Foreign Institutional Investor (FII) Flows

Some Indian Perspectives

R.K. Pattnaik and *S.N.V. Siva Kumar*

Worldwide there has been a long debate both in academic and policy circles with regard to the Foreign Institutional Investor (FII) flows, mainly due to their volatility and pro-cyclicality, and consequent adverse impact on the monetary and macro-economic management. Contemporaneous with the global debate, the issue has surfaced and resurfaced in India also in tune with the magnitude of the flows both in upswing and downswing. India has seen massive flows and sudden stops and reversals. The present article is an attempt to analyze the underlying issues and put forth some policy options. Indian approach to capital flows, especially, FII flows, has stood the test of time. The Indian authorities, with a combination of sound macroeconomic policies, prudent debt management, exchange rate flexibility, effective management of the capital account, accumulation of appropriate levels of reserves as self-insurance and development of resilient domestic financial markets, have provided a sustainable response to the large and volatile capital flows.

WORLDWIDE there has been an extensive debate both in academic and policy circles with regard to the Foreign Institutional Investor (FII) flows mainly due to volatility and pro-cyclicality, of such flows and consequent adverse impact on the monetary and macroeconomic management. It is pertinent to mention that the issue has surfaced and resurfaced in India also in tune with the magnitude of the flows both in upswing and downswing. India has seen massive flows and sudden stops. Now, there is a growing consensus that capital flows into Asia will be around US$330 billion each in 2010 and 2011. Given the Indian higher growth potential and interest rate differential analysts are expecting massive capital flows,

The authors acknowledge technical assistance received from Ms. Vandana in the preparation of this paper.

particularly in terms of FII flows. Accordingly, a question contextually is asked, should FII flows be restricted by imposing some tax (a variety of Tobin tax)? Or, Indian authorities should welcome this with appropriate policy strategies?

Against the above backdrop, the present paper is an attempt to analyze the underlying issues and put forth some policy options. The article is organized thus. Section I presents the assessment covering the definition and concept of FIIs in Indian context along with a brief account of theoretical and empirical debate including the views of policymakers in India. Section II presents the stylized facts. The issues and policy options are dealt in Section III. The concluding observations are presented in Section IV.

I

ASSESSMENT

Definition and Concept

Foreign Institutional Investment in India, is a part of portfolio investment, according to the International Monetary Fund (IMF) *Balance of Payment Manual* 6 (BPM6).

Portfolio investment is defined as cross-border transactions and positions involving debt or equity securities other than those included under direct investment or reserve assets. Thus, as reported in the Balance of Payment (BOP) Manual of Reserve Bank of India (November 2010) these investments cover all portfolio investment by overseas pension funds, mutual funds, investment trusts, asset management companies, nominee companies, banks, institutional portfolio managers, university funds, endowments, foundations, charitable trusts, charitable societies, and trustees or power of attorney holders incorporated or established outside India proposing to make proprietary investments or investments on behalf of a broad-based fund (i.e., a fund having more than 20 investors with no single investor holding more than 10 per cent of the shares or units of the fund).

Investments by FIIs are mainly in debt and equity papers, both in the secondary as well as primary markets. FII investments are generally made in existing companies. Data on FII investments in the Indian equity market are collected through custodians. All sales/purchases by FIIs are reported to the Reserve Bank of India (RBI) by custodian banks on a daily basis. The RBI monitors FIIs' adherence to the overall cap of 24 per cent/sectoral cap. The individual FII limit of 10 per cent/NRI limit of 5 per cent is monitored by custodian banks. Purchases made by FIIs in both debt and equities in the Indian capital market are included under credit (inflows), while sales by FIIs are included under debit (outflows). Thus, FII investment in India is recorded on a gross basis.

In the hierarchy of capital flows, conceptually, portfolio flows are regarded as speculative flows, more volatile and also termed as *"Hot Money"* in comparison to foreign direct investment because of herd behaviour and potential for large outflows. In view of this, the emerging market economies have put restrictions in terms of quantity or price. In India also there are quantitative restrictions in debt flows (up to US$20 billion in corporate debt and US$10 billion in Government approved securities) and price restrictions in terms of withholding tax.

Pros and Cons of Capital Flows: Theoretical and Empirical Literature

There has been a growing and extensive academic debate on this topic. It is held that this debate, though somewhat inconclusive on the surface, however, yields several valuable insights on closer inspection. The theoretical arguments based on the standard neoclassical paradigm state that capital flows enhance economic growth by supplementing domestic savings and investment through external capital. The empirical studies mostly contradict the theory, as the studies did not find any unconditional positive growth effects. Studies by Echingreen (2001), Edison *et al.* (2004), Edwards (2001), Henry (2003, 2007), Prasad *et al.* (2004), Rodrik (1998), Reinhart & Reinhart (2004) are a few much-quoted cross-country empirical studies. It is of interest to note that though these studies were unable to establish any unequivocal relationship of growth and capital flows, there was, however, a mention to "collateral benefits" in terms of development of domestic financial markets, promotion of financial discipline, reduction of borrowing cost and better governance.

While commenting on the benefit and cost of capital flows, Bank for International Settlements (BIS) Report 2009 (Chairman: Dr. Rakesh Mohan) observed that in practice capital flows in terms of sheer size, volatility and form have very often put emerging market economies in major difficulties in macro economic and monetary management. This view is also corroborated by the Mundel-Fleming theory of *"Impossible Trinity",* i.e. the open capital account interferes with simultaneous management of fixed/managed exchange rate and independent monetary policy.

