How to manage the offshore rupee market

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The Reserve Bank of India (RBI) task force on offshore rupee markets recently submitted its report. The rationale for the existence and use of offshore markets for foreign exchange is rooted in capital controls. The expansion in cross-border capital flows coupled with capital controls led to the demand for non-deliverable forwards (NDF) on the part of those who have restricted access to onshore forwards markets and seek to hedge foreign exchange rate movements. Expectedly, the market is dominated by Asian and Latin American currencies subject to convertibility constraints.

The market for rupee NDF took off during the 1990s and has expanded since. Though it is difficult to measure fully, the Bank of International Settlements (BIS) estimated the average daily turnover in the offshore market for the rupee at $16.42 billion in 2016, compared to the total foreign exchange over the counter market turnover of $34.94 billion. Given the size of the offshore market, it can have ramifications for exchange rate management by the RBI. For example, during the steep depreciation of the rupee in 2013, it was argued that the NDF market disrupted the domestic market for foreign exchange. Such an impact rests heavily on the premise of a feedback loop between offshore and onshore prices.

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While the empirical evidence across countries is not definitive on whether onshore prices are affected by NDF or vice versa, the two are certainly associated. The report affirms that there are price linkages between the offshore and the onshore market, where the former influences the latter during periods of exchange rate pressure. This is intuitive, since during periods of pronounced external imbalances the offshore market may fully price expectations that are not priced into tightly regulated onshore markets.

The task force has proceeded on the basis that the existing framework for capital account management will continue. The persistence of controls implies that the market for NDF will not dissipate. Therefore, the challenge is to increase the RBI's reach in offshore markets that are at the moment highly liquid and concentrated in jurisdictions such as London, Singapore and Dubai. The main concern for policymakers is that information on trades in these markets may not be fully observed. An accurate estimation of these trades and, therefore, of exchange rates can be useful for better exchange rate management.

International experience tells us that varied approaches can be adopted to deal with offshore markets. It could entail allowing domestic agents to participate in offshore markets or bringing the market onshore by calibrating restrictions on participation. Even within these two broad alternatives the design of the solution is nuanced across developing countries and, admittedly, must be tailored to the needs of the economy. Given that India remains committed to capital controls, the dilemma for policymakers is how to bring this market to India while keeping NDFs and onshore markets segmented.

The International Financial Services Centre (IFSC) offers a reasonable solution to this problem, since capital controls under the Foreign Exchange Management Act, 1999, do not apply. As for segmenting the two markets, it is recommended that allowing only certain approved entities and distinct net open positions should be allowed, and domestic banks should be restricted from participating. In principle, the proposal seems tenable, but the main consideration remains — how to incentivise the shift of offshore volumes to IFSC. Unless a specific gain is foreseeable from shifting the activity to IFSC, a fund or an investor may continue to operate in international financial centres such as London.

Other than extending market hours and easing KYC norms, the report predictably recommends greater tax certainty and incentives. In so far as clarity in the application of the law is concerned, it has been repeatedly observed to be uncertain, and the point is well taken. A definite method must be prescribed for classification of income derived from currency derivatives, though the extent of this problem for tax-exempt entities in IFSCs is not clear. Further, the recommendation that the tax regime be aligned with offshore financial centres is ambiguous.

For one, each country taxes income from derivative trading differently. Often, for the purpose of tax planning, funds operating in derivative markets are domiciled in low-tax jurisdictions. One study estimates that in 2015, a fourth of global hedge funds were legally registered in the Cayman Islands. Other structures being used include tax transparent entities. Further, tax exemption is already in place for units operating within the IFSC. To add to this, in the recent Budget, category III Alternative Investment Funds, which includes hedge funds operating in the IFSC, were also exempted from capital gains. Therefore, many incentives are already in place and to offer anything additional, if at all possible, may not be sound from the point of view of the domestic market or other financial instruments.

As is clear, the case for bringing the NDF market to the IFSC is to better manage the exchange rate. Given that the commitment to capital account management will continue, the IFSC is the only reasonable alternative. However, the extent to which the offshore markets move to the IFSC remains to be seen.

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