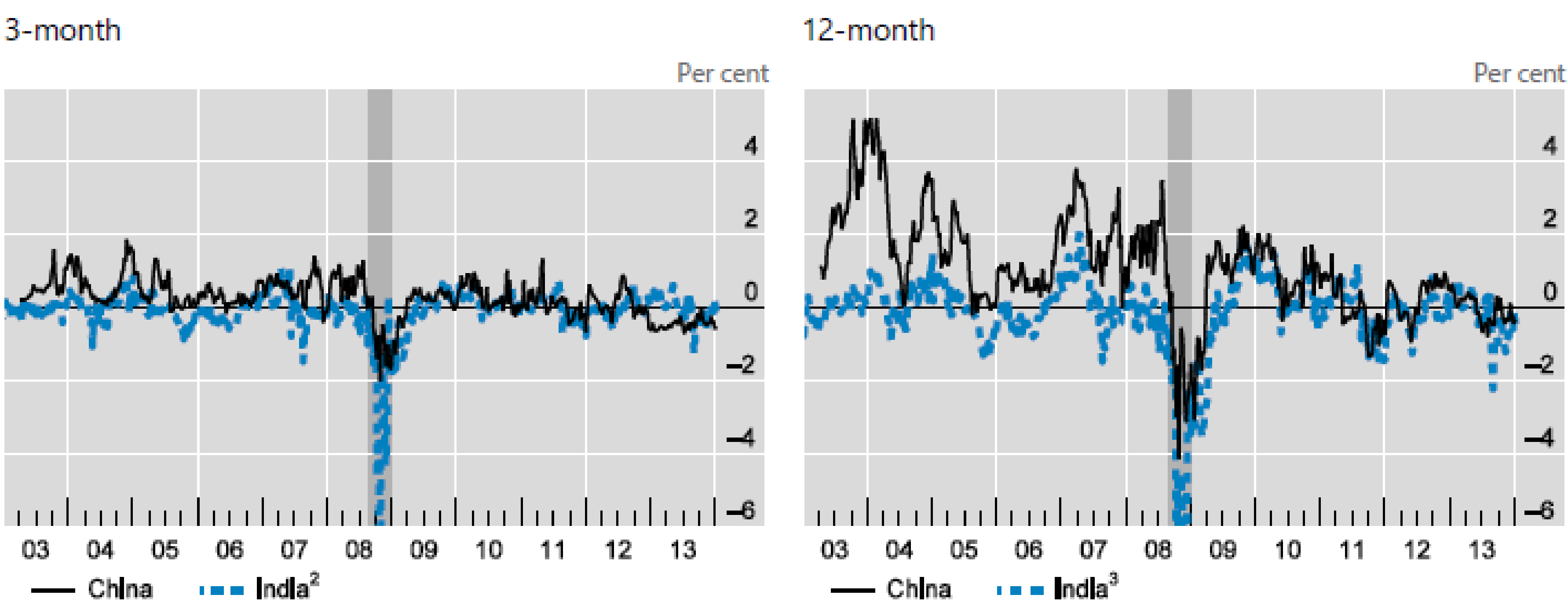
1. On/offshore forward currency premium gap

- On average, the INR forward premium gap is narrower than the CNY over 2003-2013, but the lead is shrinking.

Onshore foreign exchange forward less offshore NDF[1]

As a percentage of spot rate

Graph 2



India has been more open on average, but China catches up fast

- Post GFC, the price gap narrowed for CNY but widened for INR
- A positive forward premium gap indicates the respective currency is cheaper (appreciates less or depreciates more) onshore than offshore: CNY vs INR

Table 1: Onshore less offshore foreign exchange forward premiums (percentage of the spot)

