FPI and interest differentials

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Risk perceptions are generally high for emerging markets so debt and equity foreign portfolio flows expect a higher return. Figure 1, however, shows a steep decline in basic Indian policy repo and 10-year G-sec interest rate spreads over US rates since 2022. Figure 2 shows interest sensitive debt flows nevertheless largely increasing over this period, while equity flows fluctuate. Figure 3 shows stock market indices rising overall despite the fluctuations in equity flows. What is going on?

Figure 1: India-US interest rate differentials

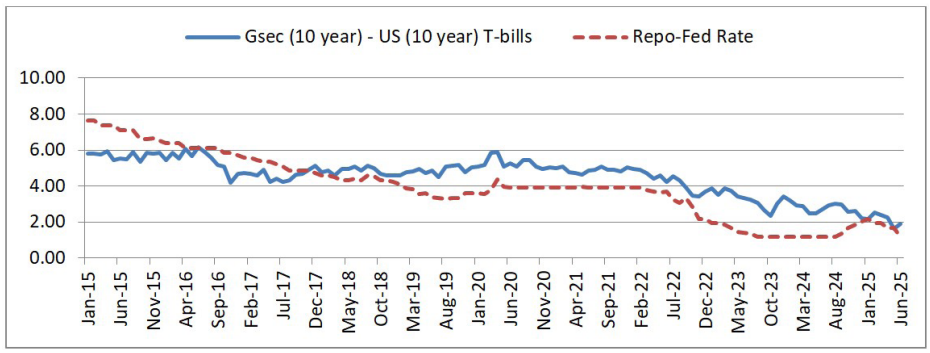


Figure 2: Equity and debt flows (USDm)

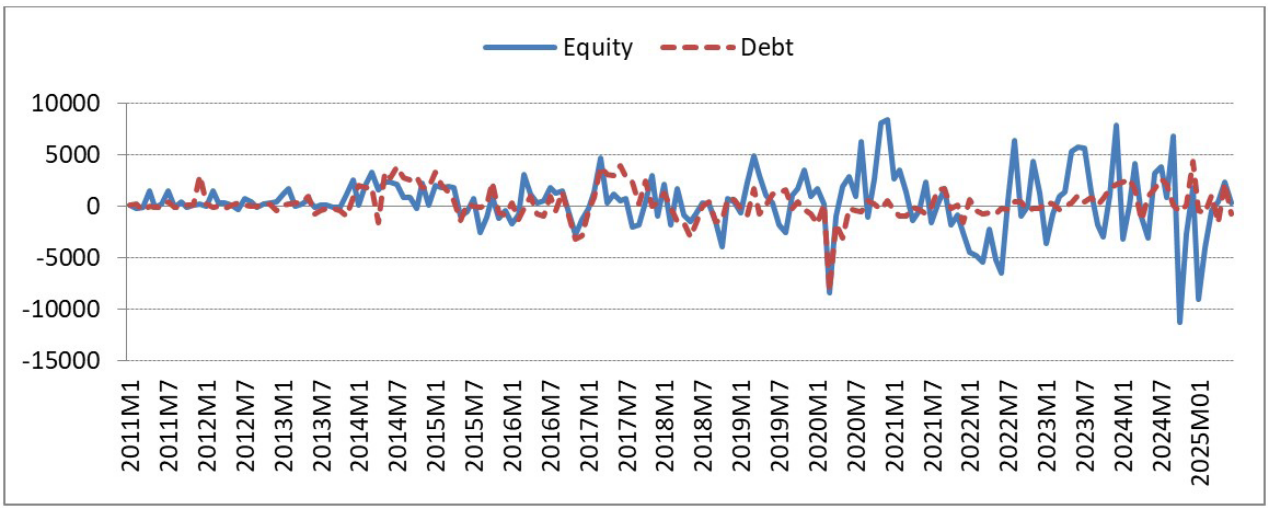
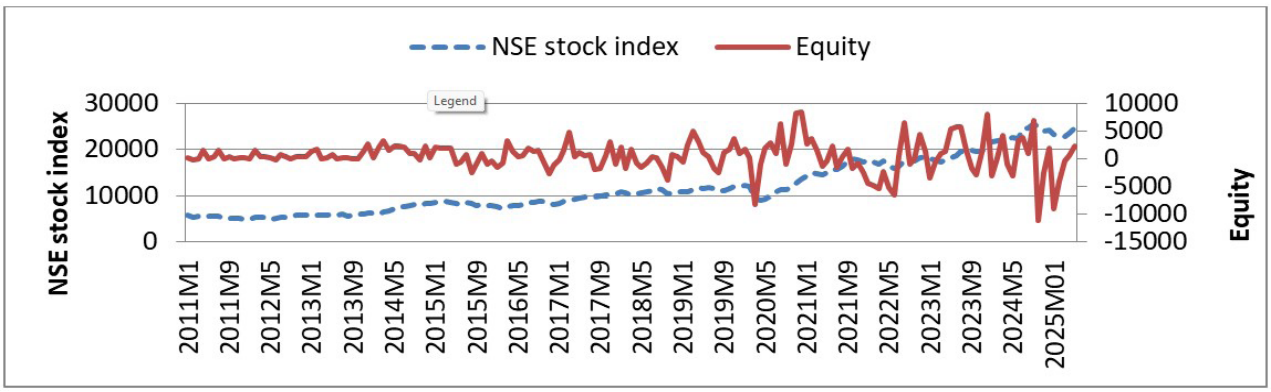


