CHAPTER 4

A PROFILE OF FOREIGN PORTFOLIO INVESTMENT IN INDIA

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CHAPTER 4

A PROFILE OF FOREIGN PORTFOLIO INVESTMENT IN INDIA

This chapter attempts to give a profile of FPI in India. It starts with the beginning of FII in India in 1992 and then goes on to analyze the trends in FII in India. Since non-debt creating FII flows have many beneficial effects, the policy initiatives have been to encourage them. However, huge inflows and outflows of FPI can be problematic. Keeping this in mind, the determinants of FPI are discussed. After discussing the benefits and costs of FPI we examine the impact of FPI on India’s important macro economic indicators like Balance of Payments, current account deficit, interest rates and foreign exchange reserves. We also examine the contribution of FPI in improving knowledge flows and corporate governance. The role of FPI in contributing to the appreciation of the Rupee is also examined.

As discussed in detail in Chapter 3, FII in India began in September 1992 as part of the capital market reforms. Since 1992, FII has been continuously liberalized (details in Chapter 3). The economic rationale behind this liberalization emanates from the many beneficial effects of FII such as:

i. FII finances current account deficit without creating debt

ii. augments the economy’s savings and investment via foreign savings

iii. increases the GDP growth rate by encouraging investment
iv. reduces the interest rate through increase in money supply

v. helps solve balance of payments problem

vi. reduces cost of capital for companies by way of higher stock prices

vii. increases stock prices by increasing demand for stocks, thereby benefiting millions of investors

viii. improves corporate governance and knowledge flows

ix. improves market efficiency

x. imparts stability to the market

It is important to note that there is a flip side to these beneficial effects. The most important argument against FII is that it is ‘hot money’. Hot money is a fair weather friend and may flow out at the first sign of trouble. Therefore, these volatile hot money flows have the potential to destabilize the economy through external shocks. And, huge capital flows can also make domestic monetary policy ineffective. The arguments in favour of and against FII appear rational and convincing. Therefore, to get the issue in perspective, it is necessary to examine and analyze in detail the determinants of FII.

4.1 Determinants of FII

4.1.1 Theoretical Argument

According to Capital Asset Pricing Model, investors should hold a diversified portfolio of securities to maximize risk adjusted returns. An effective
way of portfolio diversification is to invest across countries. On account of financial globalization, this is happening, though slowly. The share of foreign stocks in the equity portfolio of US investors increased from an estimated 2 percent in late 1980s to about 10 percent by 1997. Considering the fact that the non US market capitalization is 52 percent, the share of foreign stocks in US investors’ equity portfolio is very low and has tremendous potential to go up.

4.1.2 FPI Policy of Host Countries

Even if foreign funds are available they will not flow in, unless the host country FPI policy is favourable. FPI policy in Developing and Emerging economies, including India, started turning positive only in recent times, particularly in the 1990s. Many developing countries could not benefit out of the FPI because of the absence of favourable policy initiatives. A study by Brink and Viviers on the obstacles of attracting FPI into Southern Africa proves this point. According to the authors, lack of favourable policy and underdeveloped financial markets are the major obstacles in attracting FPI into Southern Africa.

In India’s case, the FPI policy initiative began in 1992 and has been continuously liberalized since then. Consequently, FPI progressively increased. See table 4.2.
4.1.3 Stock Returns in Dollar Terms

Perhaps the most convincing argument in favour of FPI is stock returns in dollar terms. There is empirical evidence to this effect. Tesar and Werner (1994, 1995)\textsuperscript{iii} found evidence of positive correlation between portfolio inflows and returns. However, they could not establish the direction of causality, i.e., whether portfolio flows cause dollar returns to change or vice versa.

It is important to note that the stock returns are calculated in dollar terms. This underlines the importance of exchange rate stability and why FIIs dread host country currency depreciation.

4.1.4 GDP Growth and Corporate Profitability

It is true that stock return in dollar terms is the most important determinant of FPI flows. However, stock returns depend on corporate profitability, which in turn is largely a function of GDP growth rate in general and industrial growth rate in particular. Economies with sustained GDP growth rates have shown high levels of corporate profitability. This along with exchange rate stability goes a long way in attracting FPI flows.

This argument has been truly valid in the India context. The period 2003-06, witnessed massive FPI inflows into India of $31.67 billion, compared to $15.8 billion during 1992-2003. The reason is not far to seek. The period 2003-06 witnessed Indian economic growth rising to a new trajectory of 8.4 percent
average annual growth compared to 6.2 percent in the post reform period 1992-2003. Developing and emerging economy group consists of China, India, Brazil, Mexico, Taiwan, South Korea, Malaysia, Indonesia, Philippines, Thailand, Sri Lanka, Pakistan, Turkey etc. And they attracted capital flows. Among these economies those with high growth rates have attracted more capital flows, while those with low growth rates have lagged behind.

4.1.5 Global Interest Rates

An important factor determining capital flows is the global interest rate. LIBOR (London Inter Bank Offer Rate) can be taken as the benchmark for global interest rate. Since FIIs chase better returns, it is quite natural that they withdraw funds from developing markets when LIBOR moves up. The stability in exchange rates in the developed countries is a very significant factor while considering portfolio diversification. Gordon and Gupta\textsuperscript{iv} found LIBOR to be an important factor inversely related to capital flows.

4.1.6 Financial Market Infrastructure of Host Countries

A crucial factor determining FPI into emerging markets is the state of development of the financial markets in the host countries. As mentioned earlier studies by Brink and Viviers on the obstacles in the path of capital flows to Southern Africa found that the poor state of development of financial markets and their inadequate infrastructure were the major hurdles in attracting FPI. Studies by
Bose and Coondoo\textsuperscript{v} reported that financial market infrastructure such as the market size, market liquidity, trading costs, information dissemination and legal mechanisms relating to property rights etc., are very significant in attracting FPI to emerging markets.