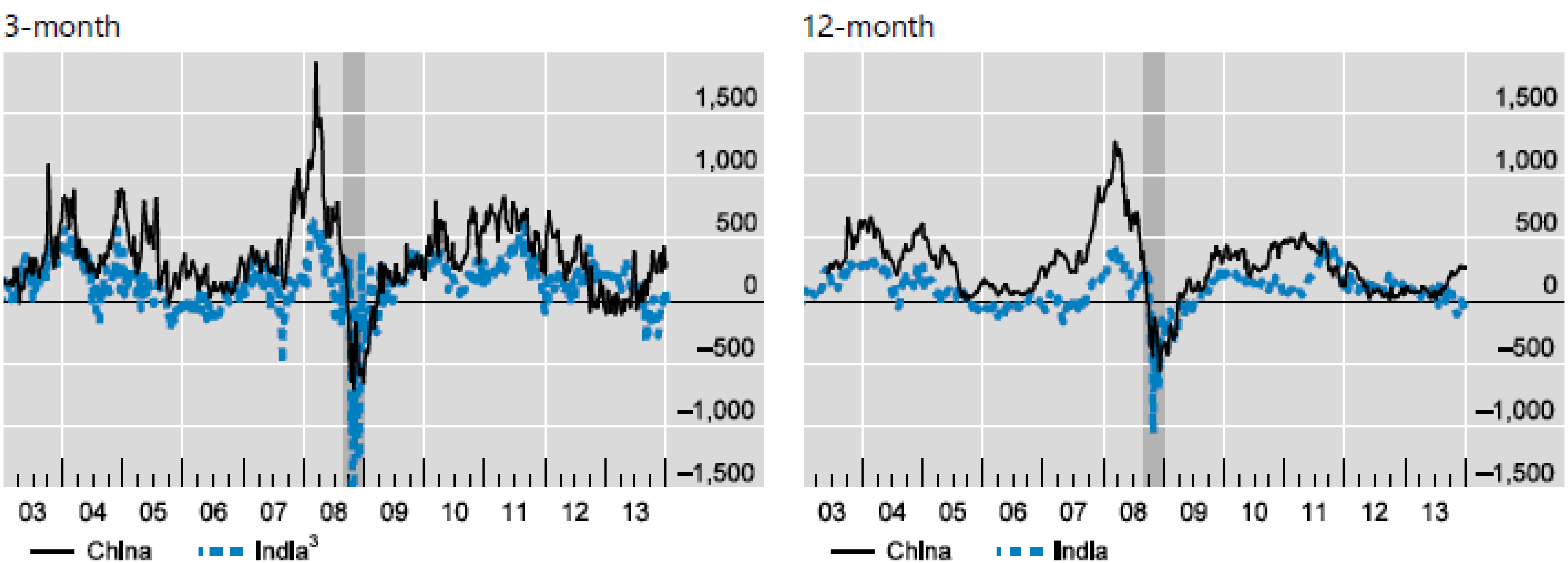
	Three-month			12-month		
	Pre crisis	Post crisis	Full sample	Pre crisis	Post crisis	Full sample
Period average						
CNY[1]	0.5126	0.0494	0.2508	1.8510	0.3851	1.0518
INR	−0.0399	−0.0029	−0.0928	0.0297	−0.0745	−0.1601
KRW	−0.3007	−0.0287	−0.1726	−0.1263	−0.1015	−0.1334
Benchmark[1,2]	*−0.1315*	*0.1019*	*−0.0369*	*−0.3403*	*0.2510*	*−0.0766*
Average of absolute value						
CNY[1]	0.5303	0.3279	0.4489	1.8549	0.7464	1.3290
INR	0.2579	0.2849	0.3334	0.4476	0.6142	0.6511
KRW	0.4365	0.2056	0.3406	0.4676	0.2562	0.3865
Benchmark[1,2]	*0.5828*	*0.3634*	*0.4628*	*1.1589*	*0.7246*	*0.8964*

2. On/offshore money market yield gap

- Again, over the past decade, the money yield gap has been on average narrower for INR than for CNY.

Onshore money market yield less offshore NDF-implied yield[1,2]

In basis points | Graph 3



India has been more open on average, but China catches up fast

- However, once again, post GFC, China's financial openness is advancing, but India is backtracking.
- For both CNY and INR, money market instruments cheaper onshore than offshore.