Figure 3: NSE 50 stock index and equity flows (USDm)



Aligning policy real interest rates to needs of the domestic cycle, although it means falling spreads, requires independence from US policy. This independence was needed, since following Fed tightening in 2013 and 2018 had contributed to India's decade long growth slowdown. In the post-pandemic period the MPC demonstrated that this freedom exists.

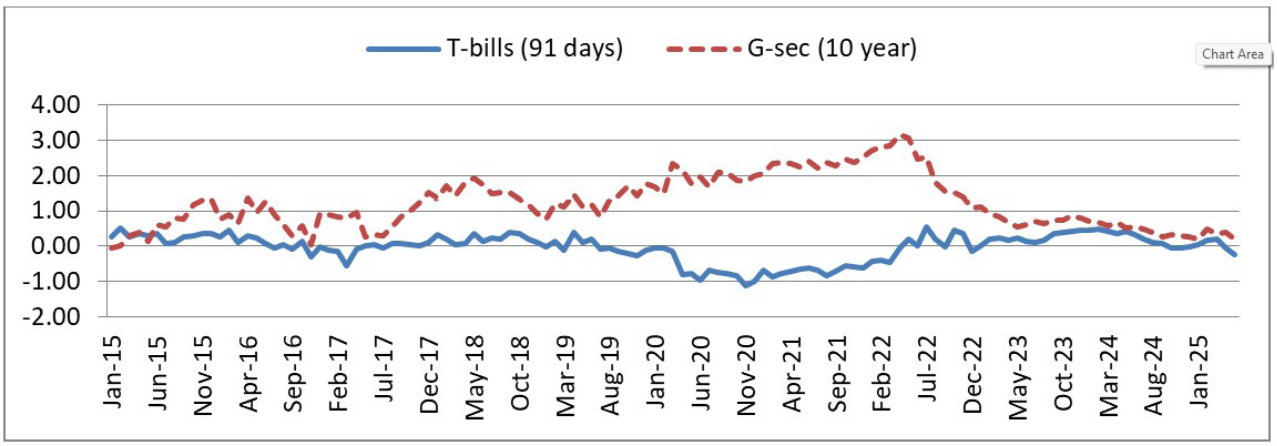
India's interest rate spreads with the US had widened during the pandemic as the Fed cut rates to zero but the MPC cut the repo only to its inflation target of 4% in mid-2020. The Fed began raising rates in March and India in May 2022. Big steps brought the Indian repo to 6.50% in February and the Fed rate to 5.25-.50% in July 2023, with respective pauses after that. The spread reached a lifetime low of 1.17 when the Fed paused, since the MPC had not continued to raise with the Fed. The spread rose somewhat when the Fed began cutting in Oct 2024 but the MPC did not cut, but fell again as the MPC began cutting in February 2025 and was back at 1.17 with its June 50bps cut.