This argument is perfectly valid in the Indian context. Even though India had the good fortune of having one of the oldest stock exchanges in the world, it had many limitations till 1992. Starting from 1992 sweeping reforms were implemented in the Indian capital market. These reforms included dematerialization of securities, On Line Trading, rolling settlement, institutional reforms like setting up of the SEBI and the NSE and the opening up of the market to FIIs. These reforms substantially improved the financial market infrastructure in India, and greatly reduced the transactions costs in the market. Consequently, the flow of FII underwent a massive explosion from $244 million in 1992-93 to $12492 million in 2005-06.

4.1.7 Exchange Rate

FIIs are attracted by stock market returns measured in dollar terms. Sometimes, attractive domestic returns measured in domestic currency may be neutralized by depreciation in the domestic currency. For instance an attractive 14 percent return in a year calculated in terms of domestic currency may prove to be quite unattractive if the currency depreciates by 10 percent a year, yielding a paltry real return of 4 percent only. Therefore, the exchange rate is an important
factor determining the FPI inflows. This emphasizes the need for maintaining exchange rate stability in developing economies if they are keen on attracting FPI inflows.

### 4.1.8 Political Stability

As per Keynes’ famous remark, “investment is an act of faith”. Any governmental action jeopardizing this act of faith can have devastating consequences for long term investment. Political instability can wreak havoc on economic policy and investment decisions. In many developing countries, coming into power of left governments had led to stock market crashes due to panic selling by institutions. India herself experienced this in May 2004 when the ruling NDA was unexpectedly defeated in the elections and the UPA government supported by the left parties assumed power. On 4\(^{th}\) May 2004, two prominent leaders of the left remarked that the new Government will reconsider economic reforms. This sent shock waves through the market and the market crashed by 840 points intra day. Even though assurances from the Prime Minister and Finance Minister salvaged the situation later, this episode came as a stark reminder that continuity in policies is integral for market stability.

### 4.1.9 Credit Rating

An important factor influencing capital flows is Credit Rating. FIIs invest in countries that enjoy a good credit rating. Credit rating reports by agencies like
Moody’s and Standard and Poor influence FII. Downgrading of credit rating has been followed by fund withdrawals.

Having discussed the determinants of FPI minutely, let us now examine in detail the important benefits and costs of FPI.

4.2 Benefits of FPI

The major arguments in support of FPI based on the benefits from such capital flows are the following:

4.2.1 Finances current account deficit without creating debt

Since most of the developing countries have chronic current account deficits, financing these deficits is a major macro economic challenge faced by these countries. Financing the deficits through borrowing creates the burden of external debt and the burden of servicing it. The Latin American Debt Crisis is a good example of the costs imposed by increasing external borrowings. In India the major reason for the Balance of Payments crisis of 1991 was the massive external borrowing during 1985-90.

ODA, which was a major source of financing current account deficits, is no longer available in required quantities. This brings us to FDI and FPI as the means of financing deficits in current accounts. (The issue of FDI vs. FPI is discussed later in this chapter.)
FPI has a great advantage that it does not create debt. The return for FPI is the return generated by the market and this does not put any burden on government finances.

4.2.2 Supplements domestic savings and augments investment

Developing countries suffer from the problem of low savings, low investment and low growth. This low level cumulative causation can be broken only by supplementing domestic savings with foreign savings. A strong argument favouring FPI is that it is foreign savings, and it supplements domestic savings. Higher savings push up investment and economic growth.

This trend occurred in India. During the 4 year period 2003-07, India’s GDP growth rose to a new trajectory, 8.4 percent against 6.3 percent during 1992-2003. The main reason for this jump was the increase in investment from 27 percent to 34 percent\textsuperscript{vi}. FPI, along with remittances played a positive role in this.

4.2.3 Reduces the interest rate and facilitates investment and growth

Interest rate is essentially a function of money supply. FPI, by increasing money supply, reduces interest rate. A low interest rate regime is favourable to economic growth. Low interest rates, by increasing aggregate demand, facilitate increased investment. Also, low interest rate, by reducing the cost of capital, encourages investment in the economy\textsuperscript{vii}. 
Low interest rate regime in India during 2002-07 substantially facilitated the growth of interest elastic sectors like housing, automobiles, consumer durables etc. Consequently these sectors attracted huge investment also. An important factor that contributed to low interest rate was the increase in money supply caused by FII inflows during this period.

4.2.4 Reduces the cost of capital for corporates

One of the most important determinants of investment by corporates is the cost of capital. Cost of capital depends on the required rate of return, which in turn is influenced by stock prices. FPI, by increasing the demand for stocks, pushes up stock prices. This, in turn, reduces the required rate of return and thereby the cost of capital.

4.2.5 Benefits to investors

FPI by increasing the demand for stocks increases stock prices. Even though there is some controversy whether FPI is a cause or effect of increased stock prices, the fact remains that it is correlated with stock prices. Increase in stock prices benefits millions of investors. Also, this indirectly helps in economic growth through the wealth effect.

India witnessed an explosion in FPI since 2003. During 2002-06 the country received a total FPI of $34.16 billion\textsuperscript{viii}. This period also witnessed an unprecedented sustained rally in stock prices and market capitalization. The
average annual BSE SENSEX shot up from 3206.29 in 2002-03 to 10994.75 in 2006-07. Market capitalization during this period shot up from Rs. 572198 crores to Rs. 2993779 crores. Obviously, millions of investors benefited.