It is also held that FII flows which are generally speculative in their constant *"search for yield"* and have the potential of an asset price bubble or burst thus a threat to financial instability and thereby lead to output and employment loss in the destination economy.

As regards the determinants of capital flows the literature usually distinguishes between country-specific "pull' factors (openness of domestic financial market, credible macro policies, fiscal policy) and "push" factors (interest rate differential between developed countries and EMEs, lower returns and volatility, and tightening regulatory pressures in developed markets).

In response to the rebound of capital flows, particularly portfolio flows, two IMF papers (IMF 2011 and IMF 2011a) have mentioned that emerging market economies (EMEs) are experiencing a surge in capital inflows, lifting asset prices and growth prospects. While inflows are typically beneficial for receiving countries, inflow surges can carry macroeconomic and financial stability risks. This paper reviews the recent experience of EMEs in dealing with capital inflows and suggests a possible framework for IMF policy advice on the spectrum of measures available to policymakers to manage inflows, including macroeconomic policies, prudential measures and capital controls. Illustrative applications of this framework suggest that it may be appropriate for several countries, based on their current circumstances, to consider prudential measures or capital controls in response to capital inflows.

The IMF paper further opined that it is difficult to provide a generalized assessment regarding the effectiveness of capital flows management (CFM). The appropriate use of CFM will necessarily be determined by the particular macroeconomic, institutional, and market circumstances faced by each country. To the extent that appropriate macroeconomic adjustment has been made, these measures may be complementary to – rather than a substitute for –macroeconomic policy responses.

Views of the Indian Policymakers

It may be recalled that the High level Committee on Balance of Payments, 1992 under the chairmanship of Dr. C. Rangarajan set the broad approach of external sector reform and also FII flows with a cautious policy approach to short term debt creating flows. Since then, India has seen "massive" capital flows in 2007-08, "sudden stop" in 2008-09, "reversal" in 2009-10 and the potential for higher flows in the near future. In the following discussions the views of Dr. Y.V. Reddy (January 2008) former Governor RBI, who designed the policies to manage the massive flows in 2007-08 and the present Governor Dr. D. Subbarao (May 2010 and August 2010), who designed the policies for sudden stop in 2008-09, recovery in 2009-10 and currently the potential of a large flow.

Dr. Reddy opined that appropriate management of capital account is critical for both growth and stability. To the extent monetary and exchange rate management are very complex in the context of well known *trilemma*, Dr. Reddy recommended the following:

First, all large capital flows are treated as temporary and if these flows result in excess volatility in the forex markets, some intervention is necessary.

Second, timing and quantum of sterilized intervention need to be made in conjunction with domestic and liquidity conditions.

Third, operationally, the issue is often not "which" instrument but "how much" of each instrument needs to be utilized with due regard to capital flows, market conditions and monetary as well as credit developments.

Fourth, enlargement of absorptive capacity is an appropriate approach, but only to the limit of sustainable levels and is achievable over medium terms under normal circumstances.

Fifth, liberalizing outflows may not be of great help in the short run because greater liberalized regime generally attracts more inflows.

According to Governor D. Subbarao, capital flows are important to meet the investment needs of EMEs. To manage the adverse macroeconomic impact of volatile capital flows three options are: (a) do nothing (exchange rate option) in which exchange rate will appreciate; (b) allow the flows to come in but intervene in the forex market (reserve accumulation options); and (c) deploy capital controls–Tobin tax type. Against this backdrop, Governor Subbarao mentioned that Tobin tax type is not currently contemplated but no policy instrument is clearly off the table. To the question "are capital controls an appropriate mechanism for managing capital account? The answer of the Governor is a qualified "yes".

The Chief Economic Adviser of Government of India, Dr. Kausik Basu (December 2010) in a press interview mentioned that excessive capital flows may force policy rethink, if necessary. According to him, the best course is market-based intervention; this is what the RBI does. If one has to go further, preference could be given to tax-based intervention.

Finally, there could be capital controls as happened in South Korea and Taiwan.

Governor Subbarao in April 2011 has mentioned that since capital flows have become such an emotive topic around the world over recent months, it is important to be mindful of a few realities. First, EMEs do need capital flows to augment their investible resources, but such flows should meet two criteria: they should be stable; and they should also be roughly equal to the economy's absorptive capacity. The second reality that we must remember is that capital flows are triggered by both the pull and push factors. The pull factors are the promising growth prospects of EMEs, their declining trend rates of inflation, capital account liberalization, and improved governance. Among the push factors are the easy monetary policies of advanced economies which create the capital that flows into the EMEs. The RBI Governor has further mentioned that to the extent that lumpy and volatile flows are a spillover from policy choices of advanced economies, managing capital flows should not be treated as an exclusive problem of emerging market economies. How this burden is to be shared raises both intellectual and practical challenges. The intellectual challenge is to build a better understanding of the forces driving capital flows, what type of policy instruments, including capital controls, and work in what situations. The practical challenge is the need to reach a shared understanding on an organizing framework for cross-border spillovers of domestic policies in capital-originating countries, and the gamut of policy responses by capital receiving countries.

II

STYLIZED FACTS

Net Capital flows into India till fiscal 2003-04 were modest at around US$10 billion at a maximum during 2002-03. It jumped to US$17 billion in 2003-04, and further increased to US$28 billion in 2004-05. Subsequently, the net capital inflows became massive in 2007-08 at around 8.7 per cent of GDP. Due to knock-on effect of economic-crisis there was outflow of FII in net terms during 2008-09 to the tune of US$15 billion. However, the quick reversal took place in 2009-10, as FII net inflows recoded a sharp rise and accounted for 2.3 per cent of GDP which was a record. Continuing the momentum, during April-February of 2010-11 FII inflows amounted to US$29.4 billion.