Markets were uncomfortable with narrowing spreads especially during risk-off outflows such as after the Ukraine war broke out and again in 2023 as the MPC paused but the Fed kept raising rates. The charts, however, show that debt flows came in at lower spreads over risk free US rates and equity markets are now deep and diverse enough to absorb global risk-related outflows without crashes. But market analysts are still not convinced of this and tend to worry as spreads reduce. They point towards historically high spreads. But there are reasons why the future can differ from the past and degrees of freedom exist for setting policy rates today.

Uncovered interest rate parity (UIP) tells us under arbitraging free capital flows Indian nominal interest rates must equal those of the US + expected depreciation+ country risk premium. But more stable Indian macros, lower inflation differentials and stable growth, among the highest in the world, growing economic size and diversity are all reducing country risk premium. Sensitivity to commodity prices has also waned.

Timely regulatory and other relief to the financial sector, but with sunset clauses, had prevented moral hazard, reduced risk premia and interest rate spreads. Financial and corporate balance sheets were stronger. Figure 4 gives the spread of Indian short T-bills and 10year GSecs over the policy repo rate. While liquidity and the supply-demand balance affects short term yields, additional factors such as expected inflation, growth and other factors affecting country risk influence the long term GSecs spread. This rose even when repo rates were cut to 4% after the pandemic although large durable liquidity infused made the spread on T-bills negative. But GSecs spread began to fall as macro parameters improved by end 2022. The falling spread is an indicator of falling country risk.

Figure 4: Spread of Indian T-bills and GSecs over policy repo rate



Moreover, UIP holds under free foreign inflows. Debt flows sensitive to interest differentials are still not fully free in India. Carefully sequenced moves towards capital account convertibility had started by freeing equity inflows, while caps on debt flows, especially short-term debt, flows continued.

The rationale was that even though equity flows are volatile they are at least risk sharing. Debt outflows impose a greater burden in downturns. Short-term debt is riskier since it is difficult and expensive to roll it over at crises times, as asset values fall and the currency depreciates. Moreover, higher growth attracts equity flows and lower interest rates encourage growth. But debt flows come into government or corporate bonds to earn an interest differential, so outflows affect domestic interest rates in addition to the exchange rate, when debt flows are free and large as in advanced economies (AEs) and many emerging markets (EMs). Policy has to raise interest rates to retain debt flows, thus hurting growth, as well as equity flows. The inflationary impact of depreciation and rising risk premiums can stall a policy rate cutting cycle. Depreciation also reduces returns to both debt and equity foreign portfolio flows (FPI).

Financial liberalization was based on the realization that controlled markets can be fragile. Since thin markets are also volatile, however, the aim was to liberalize in line with growing depth and diversity of domestic markets. The extent of liberalization was to be appropriate for the current structure, while reforms made that structure more shock-resistant.

The surges and sudden stops in capital flows EMs face create too much volatility in thin markets. If foreign flows exceed 10% of domestic markets, domestic interest rates become too volatile. This was the case in Indonesia during the taper tantrum, for example. Even post-pandemic its central bank had to follow the Fed.

Inadequate and mostly bank-based prudential regulation in AEs means capital flow volatility is most often due to global, not domestic factors—but large terms of trade, interest and exchange rate shocks that follow hurt firms. Policy in liberalized India aimed to moderate them not by controlling and freezing prices, but by appropriate intervention, working now through markets and innovative buffers designed to absorb risk. Volatility was to be sufficient to encourage hedging and market development.