**4.2.6 Helps solve balance of payments problem**

A major problem that developing countries face is the Balance of Payments Problem caused by unfavourable trade and current accounts. This leads to foreign exchange crisis and eventual devaluation of the currency with consequences such as inflation and increase in external debt. Under such circumstances, developing countries normally approach the IMF for foreign exchange loans. But, the foreign exchange loans sanctioned by IMF involve conditionalities which may not be politically acceptable to developing countries. Therefore, Balance of Payments crisis becomes not only an economic problem but also a political issue.

India experienced a major Balance of Payments problem in 1991. India’s foreign exchange reserves fell to less than $ 1 billion. This was sufficient for only 2 weeks of imports and the country was just a few days away from defaulting on her international commitments. Finally India approached IMF for a conditional loan under the Structural Adjustment Program and this led to liberalization of the Indian economy. In retrospect, that Balance of Payments crisis was a blessing in disguise. But the short period adjustment was painful with inflation touching 16.7 percent in 1991-92.
A better way to manage the Balance of Payments problem is to finance it through capital flows such as FPI. In recent times India has been doing this. FII inflows contributed $40.33 billion between 1992-93 and September 2005 to Balance of Payments.

This corresponds to 28.3 percent of foreign exchange reserves at end September 2005. At the end of April 2007 FPI stands at 52 billion out of the total foreign exchange reserves of $197 billion. Clearly, FPI has played a positive role in managing the Balance of Payment problem.

**4.2.7 Improves knowledge flows**

FIIs are known for best practices and systems. They promote modern market ideas and innovations such as modern trading systems, new financial products such as derivatives, new systems of holding securities such as depositories etc. Furthermore, they increase competition in financial intermediation benefiting the market at large.

Many reforms introduced in the Indian capital market since 1992 were in fact necessitated by FPI. For Instance, FPI would have been impossible in the absence of depositories. Similarly many of the best practices introduced in the Indian capital market such as the establishment of institutions like SEBI, happened due to these knowledge flows. SEBI was constituted on the lines of the SEC (Securities Exchange Commission) of the USA.
4.2.8 Improves corporate governance

It is a global experience that sound corporate governance leads to improved efficiency and higher shareholder value. FIIs, used as they are to advanced systems of corporate governance in developed countries, choose for their portfolios only companies known for their sound corporate governance. Higher stock prices caused by FII selection is a major attraction for companies since it reduces their cost of capital. Also, getting included in the FII portfolio has become a much sought after status symbol for companies. This has created a situation where companies are competing to improve corporate governance. For instance, most of the blue chip software companies have accepted the U S GAAP (Generally Accepted Accounting Practices) accounting system.

In the pre-reform period, the Indian capital market was notorious for stock price manipulation, insider trading and lack of transparency in corporate balance sheets. In all these areas there has been a substantial improvement since then. To a great extent, the credit for this should go to FII which paved the way for better corporate governance.

FII, domestic institutional investment and the tremendous growth of capital market have created many AMCs (Asset Management Companies) who do extensive research. Almost all companies are on the radar of this huge army of highly qualified researchers. Any wrong doing or unhealthy practice by a company will lead to heavy selling in their stocks leading to a crash in their prices.
Companies who are aware of this will always like to avoid this market punishment. Thus, FPI leads to enhancement of corporate governance.

**4.2.9 Improves market efficiency**

FII, by increasing the trading volume, reduces the transaction costs and thereby improves market efficiency. It also imparts greater liquidity to the market. Market efficiency as measured by transaction costs, liquidity, turnover ratio etc., has improved substantially in recent times. This is almost entirely due to the reforms introduced in the Indian capital market. Modern Online trading systems and depositories have substantially reduced the transaction costs in the Indian capital market. Introduction of derivatives trading has increased liquidity and turnover ratio in the market by a wide margin compared to the previous system. It is a remarkable fact that, in all these, FII played a prominent role.

**4.2.10 Imparts stability to the market**

FIIs are often criticized for destabilizing the markets through herding and positive feedback strategy. Of course, there is merit in this criticism. But, there are also instances of FIIs stabilizing the markets by buying stocks when domestic institutional investors and retail investors sell. Domestic institutions and investors are more sensitive to bad news such as reports of a poor monsoon. It is quite possible that under such circumstances, globally diversified portfolio managers can take a more dispassionate view of the prospects for Indian economy and
engage in stabilizing trades. Again, FIIs do not panic and sell like retail investors or domestic institutions acting under redemption pressure, during crisis periods. For instance, during the market melt down caused by the 2000 scam, FIIs were net buyers to the tune of $ 8.38 billion during November 2000 to March 2001.

4.3 Costs of FPI

FPI has its costs too. The important negatives are discussed below:

4.3.1 Volatility in ‘hot money’ flows

FPI, unlike FDI, is regarded as hot money, i.e., highly sensitive money that flows in and out very fast. Hot money is only a fair weather friend and can leave at the slightest hint of trouble. In the modern age of electronic fund transfer, millions of dollars can be transferred at the click of a mouse. FDI, which is investment in plant and machinery, cannot be transferred that easily.

FIIs have often been accused of herding (many FIIs acting together) and pursuing ‘positive feedback strategy’ (buying when prices are going up and selling when prices are going down) in trading. These practices aggravate volatility leading to serious crisis. According to Jeffrey Saachs, during the East Asian currency crisis, short term lenders left East Asia in herdes, exacerbating currency crashes. Saachs called this ‘rational panic’ caused by the shortage of foreign exchange reserves to meet demand. Such volatile fund flows can lead to sharp currency appreciation during ‘inflows’ and depreciation during ‘outflows’.
However in India, till date, there is no such evidence of hot money flight. Even during the crisis periods of East Asian Crisis, the Pokharan explosion and the 2000 Scam, FIIs did not sell heavily. Monthly sales never crossed $ 1 billion. Consequently, India easily weathered these storms. Regarding positive feedback trading, Gordon and Gupta (2003)\textsuperscript{4} found no evidence in India.