In the above context, it is of interest to analyze the impact and management of such inflows.

FII Flows, Capital Flows, Current Account Deficit and Foreign Exchange Reserves

FII flows and capital flows broadly had a co-movement in terms of magnitude and direction (Chart 1).

Furthermore, the Current Account Deficit (CAD), which was of lesser order till 2004-05, showed some increases, and gradually the magnitude became substantial. For example, during 2009-10 CAD as a percentage of GDP was around 2.9 per cent as against 2.4 per cent in 2008-09 and 1 per cent in 2006-07. Net capital flows, even after financing current account deficit, had resulted in substantial accumulation in foreign exchange reserves (Chart 2). Capital flows in excess of CAD was US$15 billion in 2009-10 as against a shortfall of around US$22 billion in 2008-09 and a record excess of around US$91 billion in 2007-08.

Monetary and Liquidity Management by RBI

The co-movement of capital flows and FII flows as discussed above reflects that there is no law of capital flows or any reliable tendency, i.e. they never come in at the precise time or in the exact quantity as appropriate for the economy. Therefore, managing these flows had built-up pressure in the monetary and exchange rate management of RBI. On account of this development RBI, apart from market intervention had also undertaken policy measures which includes upward/downwards revision of repo, reverse repo and Cash Reserve Ratio and introduction of a new instrument called Market Stabilization Scheme (MSS).

Capital Flow and Movement in Exchange Rate

The exchange rate policy of RBI is not guided by a fixed or pre-announced target or ban. The policy is to intervene in the market to manage excess volatility. It is pertinent to note that this "volatility-centric approach" to exchange rate had by and large followed from the large volatility of capital flow, especially, FII flows. For example, during 2008-09 due to large FII outflow rupee depreciated against US dollar by 21.5 per cent and appreciated against the US dollar during 2009-10 by around 13 per cent and further appreciated by 1.3 per cent during current year so far up to October 2010 over end March 2010. However, movements in Real Effective Exchange Rate (REER) and Nominal Effective Exchange Rate (NEER) of 36 countries rupee has depreciated in October 2010 over the base (Chart 3).

Market Intervention by RBI

RBI has followed two alternatives approaches to deal with the capital inflow-outflow. The first approach was to intervene in the foreign exchange market to prevent appreciation and sterilize the resultant liquidity. The second approach was not to intervene in the foreign exchange market. This was noticed in the recent period since September 2009 (Chart 4).

Impact on Capital Market

It may be recalled that FIIs have been permitted to invest in primary and secondary market effective 14 September 1992. However, their first investment was made in January 1993. FIIs operate by registration with the Securities and Exchange Board of India (SEBI) and RBI's general permission. The evolution of FII policy in India displays a steady and captious approach to liberalize the quantitative restrictions. The policy liberalization broadly include: (a) relaxation of investment limit, (b) relaxation of eligibility conditions, and (c) liberalization of investment instruments accessible for FIIs. As on 29 April 2011 there are 1,729 registered FIIs in India and the cumulative FII investment amounted to US$123.2 billion of which equity was US$103.1 billion and debt was US$20.1 billion. It may be mentioned that from April

2007 to December 2010 (Up to 8 December) 748 FIIs have been added reflecting their business interest and confidence in economic management of India. The FII turnover in equity segment in Indian stock exchanges was US$426,206 million in 2007-08 accounting for 16.6 per cent of the total turnover. Due to knock-on-effect of global crisis, the figure came down to US$226,226 million forming 15 per cent of the total turnover. Due to regulatory impact the total value of participatory notes (P-Notes) as percentage of assets under management of FIIs had decreased to 15.5 per cent as of June 2009 from 44.4 per cent as of March 2007.

Till December 1998 FII investment was in equity only. Investment in Debt was permitted in January 1999. Gradually, the limit of investment has increased. The FIIs in recent years had shown preference to debt also (Chart 5). Currently, FIIs can invest in corporate debt up to US$20 billion and US$10 billion in Government Securities.

According to the National Stock Exchange (NSE) Report 2009, the FIIs at end-March 2009 held the highest stake in the banking sector (14.7%) followed by finance (13.01%) and FMCG sector (12.72%). The total percentage share by FIIs acorss different sectors was 8.40 per cent as on end-March 2009 as against 10.62 per cent at end-March 2008 and 10.78 per cent as end-March 2007.

The FIIs interest in the Indian Stock Market can be gauged from various indicators as set out in Table below.

FII market indicators	**2006-07**	**2007-08**	**2008-09**
Traded Value/GDP	11.08	18.03	10.83
MC of FIIs/Total MC	16.10	14.66	12.50
MC of FIIs/GDP	13.14	15.08	6.80