Table 2 Onshore Money-Market Yield Less Offshore NDF-Implied Yield (in basis point)

	Three-month			12-month		
	Pre crisis	Post crisis	Full sample	Pre crisis	Post crisis	Full sample
Period average						
CNY	436.8	316.1	354.7	381.1	208.2	280.1
INR	148.0	181.5	146.3	101.5	107.7	95.0
KRW	49.5	105.2	90.6	67.2	98.9	89.2
Average of absolute value						
CNY	437.0	345.3	392.7	381.1	235.4	308.9
INR	192.7	212.9	215.2	132.1	138.4	141.1
KRW	76.6	113.8	111.6	68.5	99.5	90.7

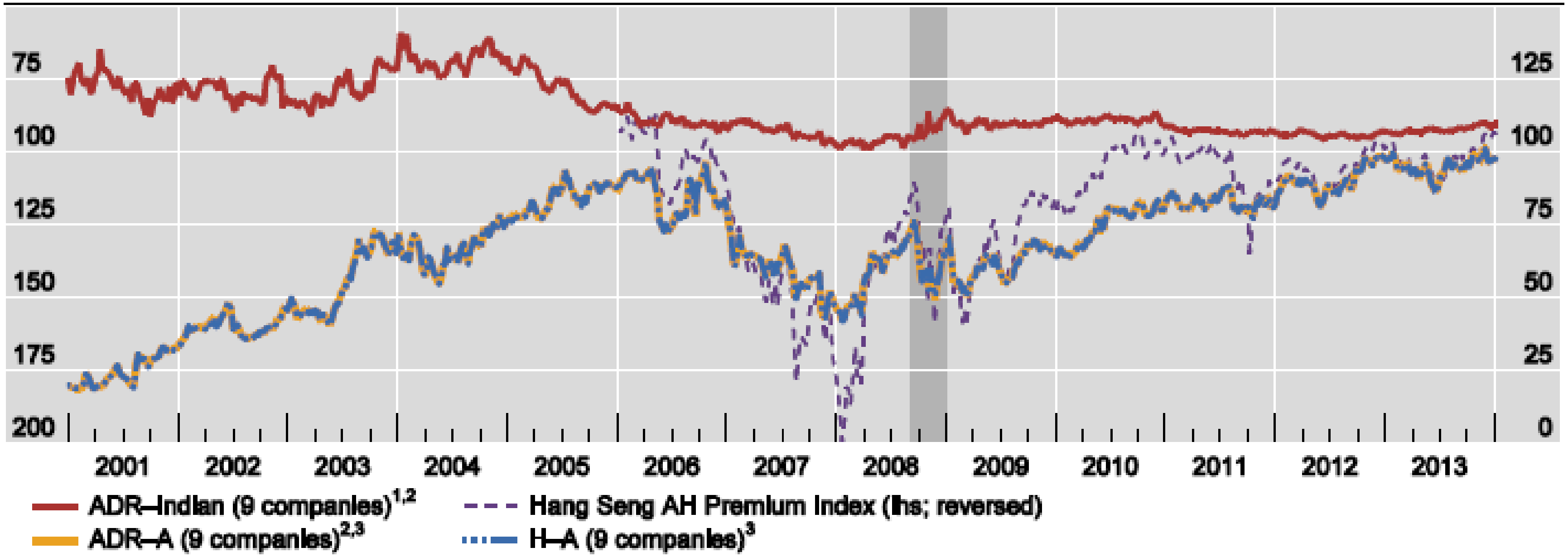
3. Stock price gap: Shanghai premium and Mumbai discount

- Lately, both Shanghai premium and Mumbai discount have been vanishing rapidly.
- The new Shanghai-Hong Kong Stock connect in fact witnessed much more “northbound flows” and “southbound flows”.

Ratios of overseas share prices to equivalent local share prices

In per cent; weekly average

Graph 4



India has been more open on average, but China catches up fast

- Benchmarking against Hong Kong as a real-world case of perfect capital mobility, both Shanghai and Hong Kong still have some way to go.