4.3.2 Vulnerability to balance of payments

Quick and sharp inflows and outflows can render the Balance of Payments position vulnerable, with devastating consequences. Developing countries with meagre foreign exchange reserves will be more prone to such vulnerability. Sharp depreciation in the currency caused by such outflows can lead to hyper inflation in countries which are dependent on oil imports. Hyper inflation can have devastating social and political consequences as in Indonesia during the East Asian currency crisis. Hyper inflation and social turmoil resulted in President Suharto fleeing the country.

4.3.3 Foreign take over of domestic companies

A major concern about FPI is that sometimes the dividing line between FPI and FDI will disappear and foreign funds acting in cohort with foreign companies will take over domestic companies. Critics argue that such takeovers can be part of the strategy of neo colonialists and that it can adversely impact India’s industrialization and harm her national interests\textsuperscript{x}.
This will appear to be a genuine concern, particularly during the present time when FIIs are the major shareholders in many of India’s blue chip companies like Infosys, TCS, HDFC, Bharti etc. However, appropriate legislation can prevent such takeovers. In India, there are safety nets and appropriate legislation. For example:

i. Transactions in business of securities on the stock exchanges are only through SEBI certified brokers. Off market bulk deals have to be reported to the SEBI.

ii. Every transaction is settled through a custodian who is under obligation to report to the SEBI and RBI, all transactions on a daily basis.

iii. Provisions of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997, apply.

iv. Monitoring of sectoral caps by RBI on a daily basis.

These safety nets are adequate to prevent any possible takeover threat. Therefore, while takeover threat is a theoretical possibility, practically, it is very difficult, almost impossible.

Moreover, global experience is that FIIs are portfolio investors interested only in investment returns and not in company takeovers.
4.4 FDI versus FPI

Because of the problems associated with FPI, there is a general preference for FDI over FPI.

The IMF defines FDI as “that category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy.” Here, lasting interest implies the existence of a long term relationship between the direct investor and the enterprise and also a significant degree of influence by the investor in the management of the enterprise.

Institutional investors, on the other hand, are specialized financial intermediaries managing the savings of small investors with the objective of maximizing returns and minimizing risks.

The long term objective and interests of FDI and the short term interests of FPI are evident from these descriptions. Therefore, critics of FPI argue that that FIIs are fair weather friends and will leave the country at the slightest hint of trouble. On the other hand FDI, being investment in plant and machinery, will remain for long. Even if FDI wants to leave, that is not possible in the short run, and therefore, it will not exacerbate capital flight and expose the economy to external shocks. Moreover, since FDI involves running business enterprises, it
would have developed lots of linkages with customers, suppliers, dealers etc., and this creates an environment of lasting interest and relationships.

These are convincing arguments. Apparently stable FDI is preferable to volatile FPI. But, deeper analysis will reveal that there is more to this argument than meets the eye. Many counter arguments can be made in favour of FPI. For instance, all foreign investors – whether direct or portfolio – are fair weather friends interested in making profit. They invest for returns, not for the host country’s development. Benefits which the host countries derive are the indirect spillovers of the investment. If they do not make money by staying invested, they leave. So there is nothing sacrosanct about FDI.

There is a very important argument in favour of FPI. This is the ‘home grown entrepreneurship argument’. India is well known for her home grown entrepreneurship. Since liberalization, Indian companies have performed better than MNCs. The series of acquisitions of foreign companies by domestic companies, typified by the acquisition of Corus by Tata Steel and Novelis by Hindalco are testimony to the success of this home grown entrepreneurship. It is in India’s interests that this home grown entrepreneurship is encouraged. These home grown entrepreneurs prefer portfolio investors who share the risks of business without interfering in the management of the company. This strategy has produced many success stories in recent times.
For instance: Sunil Mittal developed Bharti into a world class Telecom company using substantial portfolio funds. Economic rationale demands that this model be encouraged.

Again, if FDI is to be preferred to FPI and encouraged, then it needs to be liberalized more. This might encourage FDI style control oriented purchases by FIIs. This is not desirable.

Studies by Shah and Patnaik (2004) have shown that India is better equipped to attract more FPI than FDI. According to Shah and Patnaik, “Net FDI flows into India have remained small either when compared with Indian GDP or when compared to global FDI flows. Compared to China very little FDI has come to India. This may be associated with infirmities of the Indian indirect taxes and transportation infrastructure. India is more important as a platform for services production as a part of global production chains, where difficulties of indirect taxes and transportation infrastructure are less important. However, services production is less capital intensive and induces smaller net FDI flows. Given the size of the Indian economy and the relative lack of correlation with the global business cycle, Indian equities have had low correlations with global risk factors. In addition, India has fared well in creating institutional mechanisms of a modern liquid, equity market. Through these factors, portfolio flows have predominated. India’s share in global portfolio flows is higher than India’s share in global FDI flows, and net portfolio flows are substantial when compared to Indian GDP.”
This analysis on FDI versus FPI, particularly in the Indian context, indicates that FPI is as important as FDI. The volatility and vulnerability argument against FPI, though convincing, do not appear to be very relevant and much of a problem for India since India’s macro economic management takes care of that. The ‘takeover threat’ argument has been addressed by appropriate legislation.

4.5 The Issue of Monetary Management: ‘The Problem of Impossible Trinity’

The real problem arising out of portfolio flows is the complexity of monetary management, particularly the problem of the “impossible trinity.”

The objective of policy makers is to create an environment where the central bank can achieve desirable price, exchange rate and interest rate levels and keep them stable, while formulating policies to benefit from external capital flows. Unfortunately, these objectives are not compatible, sometimes even contradictory; hence the name ‘impossible trinity’. Capital flows lead to appreciation of domestic currency hurting exports. To prevent this, Central Banks intervene and buy foreign currency leading to increase in money supply, which is inflationary. To manage inflation, Central Banks will be forced to increase interest rates. Thus, moderate inflation, reasonable interest rate and stable exchange rate become irreconcilable goals in the context of increasing capital flows.