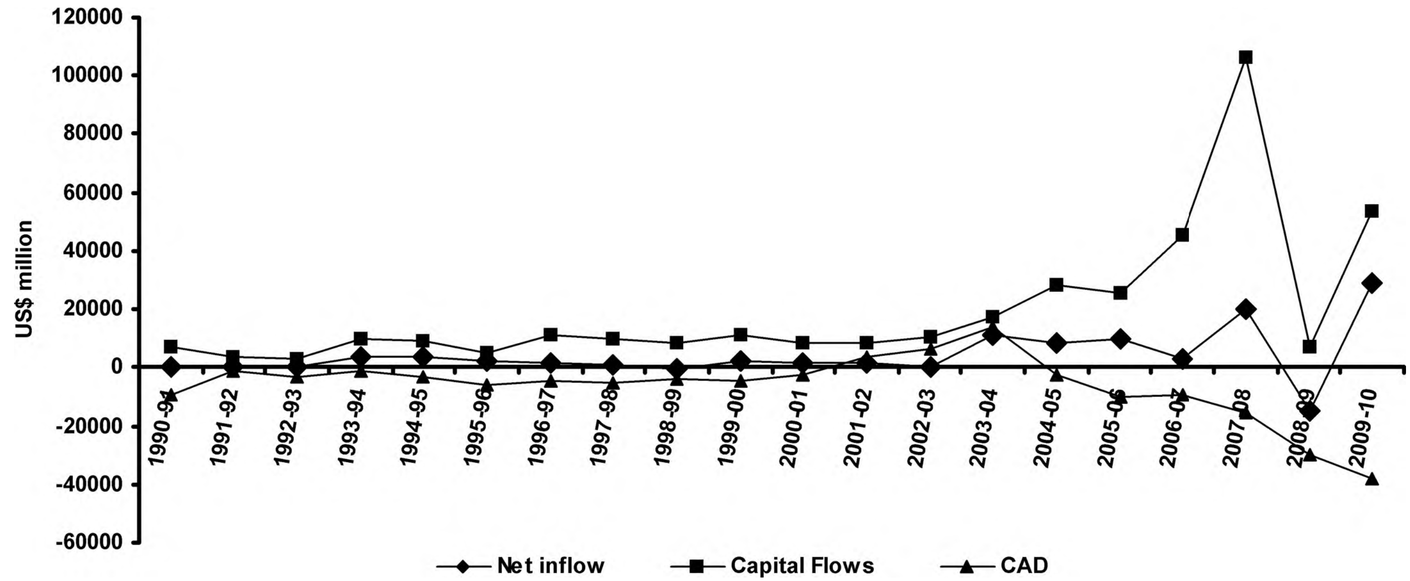
MC: Market Capitalization *Source:* NSE.

There is a strong co-movement in the FII investment and BSE Sensex (Chart 6). The Nifty Volatility Index has been low with higher FII net investment and *vice versa*. (Chart 7)

While commenting on the *en mass* exit of FIIs the Report of the Working Group on Foreign Investment, Government of India (Chairman: U.K. Sinha), July 2010 had observed that there is little evidence of *en mass* exit during the major episodes of market stress in India.