As part of this process, by 2013 caps on government debt for foreign investors had been raised to USD 30 billion (overall debt limit including corporate bonds at 81 billion). But even in December 2013, after relaxation in debt caps, the share of debt securities was still small at 36 per cent of equity securities and 6 per cent of total external liabilities. So the rise in Indian yields, after the US taper-tantrum, was driven more by unnecessary policy tightening, not the debt outflows. Policy did not utilize degrees of freedom from the careful sequencing of capital account convertibility.

The next step was to move to caps on debt inflows as a percentage of the domestic market. In April 2020, in order to give FPI the freedoms needed for Indian GSecs to be included in global indices, some securities were notified under the fully accessible route (FAR) with no limits on FPI investment in these securities. On 28th June 2024, 23 GSecs were included in JP Morgan's GBI-EM Index, the beginning of this process. Two additional routes for FPI to invest in debt are the medium term framework (MTF) and the voluntary retention route (VRR). The MTF allows investment in GSecs within an overall limit, fixed as a percentage (6%) of the total outstanding stock of GSecs. VRR are broadly free of macro-prudential controls but are subject to a minimum retention period of three years.

Post pandemic, after initial outflows, total foreign debt capital in India had stayed constant at around $100bn while equity inflows had returned even as differentials narrowed in 2023. In 2024, debt inflows rose with falling country risk and moves for inclusion in foreign indices. About an additional net$25bn came in, despite spreads at only 1.17%. On 8 July, 2025, the CCIL website gave average FAR investments as 6.45% of outstanding stock. The others are much lower. Therefore capital affected by UIP is still small as a share of the market.

Moreover, returns to fixed income flows depend more on currency movements and country risk than on interest rate differentials. We have seen country risk is coming down. What about currency movements?

Volatile capital flows especially affect EM exchange rates. The magnitude of expected depreciation is normally high for EMs, although that depreciation maybe only rarely observed in the data and is largely due to global, not domestic factors. Expectations of exchange rate fluctuations and policy uncertainty contribute to the excess premium global investors charge from EMs. The UIP risk premium averages about 3%, raising borrowing costs.

For EMs the interest rate differential (IRD) is always positive. Episodes of sharp depreciation are not fully offset by appreciation, whereas in AEs there is more even two-way movement. Volatility is more variable across EMs. If appreciation follows depreciation it reduces the need for interest rates to rise and impact the IRD, which, therefore tends to be near-zero or negative for AEs. But IRD overcompensates and exceeds depreciation in EMs.

Therefore, a free float can be too volatile in EMs and raise borrowing costs. Depreciation can lead to further outflows and self-fulfilling depreciation. An EM with flexible exchange rates, therefore, requires additional instruments to mitigate this excess volatility, which often results in persistent real deviation from competitive exchange rates, which hurts export and growth.

Markets tend to have more confidence in countries with large buffers for self-insurance. Intervention can also abort pass-through to inflation from exchange rate over-depreciation. On average, the frequency of use of prudential FX policy is, therefore, much higher in EMs than in AEs.

The Indian exchange rate after the 1990s reform was market-determined with intervention to reduce excess volatility. After the global financial crisis in 2008, however, intervention became minimal because of the fear that FX markets were now too large. Volatility peaked, but intervention resumed and successfully brought it down.

Despite the many shocks of the post-pandemic period, multiple instruments such as India's large FX reserves and macro-prudential regulation were used to prevent excess volatility and real exchange rate misalignment during global risk-off outflows. FX reserves fell in risk-of periods but recovered as inflows returned. Risk premiums, average depreciation and the IRD fell. At times, during periods of risk-on inflows volatility fell too much, leading to complaints from markets. But the crawling depreciation regime adopted was able to prevent real appreciation despite large inflows. Although the NDF market was now very large, RBI instruments were effective. Intervention helped preserve healthy economic growth.

These many ways in which risk has reduced make lower interest rate spreads feasible. The process will continue as larger size and diversity reduces the ripple-effect of shocks and improving efficiencies and lower costs reduces bank interest margins, without compromising profitability.