Table 3 Ratios of Overseas Share Prices to Local Share Prices and Convergence Speed

	H-A ratio 41 dual-listed companies	H-A ratio 9 triple-listed companies	ADR-A ratio 9 triple-listed companies	ADR-H ratio 9 triple-listed companies	ADR-India ratio 9 dual-listed companies
Period average (%)[1,2]					
Pre crisis	53.10	53.30	53.30	99.89	128.89
Post crisis	87.67	79.99	79.93	99.98	108.07
Full sample	64.91	62.29	62.25	99.91	121.64
Estimated half-life (days)[2,3]					
Pre crisis	255	125	111	1	35
Post crisis	109	213	162	1	13
Full sample	259	174	142	1	49

Implications for China's capital opening

Some stylized facts

- Big current surplus for the past decade
- Concurrently large net private capital inflows
- Consequently, big official reserves buildup

The consensus view

- Asymmetric control controls restricting private capital outflows
- Fuller capital account liberalization points to bigger private gross external positions and rising net private net external assets
- Mostly focusing on direct and portfolio investment flows
- **A big hole: price signals and bank flows**

Table 4: Impact of capital account liberalization in China on direct and portfolio investment (stock adjustment as percent of GDP)

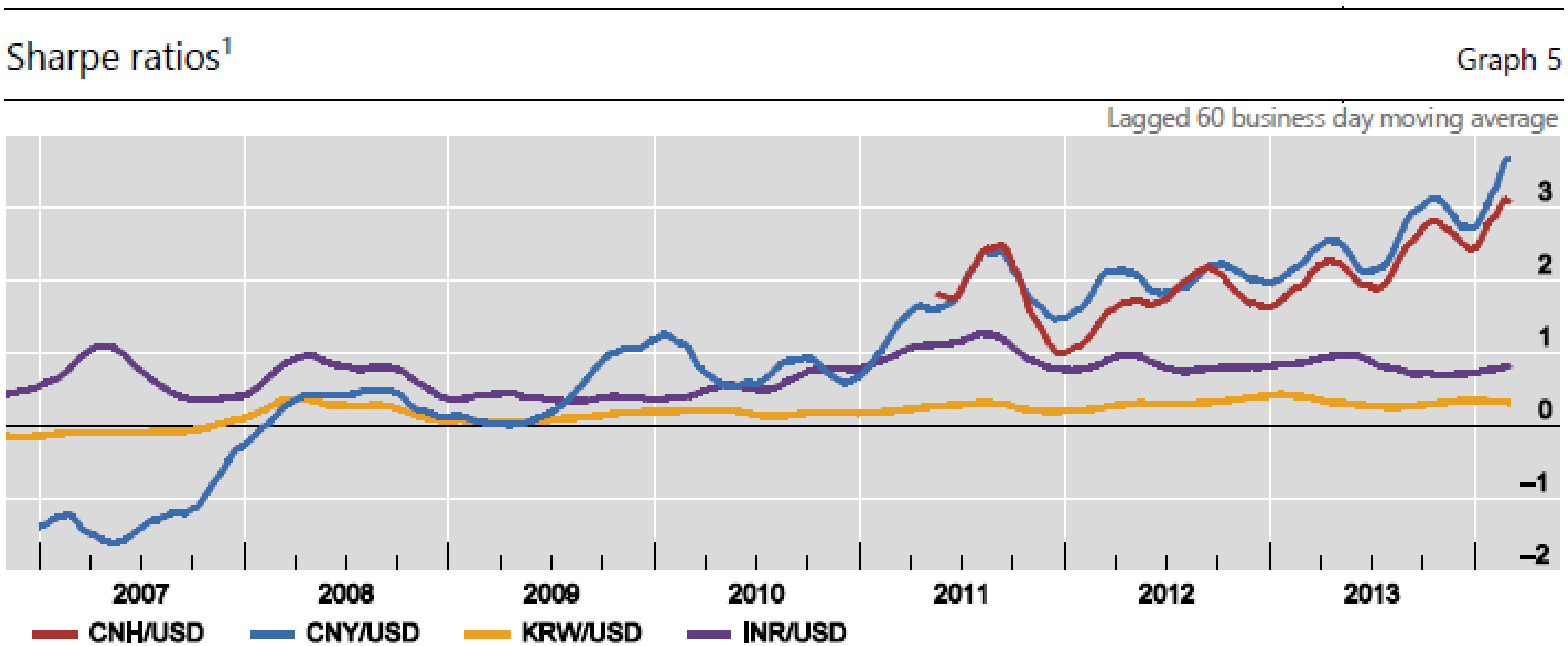
	Bayoumi & Ornsorge (2013)		He et al (2012) I 2020	*Memo: Actual 2010*
		adjusted for smaller domestic stocks		
FDI assets			21.6	*5.3*
FDI liabilities			11.2	*25.1*
Net FDI			10.4	*-19.8*
Portfolio assets	15.4-24.9	9.4-15.1	24.2	*4.3*
Portfolio liabilities	1.7-9.9	1.7-9.9	16.4	*3.8*
Net portfolio	10.7-18.1	4.1-8.2	7.7	*0.6*

What about prices and bank flows?