CHART 1

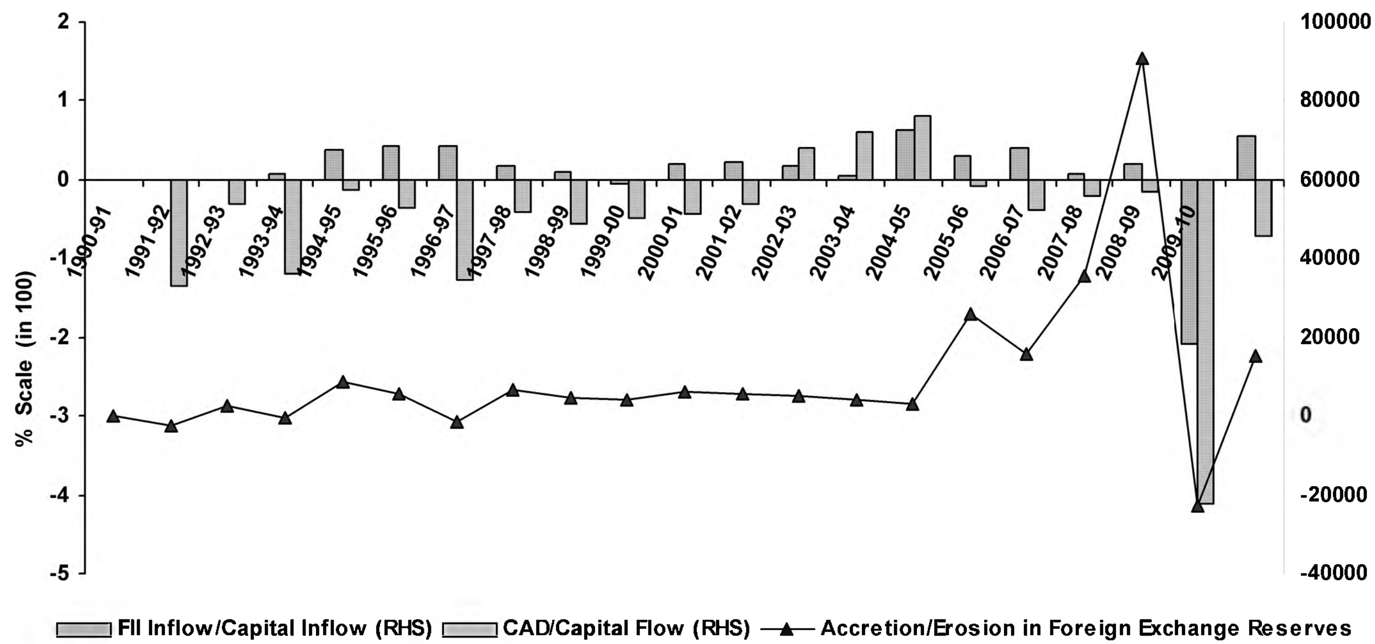
FII FLOWS, CAPITAL FLOWS AND CAD



Source: Reserve Bank of India

CHART 2

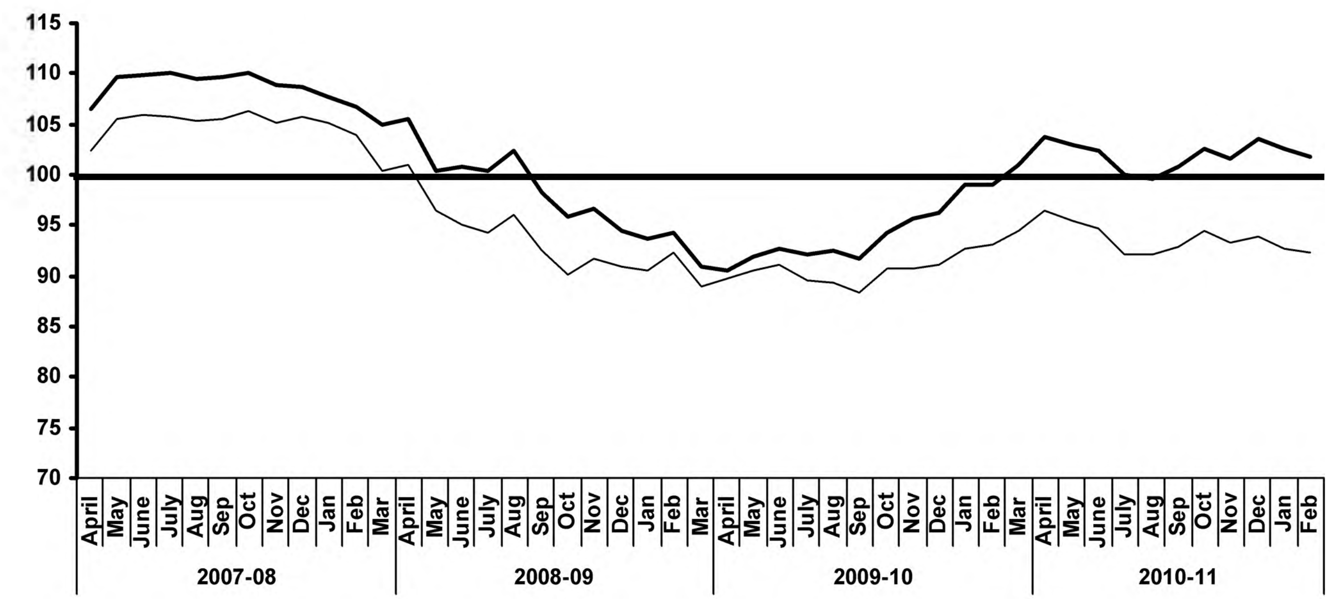
CAPITAL FLOW AND ACCRETION/EROSION TO FOREIGN EXCHANGE RESERVES



Source: Reserve Bank of India.

CHART 3

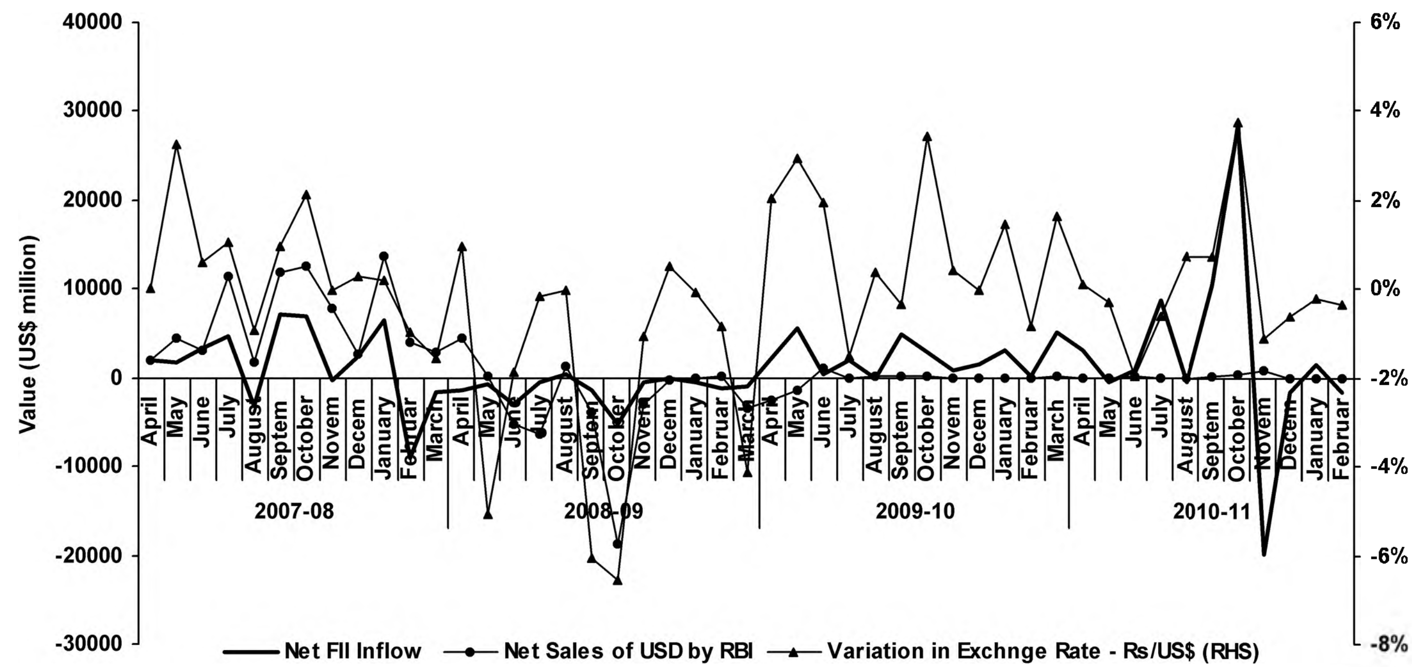
MOVEMENT IN REER AND NEER



Source: Reserve Bank of India.