Managing this problem of ‘impossible trinity’ is the real issue involved in capital flows. India has been experiencing this problem in recent times. Sharp
increase in remittances, software exports and FPI has been increasing the supply of dollars. RBI has been mopping up dollars to keep exchange rate stable. This increased the money supply in the economy. To preempt the inflationary fallout of this increased money supply, RBI has been resorting to sterilization i.e., mopping up excess money supply by selling bonds. The Government introduced MSS (Market Stabilization Scheme) in 2004 to manage this situation. But MSS and the policy of sterilization has a cost in terms of the interest rate differential between what the RBI earns from investment of the excess foreign exchange reserves (in US treasury bills and bonds) and the interest that it pays on MSS bonds. This cost puts a limit to the MSS bonds.

It appears that the RBI has almost given up the pursuit of ‘the impossible trinity’. In the first 6 months of 2007, the Rupee has almost appreciated by 10 percent. The exchange rate touched Rupees 40 and paisa 80 to the dollar on 16th May 2007. Now, it appears that the RBI has abandoned the policy of managing the Rupee and has reconciled to a market determined exchange rate.

The real challenge, therefore, is to formulate policies that can maximize the benefits of increased capital flows while keeping exchange rate stable, inflation moderate and interest rate reasonable.
4.6 FPI in India

FIIs were allowed to invest in India in September 1992. Since then the number of FIIs registered with the SEBI has been steadily increasing. See table 4.1.

TABLE 4.1
FOREIGN INSTITUTIONAL INVESTORS REGISTERED IN INDIA

<table>
<thead>
<tr>
<th>Fin. year</th>
<th>FIIs registered during year</th>
<th>Total registered at year end</th>
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</thead>
<tbody>
<tr>
<td>1992-93</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1993-94</td>
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<td>145</td>
<td>685</td>
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<tr>
<td>2005-06</td>
<td>131</td>
<td>803</td>
</tr>
</tbody>
</table>

As on October 31, 2005

Source: SEBI Annual Report 2005-06
FPI in India has shown a steady upward trend, barring brief periods of mild volatility.
### TABLE 4.2

**FOREIGN PORTFOLIO INVESTMENT IN INDIA**

<table>
<thead>
<tr>
<th>Year</th>
<th>SEBI Data</th>
<th>RBI Data</th>
<th>SEBI Data</th>
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<tr>
<td></td>
<td>Purchases</td>
<td>Sales</td>
<td>Net in Rupees</td>
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<tr>
<td>1992-93</td>
<td>17</td>
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<td>1993-94</td>
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<td>2005-06</td>
<td>1,65,032</td>
<td>1,50,886</td>
<td>14,146</td>
</tr>
</tbody>
</table>

Source: SEBI Annual Report 2005-06

It is clear from the table that barring 1998-99, the FPI in India has been always positive and on the uptrend. 1998-99 was the only exceptional year when FPI turned negative following the economic sanctions against India consequent on the Pokharan nuclear explosion. By end 2005-06, the cumulative FPI in India
touched $39.27 billion. By March 2007 this has touched $55 billion. A creditable achievement indeed!

4.7 Macro Economic Impact of FPI

Now we examine the impact of FPI on India’s important macro economic indicators like Balance of Payments, current account deficit, interest rates and foreign exchange reserves. We also examine the contribution of FPI in improving knowledge flows and corporate governance. The role of FPI in contributing to the appreciation of the Rupee is also examined.

The Crisis of 1991

Mid 1991 witnessed India plunging into its worst macro economic crisis since independence. This serious Balance of Payments crisis emerged as a foreign exchange crisis. In June 1991, India’s foreign exchange reserves fell to less than $1 billion; this was just sufficient to meet two weeks of import requirements. The State Bank of India was just two days away from defaulting on her international obligations. With the fiscal deficit exceeding 8 percent of the GDP and the Current account deficit exceeding 2.5 percent of the GDP, the macro economic fundamentals had turned from bad to worse. NRIs withdrew funds from the NRE (E) accounts resulting in a flight of capital from the country. Inflation shot up to 16.7 percent. International credit rating agencies Standard and Poor and Moodys downgraded India’s credit rating to speculative grade. With the macro
economy in such poor state and investor confidence levels at very low ebb, India had no alternative but to approach the IMF for assistance. The IMF loan, sanctioned under the Structural Adjustment program, played a very important role in ushering in economic reforms in India.

An important factor that led to the foreign exchange crisis of 1991 was the spurt in India’s foreign debt in the eighties. The first dose of liberalization initiated in the latter half of the 1980s necessitated substantial imports. This led to widening trade and current account deficits. Since these deficits were financed through borrowings, it led to sharp rise in the India’s foreign debt. India’s foreign debt shot up from $ 20.63 billion in 1980 to $ 83.80 in 1991. The Debt Service Ratio spurted to an alarming 35.3 percent. This unsustainable external sector situation along with the oil crisis of 1991 led to a full blown Balance of Payments crisis by mid 1991. The realization that it was the mode of financing of the trade and current account deficits through borrowing that led to the crisis, prompted a rethink in the mode of financing the deficits. The Rangarajan Committee recommended a switch from debt creating capital flows to non-debt creating capital flows such as FDI and FPI. This led to the policy initiatives favouring FPI.

4.7.1 CAD (Current Account Deficit) financing through FPI

In the early years following reforms, the current account deficit continued to be high and the Rupee continued to depreciate steadily. The increase in FDI was slow and grossly inadequate to finance the current account deficit. But the large capital
flows in the form of FPI really helped the country to finance the deficit without adding to its foreign debt. This is evident from table 4.3.

