India’s openness on the capital account

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Outline

- India's openness on the capital account
- Interest Parity
- Forward market mispricing

India’s openness on the capital account

Gross capital inflows

(Gross inflows, percent to GDP)

Year	Total	Private
1991-92	11.59	8.81
1995-96	7.22	6.34
2002-03	9.75	9.19

What changed!?

Elements of openness

Current account The current account was sharply liberalised in the 1990s, and is a well known channel for evading capital controls.

Investment flows FDI, foreign portfolio investment, outward flows: These are new, and least-controlled.

“Other capital flows” These may play a role in evasion of capital controls.

Loans These are subject to significant restrictions.

Banking flows RBI has detailed control on capital flows intermediated by banks - e.g. RBI sets the *interest rate* on “NRI deposits”.

Growth of current account

	1991-92	2001-02	1991-92	2001-02
	(Billion USD)		(Percent to GDP)	
Merchandise				
Exports	18.3	44.0	6.9	9.3
Imports	21.0	51.6	7.9	11.9
Invisibles				
Exports	9.5	36.7	3.6	7.4
Imports	7.9	23.2	2.9	4.5
Sum	56.7	155.5	21.3	33.1

Growth and deregulation of capital account

(Gross private flows, percent to GDP)

	1990-91	1995-96	2000-01
Investment flows	0.05	1.99	5.92
Other capital flows	1.85	1.20	1.88
Loans	3.76	4.62	8.16
Banking flows	8.40	3.63	5.63
Total	14.07	11.43	21.59

Gross private flows (capital + capital account) From $\approx$ 35% of GDP to $\approx$ 55% of GDP in a decade.

Interest Parity

Uncovered Interest Parity

- Return on rupee deposits
- Expected depreciation

Covered Interest Parity

- Return on rupee deposits
- Arbitrage
- Forward premium

Restrictions on the INR/USD forward market

- Most direct participants in the current account and the capital account *are* permitted to do “hedging” transactions.
- In a normal currency forward market, covered interest parity determines the forward premium.
- RBI mostly prohibits currency forward arbitrage - so CIP is broken.
- Errors between fair value and market value are arbitrage opportunities.

Measurement of currency expectations

- An extensive literature is based on measures of currency expectations.
- They impact on market microstructure, capital flows, etc.
- In pegged regimes, currency expectations are very important, since they shape capital surges, speculative attacks, etc.
- Typically based on survey evidence.
- Example: *Currency forecasters digest* (CFD), now called *Financial Times currency forecaster*.
- There is no comparable dataset in India.

The forward market!

- CIP arbitrage is blocked by the rules.
- RBI generally does not manipulate forward prices.
- *The forward premium ends up reflecting contemporary speculative views about the rupee.*
  Example: If rupee appreciation is expected, the exporter hedges but the importer does not. This puts downward pressure on the forward premium.
- This is a unique source of data about expectations – daily frequency, not merely a survey.
- *Note*: Agents do not forecast economic fundamentals; they are just forecasting the behaviour of RBI.

Fair value versus market value