CHART 4

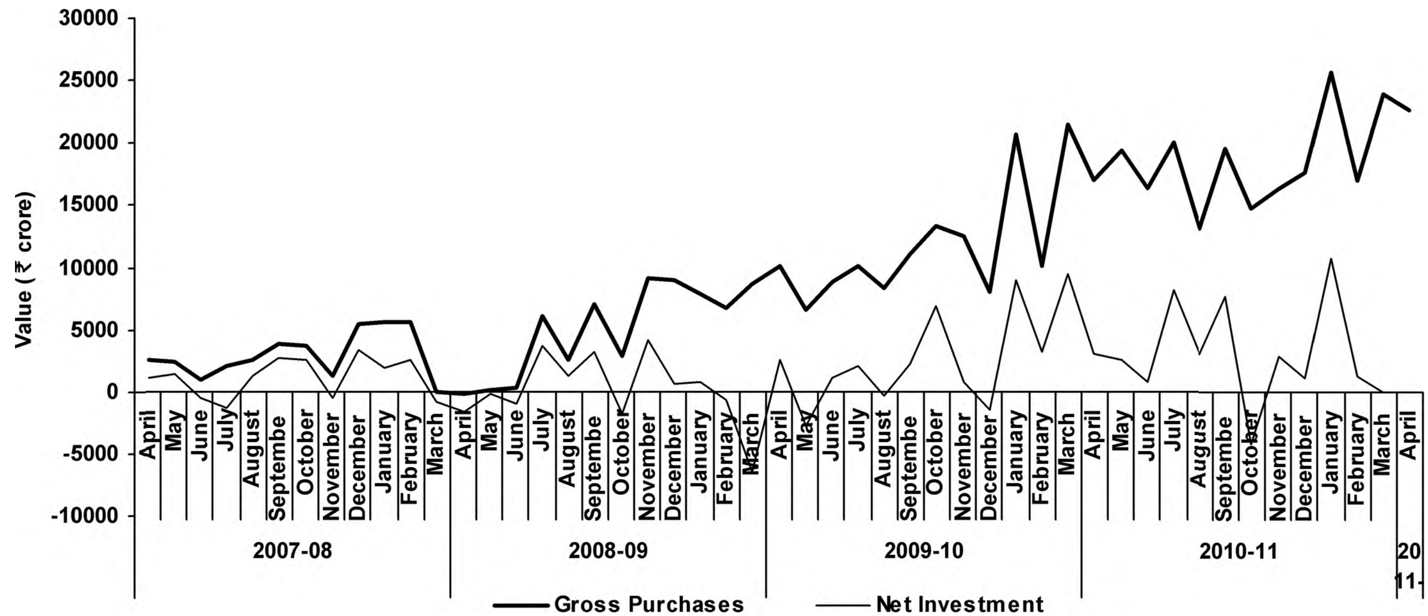
RBI INTERVENTION



Source: Reserve Bank of India.