**TABLE 4.3**

FOREIGN INVESTMENT, CAD AND FOREX RESERVES

<table>
<thead>
<tr>
<th>Fin. Year end</th>
<th>FDI ($million)</th>
<th>FPI ($million)</th>
<th>Total FI ($million)</th>
<th>CAD ($million)</th>
<th>Forex Reserves ($million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-91</td>
<td>97</td>
<td>6</td>
<td>103</td>
<td>-9680</td>
<td>5834</td>
</tr>
<tr>
<td>1991-92</td>
<td>129</td>
<td>4</td>
<td>133</td>
<td>-1178</td>
<td>9200</td>
</tr>
<tr>
<td>1992-93</td>
<td>315</td>
<td>244</td>
<td>559</td>
<td>-3526</td>
<td>9832</td>
</tr>
<tr>
<td>1993-94</td>
<td>586</td>
<td>3567</td>
<td>4153</td>
<td>-1159</td>
<td>19254</td>
</tr>
<tr>
<td>1994-95</td>
<td>1314</td>
<td>3824</td>
<td>5138</td>
<td>-3369</td>
<td>25186</td>
</tr>
<tr>
<td>1995-96</td>
<td>2144</td>
<td>2748</td>
<td>4892</td>
<td>-5912</td>
<td>21687</td>
</tr>
<tr>
<td>1996-97</td>
<td>2821</td>
<td>3312</td>
<td>6133</td>
<td>-4619</td>
<td>26423</td>
</tr>
<tr>
<td>1997-98</td>
<td>3557</td>
<td>1828</td>
<td>5385</td>
<td>-5499</td>
<td>29367</td>
</tr>
<tr>
<td>1998-99</td>
<td>2462</td>
<td>-61</td>
<td>2401</td>
<td>-4038</td>
<td>32490</td>
</tr>
<tr>
<td>1999-00</td>
<td>2155</td>
<td>3026</td>
<td>5181</td>
<td>-4698</td>
<td>38036</td>
</tr>
<tr>
<td>2000-01</td>
<td>4029</td>
<td>2760</td>
<td>6789</td>
<td>-2666</td>
<td>42281</td>
</tr>
<tr>
<td>2001-02</td>
<td>6130</td>
<td>2021</td>
<td>8151</td>
<td>3400</td>
<td>54106</td>
</tr>
<tr>
<td>2002-03</td>
<td>5035</td>
<td>979</td>
<td>6014</td>
<td>6345</td>
<td>76100</td>
</tr>
<tr>
<td>2003-04</td>
<td>4322</td>
<td>11377</td>
<td>15699</td>
<td>14083</td>
<td>112959</td>
</tr>
<tr>
<td>2004-05</td>
<td>5652</td>
<td>9315</td>
<td>14967</td>
<td>-5400</td>
<td>141514</td>
</tr>
<tr>
<td>2005-06</td>
<td>7751</td>
<td>12492</td>
<td>20243</td>
<td>-10612</td>
<td>151622</td>
</tr>
</tbody>
</table>


As is evident from the table FPI has played a crucial role in financing India’s CAD. The total CAD during the period 1990-91 to 2005-06 was $ 38.53
billion. During the same period, FPI was $ 55.44 billion. This means that the entire CAD was financed by FPI during this period. This has two implications:

One, since the entire CAD was financed through FPI, it did not add to the country’s foreign debt, as was the case in the past.

Two, higher CAD enabled the country to increase its investment rate and thereby the growth rate.

4.7.2 FPI and Foreign Exchange Reserves

In June in the crisis year of 1991, India’s foreign exchange reserves had declined to less than $1 billion. With the devaluation of the Rupee in 1991 and introduction of policies encouraging non-debt creating capital flows, India’s foreign exchange reserves started improving. It crossed $ 25 billion in 1995, $ 38 billion in 2000 and $ 141 billion in 2005. In 2007 it crossed $ 200.54 billion. See table 4.4.
## TABLE 4.4

### INDIA’S FOREIGN EXCHANGE RESERVES

<table>
<thead>
<tr>
<th>Fin. year end</th>
<th>Foreign Exchange Reserves (in US Dollar million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991-92</td>
<td>9220</td>
</tr>
<tr>
<td>1992-93</td>
<td>9832</td>
</tr>
<tr>
<td>1993-94</td>
<td>19254</td>
</tr>
<tr>
<td>1994-95</td>
<td>25186</td>
</tr>
<tr>
<td>1995-96</td>
<td>21687</td>
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<tr>
<td>1996-97</td>
<td>26423</td>
</tr>
<tr>
<td>1997-98</td>
<td>29367</td>
</tr>
<tr>
<td>1998-99</td>
<td>32490</td>
</tr>
<tr>
<td>1999-00</td>
<td>38036</td>
</tr>
<tr>
<td>2000-01</td>
<td>42281</td>
</tr>
<tr>
<td>2001-02</td>
<td>54106</td>
</tr>
<tr>
<td>2002-03</td>
<td>76100</td>
</tr>
<tr>
<td>2003-04</td>
<td>112959</td>
</tr>
<tr>
<td>2004-05</td>
<td>141514</td>
</tr>
<tr>
<td>2005-06</td>
<td>151622</td>
</tr>
</tbody>
</table>

What role did FPI play in this phenomenal rise in foreign exchange reserves?