- The new Shanghai-Hong Kong stock connect already challenges such so-called consensus:
  - ✓"Northbound flows" 3 times bigger than "Southbound flows"
- Our insight: binding capital controls allow different forwards and money yields onshore and offshore
  - ✓These price gaps tend to favor bank inflows into China
- China's gross bank flows are huge (50%), and prices can be a major catalyst to bank flow dynamics
  - ✓In the short term, China may face strong inflow pressure!

Sharpe ratios suggest the CNY is an attractive carry-trade target

- Over the past three years, the Sharpe ratio of the CNY is 4 to 10 times higher than those of its emerging market peers, attractive carry trading of CNY.
- Thus strong incentives for bank and fixed-income inflows.

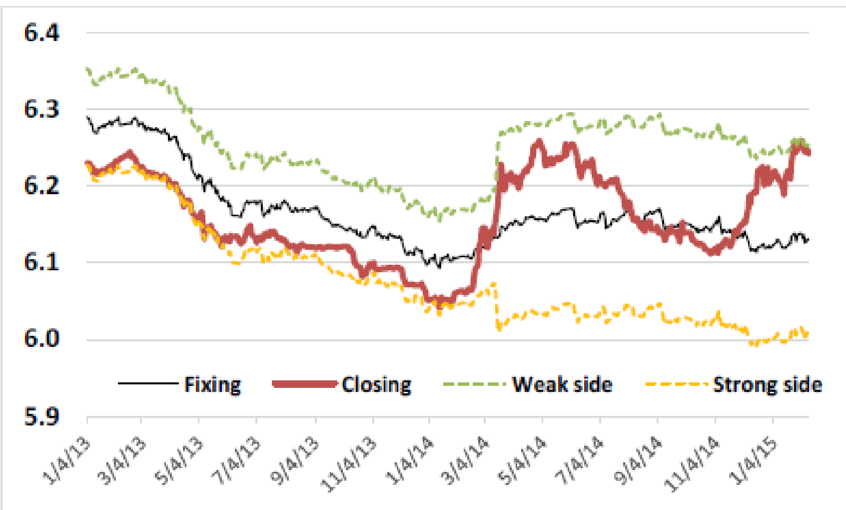


Why the latest RMB weakness vs US$?

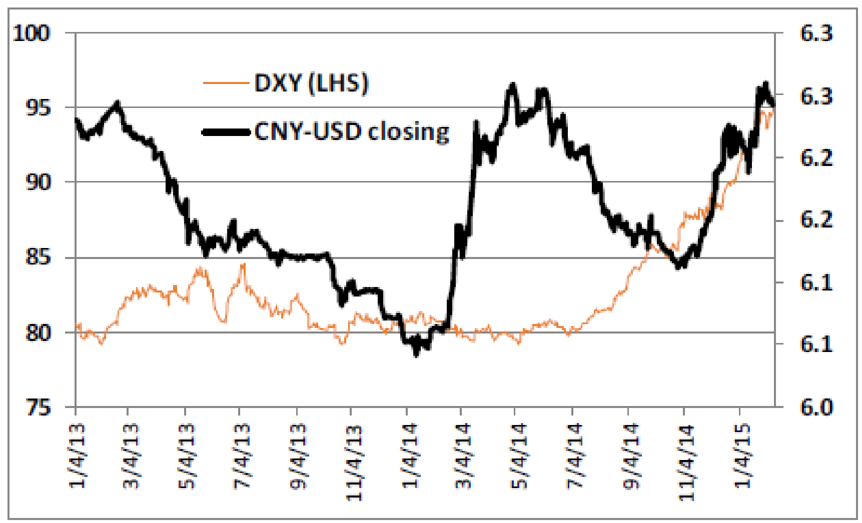
- A mighty US$, divergent US-China monetary policy, valuation concerns, worries about a more fragile Chinese financial system, and a less interventionist PBC.
- Swings in currency expectations, narrower expected rate differentials and higher currency volatility mean a lower Sharpe ratio, prompting unwinding of carry trade.