CHART 5

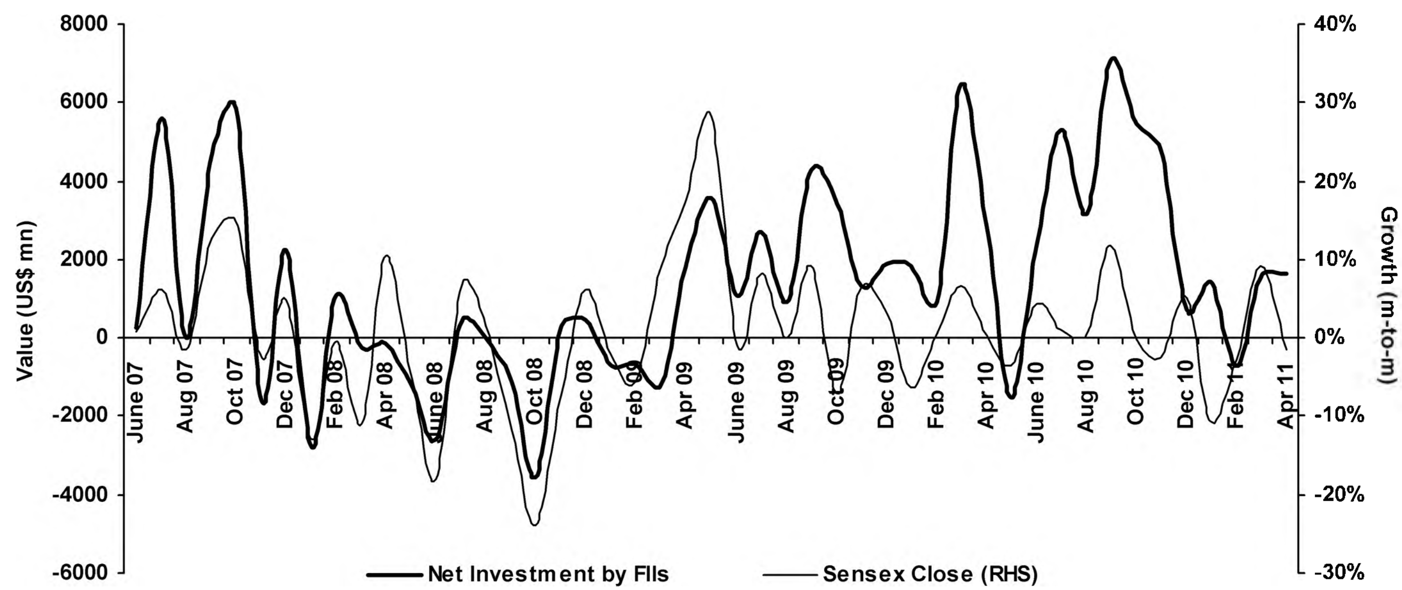
FII INVESTMENT IN DEBT



Source: Securities and Exchange Board of India

CHART 6

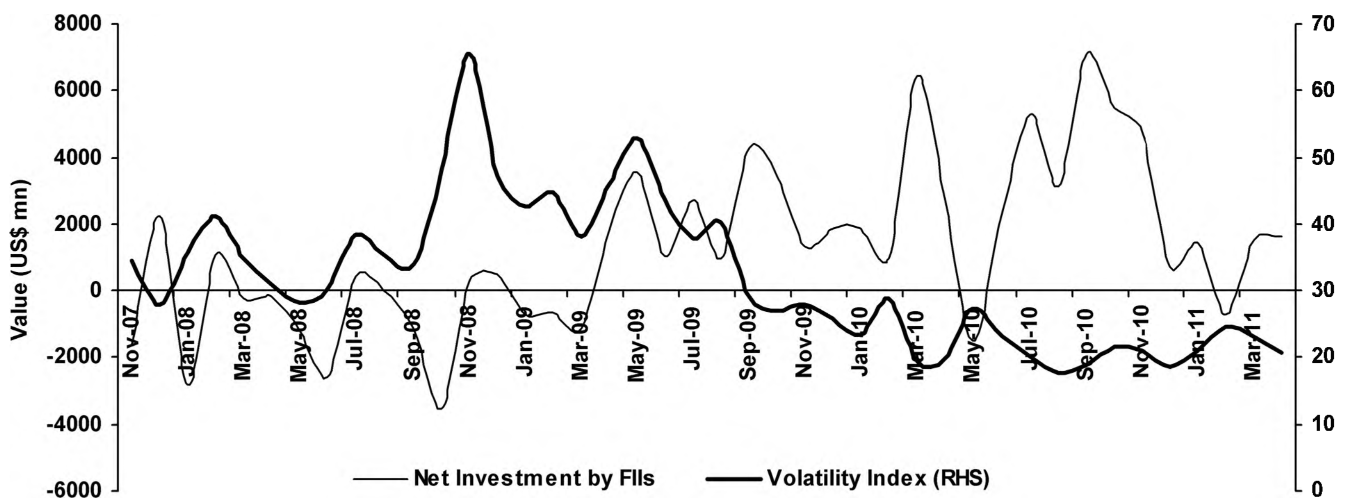
MOVEMENTS IN FII INVESTMENT AND BSE SENSEX



Source: Securities and Exchange Board of India, Bombay Stock Exchange.

CHART 7

NIFTY VOLATILITY INDEX AND FII INVESTMENT



Source: National Stock Exchange and Securities and Exchange Board of India.

III

ISSUES AND POLICY OPTIONS

Issues

Absorptive Capacity

Unlike many other Asian EMEs, India has recorded a current account deficit (CAD), which was financed by net capital flows. But the level of CAD was lower at around 1 to 1.5 per cent of GDP. The recent experience suggests the CAD-GDP ratio is increasing and way forward it is estimated that during 2010-11 this ratio would be around 3 per cent. At this level, net capital flows to the tune of US$70-80 billion could be in the medium term, and be absorbed without resorting to large sterilization measures. Notwithstanding this, it may be noted large capital inflows – whether absorbed or not – can drive up the prices of existing assets and may not lead to the creation of new assets. Asset market bubbles have been disruptive in some EMEs. Policymakers need to keep these risks in mind.

Challenges for Monetary and Exchange Rate Policy

The Indian experience of capital flows revealed that it had created challenges for monetary and exchange rate policy.

The interrelations between monetary policy, exchange rate objectives, forex intervention and domestic financial balance sheets are complex. Indian authorities followed the forex market intervention and its subsequent sterilization. The price-stability focus of monetary policy can be undermined by paying too much attention to exchange rate objectives. Over the past decade, however, Indian authorities have permitted greater flexibility in their exchange rate. Nevertheless, a prolonged period of large-scale intervention can create expectations of future exchange rate appreciation.

Capital Market Investment: Reversal of Flows

The greater presence of foreign investors should, in principle, deepen local financial markets, enhance investor diversity and improve liquidity. But they can also exacerbate the domestic macroeconomic and liquidity crisis in the times of crisis through massive liquidation of their investments in the EMEs, as has been clearly evident in the current round of turmoil. The Indian experience showed that *en mass* exit had not happened in times of market stress except in 2008-09 after the Lehman crisis of September 2008. A sophisticated and diverse domestic investor base is, therefore, also essential for enhancing the resilience of the financial system.

Quasi Fiscal and Fiscal Costs

Indian authorities had followed both market (e.g. issuing MSS bonds) and non-market (e.g. direct controls on bank lending and reserve requirements) instruments. Each instrument has its advantages and drawbacks. Choices between the different tools depend on the nature of the capital inflow shock, the macroeconomic background and the degree of development of the local financial system. The quasi-fiscal and other costs of sterilization are more likely to be outweighed by the benefits that may emanate from the maintenance of domestic macroeconomic and financial stability. Although not easily quantifiable, maintaining financial stability is of overriding importance as a policy objective, especially in a world with increasing financial globalization.