From 1993 India slowly moved to a managed flexible exchange rate. With the current account showing continuous deficit, the Rupee started to depreciate steadily. But the extent of depreciation was slow between 1995 and 2000. In fact, in real terms the Rupee was appreciating. The real exchange rate is denoted by the REER (Real Effective Exchange Rate) and not by the NEER (Nominal Exchange Rate). Between 1995 and 2000 the REER almost remained unchanged and between 2000 and 2005, the REER increased indicating Rupee appreciation. This is evident from table 4.5.
## TABLE 4.5

**REAL EFFECTIVE EXCHANGE RATE**

<table>
<thead>
<tr>
<th>Year</th>
<th>REER</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>134.94</td>
</tr>
<tr>
<td>1975</td>
<td>116.45</td>
</tr>
<tr>
<td>1980</td>
<td>108.21</td>
</tr>
<tr>
<td>1985</td>
<td>100</td>
</tr>
<tr>
<td>1990</td>
<td>74.54</td>
</tr>
<tr>
<td>1995</td>
<td>62.74</td>
</tr>
<tr>
<td>2000</td>
<td>61.71</td>
</tr>
<tr>
<td>2001</td>
<td>63.80</td>
</tr>
<tr>
<td>2002</td>
<td>67.36</td>
</tr>
<tr>
<td>2003</td>
<td>69.24</td>
</tr>
</tbody>
</table>


## FIGURE 4.5

**REAL EFFECTIVE EXCHANGE RATE**

![Graph showing real effective exchange rate from 1970 to 2003](chart.png)

- 1970: 134.94
- 1975: 116.45
- 1980: 108.21
- 1985: 100
- 1990: 74.54
- 1995: 62.74
- 2000: 61.71
- 2001: 63.80
- 2002: 67.36
- 2003: 69.24

Year
Rupee appreciation started creating problems for the export sector. Therefore, to manage the exchange rate at appropriate levels the RBI started intervening in the foreign exchange markets to buy dollars. Intervention through the mechanism of Market Stabilization Securities (MSS) added to the foreign exchange reserves. This is in addition to the foreign exchange reserves contributed by FPI. Again, as evident from table FPI not only financed the entire CAD during the period 1991-2006, but also left a surplus of $18.92 billion. In brief, FPI substantially contributed to India’s foreign exchange reserves. This positive role assumes added significance when seen in the context of the severe foreign exchange crisis of 1991.

4.7.3 FPI and Interest Rates

India’s GDP growth rate rose from 5.6 percent in the 1980s to 6.4 percent in the post-reform period 1992-2003. It further leapfrogged to 8.6 percent during the 4 year period 2003 to 2007, making India the second fastest growing economy in the world, next only to China. Many factors contributed to this structural shift in the growth rate. Factors such as sustained high growth in the industrial and services sectors, acquisition of global competitiveness by Indian companies, the explosion of entrepreneurial talent following the abolition of the License Raj, the spurt in the savings rate, a benign global economic environment………. all contributed to this high growth rate. A very important causative factor has been the decline in the interest rate.
Interest is the cost of capital. Lower interest rates lead to increase in demand for capital—for investment as well as for consumption. It is safe to assume that both these happened in India following the sharp downward trend in interest rate. The demand for investment by companies increased substantially following the high level of business confidence which in turn was caused primarily by sustained high level of consumption demand. Lending by banks increased by a much higher rate compared to earlier periods. This increase can be seen both in bank lending for investment as well as lending for consumption. Particularly, bank financing of home purchases and purchases of interest elastic consumer durables like automobiles underwent a veritable explosion. Certainly, the decline in interest rates contributed to this. Compared to earlier periods, the decline in interest rates during 1992-2006 was very steep. See table 4.6.
TABLE 4.6

STRUCTURE OF INTEREST RATE

<table>
<thead>
<tr>
<th>Year</th>
<th>Deposit rate (%) (1-3 years)</th>
<th>SBI Advance rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991-92</td>
<td>12</td>
<td>16.5</td>
</tr>
<tr>
<td>1992-93</td>
<td>11</td>
<td>19</td>
</tr>
<tr>
<td>1993-94</td>
<td>10</td>
<td>19</td>
</tr>
<tr>
<td>1994-95</td>
<td>11</td>
<td>15</td>
</tr>
<tr>
<td>1995-96</td>
<td>12</td>
<td>16.5</td>
</tr>
<tr>
<td>1996-97</td>
<td>11-12</td>
<td>14.5</td>
</tr>
<tr>
<td>1997-98</td>
<td>10.5-11</td>
<td>14</td>
</tr>
<tr>
<td>1998-99</td>
<td>9-11</td>
<td>12-14</td>
</tr>
<tr>
<td>1999-00</td>
<td>8.5-9.5</td>
<td>12</td>
</tr>
<tr>
<td>2000-01</td>
<td>8.5-9</td>
<td>11.5</td>
</tr>
<tr>
<td>2001-02</td>
<td>7.5-8.5</td>
<td>11.5</td>
</tr>
<tr>
<td>2002-03</td>
<td>4.25-6</td>
<td>10.75</td>
</tr>
<tr>
<td>2003-04</td>
<td>4-5.25</td>
<td>10.25</td>
</tr>
<tr>
<td>2004-05</td>
<td>5.25-5.5</td>
<td>10.25</td>
</tr>
<tr>
<td>2005-06</td>
<td>6-6.5</td>
<td>10.25</td>
</tr>
</tbody>
</table>

Source: RBI Handbook of Statistics on Indian Economy, 2005-06

The SBI interest rate can be taken as a benchmark of lending rate in the economy. This lending rate declined from 19 percent in 1992-93 to 10.25 percent by 2003-04: a steep decline of more than 80 percent. This steep decline in interest rate led to a huge demand for money, both for consumption and capital investment. This, in turn, gave a fillip to the growth rate in the economy pushing it from 6.4 percent to 8.6 percent.

What role did FPI play in the reduction of interest rate?
Interest is function of demand for money and supply of money (Keynes). According to the Loanable Fund Theory of interest, interest rate is determined by the demand for loanable funds and supply of loanable funds. It is a fact that increase in money supply, with the demand for money remaining the same, leads to a reduction in interest rate. Also, if the supply of money increases at a rate faster than the increase in demand for money, interest rate declines. In India, huge increase in FPI, as already explained, led to increase in the supply of money. In addition to this, the policy of market intervention through MSS further added to the money supply.