The RMB daily trading band and the USD Index **Figure 1**

RMB per US$[1]



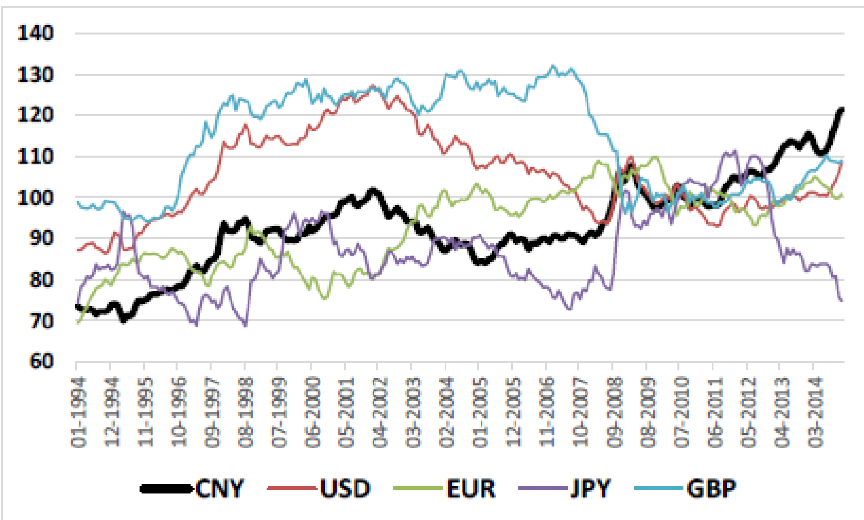
The USD Index and the CNY-USD Rate[2]



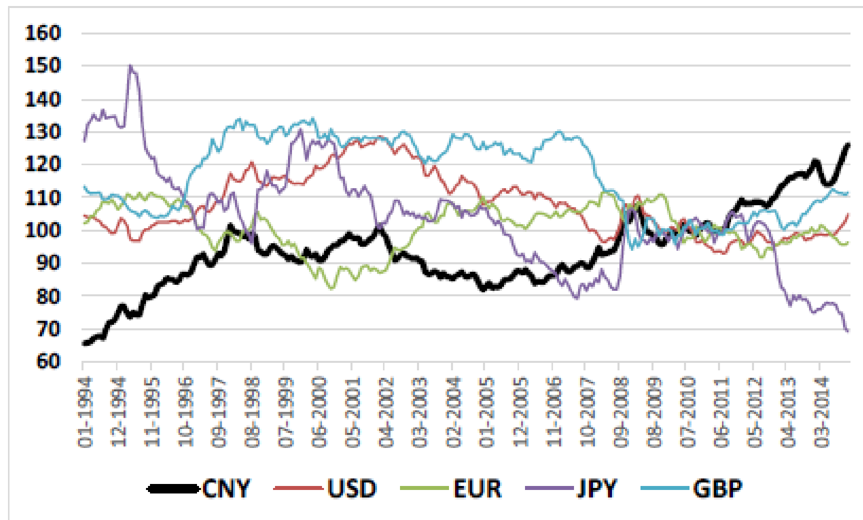
RMB trades weaker vs US$ but remains one of the few strong currencies globally

The NEER and REER of the big five currencies (2010 = 100) **Figure 1**

NEER[1]



REER[2]



[1] 2010 = 100 [2] 2010 = 100

Summary

- Our updated evidence still ranks India financially more open than China over the past decade
    - ✓But China is catching up fast since the GFC
- Tensions between our short-term inflow pressures and the consensus medium-term net private outflows
    - ✓Price signals, bank flows and capital flow volatility
- Financial stress and Fed normalization may have combined to trigger unstable private capital outflows near-term
- Fuller exchange and interest rate liberalization ahead of big breakthrough in capital opening still the best course of action

FUNG GLOBAL INSTITUTE

Asian Perspectives Global Issues

Fung Global Institute

Cyberport 1, Level 12
100 Cyberport Road
Hong Kong
Tel: (852) 2300 2728
Fax: (852) 2300 2729

www.fungglobalinstitute.org