Policy Options

Sustainable CAD-GDP Ratio

One of the critical policy objectives is to maintain a sustainable CAD-GDP ratio. The Fuller Capital Account Convertibility Report (Chairman: S.S. Tarpore) had recommended this ratio at 3 per cent. In the medium term 3 per cent CAD-GDP ratio could be one of the options. Keeping in view the growth trajectory and external sector development this ratio may be reviewed.

Flexibility in Exchange Rates and Substantial Forex Reserves

With open capital accounts, apart from continued emphasis on strengthening the domestic financial systems, policy option need to be strengthened to deal with shocks from the financial systems abroad. In this context, flexibility in exchange rates can be an effective buffer to such shocks. Furthermore, the Indian authorities continue to have forex build up as a policy option as a cushion to counteract the impact of downward pressure on the exchange rate brought about by sudden and large capital outflows. Not only could they intervene on a substantial scale to counter extreme movements in the exchange rate, but they will also be able to fund banks in dollars or other foreign currencies.

Imposition of Quantitative or Price Control

It is heartening to note that Indian authorities had successfully managed the complex issues of massive capital flows, sudden stop and recovery with the package of instrument they have coupled with the flexible and volatility-centric approach of exchange rate policy. The active capital account management policy jointly undertaken by the Government of India and RBI along with the prudent monetary and exchange rate policy followed by RBI stood the test of time. With this experience, the authorities could handle the shocks from capital flows, especially, the FII flows way forward. Keeping in view, the drawbacks of backtracking, the authorities should refrain from any capital control measure either in terms of quantitative or price such as Tobin tax. However, policy response to capital flow management, in general, and FII flow in particular should have prudential control to reduce volatility and risk to financial stability.

IV

CONCLUSIONS

To conclude, Indian approach to capital flows, especially, FII flows has stood the test of time. The Indian authorities with a combination of sound macroeconomic policies, prudent debt management, exchange rate flexibility, effective management of the capital account, accumulation of appropriate levels of reserves as self-insurance and development of resilient domestic financial markets have provided a sustainable response to the large and volatile capital flows. It is desirable that way forward, the authorities should refrain themselves from imposing any price or quantity control as a policy response to shocks from capital flows.

As RBI Governor D. Subbarao has mentioned, managing capital flows involves two important things. *First*, we need to make a judgment on how important the externalities are. And, *second*, we need to make an objective assessment of what combinations of policies may be used to minimize their impact. Now that it is broadly accepted that there could be circumstances in which controls can be a legitimate component of the policy response to surges in capital flows, policymakers must have the flexibility, and discretion, to adopt macroeconomic, prudential and capital account management policies. Importantly, they should be able to do so without a sense of stigma attached to particular instruments.

In this context, it is instructive to quote Dr. Subbarao (May 2010) in its January 2010 issue the *Economist* has said capital like water tends to flow around such obstacles (taxes). Try to dam its movements at one point and slowly but remorselessly, it would find its way. To learn to "dam" the flows so the benefit of capital flows exceed the cost remains the intellectual and policy challenge for EMEs. The EMEs as policy option could emulate the Indian approach of managing capital flows.

REFERENCES

Duvvuri Subbarao (2010a), "Volatility in Capital Flows: Some Perspectives", Comments at the High Level Conference on International Monetary System, jointly organized by Swiss National Bank and the IMF in Zurich, 11 May 2010.

---- (2010b), "India and the Global Financial Crisis Transcending from Recovery to Growth", Comments at the Peterson Institute of International Economics, Washington, April 2010.

---- (2010c), "Financial Crisis: Some Old Questions and may be Some New Answers" *RBI Bulletin*, September 2010.

---- (2011), "Global Challenges, Global Solutions: Some Remarks" (Lead Intervention by Dr. Duvvuri Subbarao, Governor, Reserve Bank of India and Leader of the Indian Delegation, at the International Monetary and Financial Committee (IMFC), IMF, Washington DC, 16 April 2011)

Edison *et al.* (2004), "Capital Account Liberalization and Economic Performance: Synthesis and Survey," *IMF Staff Papers*, Vol. 51(2).

Edwards (2001), "Capital Mobility and Economic Performance: Are Emerging Market Economies Different?" *NBER Working Paper* No. 8076.

Eichingreen, B. (2001), "Capital Account Liberalization: What Do Cross Country Studies Tell Us?" *The World Bank Review*, Vol. 16 (3).

Henry (2003), "Capital account Liberalization, the Cost of Capital and Economic Growth", *American Economic Review*, vol. 93(2).

---- (2007), "Capital Account Liberalization: Theory, Evidence and Speculation" *Journal of Economic Literature*, No. 45.

IMF (2011), IMF Staff Discussion Note, 21 April 2011 (SDN/11/10).

IMF (2011a), *Recent Experiences in Managing Capital Inflows—Cross-Cutting Themes and Possible Policy Framework.*

Mohan Rakesh (2008), "Capital Flows to India", in *BIS* (2008).

Prasad *et al.* (2008), A Pragmatic Approach to Capital Account Liberalization, *Journal of Economic Perspective,* Vol. 91(3).

Reddy Y.V. (2008), "Management of Capital Account in India: Some Perspectives", Inaugural Address at the Annual Conference of Indian Econometric Society, 3 January 2008.

Reinhart and Reinhart (2004), "Capital Flows Bonanzas: An Encompassing View of the Past and Present", NBER International Seminar on Macroeconomics.

Rodrik D.(1998), "Who needs Capital Account Convertibility?" *Princeton Essays in International Finance,* No. 207.