Interest rate is determined by a complex variety of factors. The monetary policy of the RBI is the most important factor. Reduction in the reserve ratios (SLR and CRR) following the acceptance of Narasimham Committee recommendations, substantially increased the loanable funds of the banking system. Reduction in the inflation rate also enabled the RBI to follow an expansionary fiscal policy. Along with these favourable factors, the increase in money supply caused by FPI also contributed to the decline in interest rate. Since interest rate is determined by a multiplicity of factors, it is impossible to identify the contribution of a single factor like the FPI in the interest rate reduction. However, it can be safely assumed that FPI along with other factors contributed substantially to the reduction in interest rate.
4.7.4 FPI, Knowledge Flows and Corporate Governance

One of the objectives of the capital market reforms initiated as part of the liberalization policy was to promote investment in the stock market; particularly promotion of FPI was an important objective. These capital market reforms promoted FPI and the high level of FPI, in turn, necessitated and facilitated further reforms. Establishment of many capital market institutions like SEBI [on the lines of the SEC (Securities Exchange Commission) of the U.S.A], depositories like the NSDL and CDSL, clearing houses like the NSCC and trading reforms like derivatives trading, rolling settlement etc., were, in fact, products of this mutually reinforcing process. Best practices from the developed world were brought to India. Declaration of quarterly unaudited results and acceptance of modern accounting standards like GAAP (Generally Accepted Accounting Practices) can be traced to FPI. Furthermore, companies regard inclusion in the FII portfolio as a status symbol. Such companies adhere to international best practices. For example: computer software companies like Infosys, WIPRO and Satyam which raised money through ADRs and have substantial FII have adopted the GAAP accounting standards.

FPI has also contributed to improving transparency and high ethical standards in business. Massive investment in the stock market, spurt in market capitalization, huge increase in the funds managed by AMCs and very attractive returns from stock investment have given rise to an army of highly qualified
financial professionals who thoroughly and exhaustively study the performance of companies. These financial professionals and AMCs predict the results of the companies with surprising accuracy before the companies declare their results. All major companies will be under the scanner of this large army of professionals. If a company resorts to any unethical practice FIIs are known to dump the stock sending its price crashing. This scary scenario indirectly promotes high ethical practices and corporate governance. In this era of high volume stock market turnover (average daily turnover exceeding Rs. sixty thousand crores ), it is difficult, almost impossible, to manipulate stock prices over a long period of time. It is a fact that price manipulation by operators and continuous circuit filters happen in the case of small cap stocks in which there is no institutional investment, particularly by FIIs. Large cap stocks with high level of institutional holding cannot be manipulated like this. Even if a few operators, promoters and merchant bankers manipulate and jack up the price, it may not work out in the long run. Markets punish excesses.

For instance: at the height of the bull run in India in January 2008, when the SENSEX was above 20000, the Anil Dirubai Ambani Group (ADAG) made its Reliance Power IPO at a price of Rs. 450 a share (Rs. 430 to retail investors). This price was regarded as excessive by many experts. But the euphoria generated by the huge grey market premium in the stock led to huge over subscription of 73 times in the stock. However by the time the share was listed in the market on February 8th, market sentiments had turned highly negative. On the day of listing
the share closed at Rs. 360, i.e., Rs. 70 discount to the issue price. This spoiled the image and track record of the promoters, who had high reputation among investors. To salvage the situation the ADAG made amends through a 3:5 bonus issue to the shareholders from the promoters’ quota. This brought down the issue price to retail investors to Rs. 270 a share. This is a classic case of excesses being corrected by the market. It is important to note that this is possible only in a market with necessary depth. Shallow markets can be easily manipulated by resourceful operators; but this is not possible in a market deepened by millions of retail investors and dozens of institutional investors. It is a fact that FIIs contributed greatly to deepening the capital market in India.

**Test of hypothesis**

The study made the following hypothesis:

FII has had favourable impact on India’s Balance of Payments, interest rates, cost of capital, corporate governance and market efficiency.

The study found that FII has had a favourable impact on all major macro economic indicators mentioned above. It helped in tackling BoP through non-debt financing of CADs, lowered interest rates via increasing money supply, reduced the cost of capital through higher stock prices, improved corporate governance and market efficiency.
Conclusion

FPI is determined by a complex set of factors such as the advantage of portfolio diversification, FPI policy of host countries, stock returns in dollar terms, GDP growth rate, corporate profitability, financial market infrastructure of host countries, exchange rate, political stability, credit rating level etc.

FPI has many beneficial effects. Important among these are: non-debt financing of current account deficit, supplementing domestic savings and investment, lowering of interest rate, contributing to higher GDP growth, facilitating knowledge flows, benefiting investors through higher stock prices, improving corporate governance, enhancing market efficiency etc. In India’s case, these benefits are apparent. However, unrestricted capital flow of the FPI variety is fraught with danger. Important problems associated with FPI are: volatility caused by ‘hot money’, vulnerability of Balance of Payments to sudden capital flows, threat of foreign takeover of domestic firms, managing ‘the impossible trinity’ etc. Since FPI brings substantial benefits along with some serious threats, it should be handled with utmost care. Policy initiatives in India regarding FPI have been carefully calibrated to avoid the dangers from such flows. Consequently, India succeeded in avoiding episodes of volatility which many other countries experienced. FPI in India has been growing steadily without major bouts of volatility. This issue of volatility and its consequences is examined in detail in chapter 6.
Notes and References:


viii Handbook of Statistics on the Indian Economy, Reserve Bank of India, 2005-06


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