

## **DESPITE STRONG FII INFLOW; RUPEE KEPT ON DEPRECIATING TILL AUGUST 2013**

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### **Abstract**

In India greater emphasis has been given to the foreign capital, this not only increases the productivity and the efficiency of labour but also helps to maintain adequate foreign exchange reserve. After globalization of Indian economy foreign investment in India have grown enormously with the results of minimization of trade barriers, strengthening the economy, flexible exchange rates etc.

This paper seeks to explain FII inflows since 2000 to 2013, behaviour after the announcement of QE-II. In particular, this paper tries to establish whether inflows in the form of net Foreign Institutional Investments (FIIs) into India increased after 2010. Despite FII increase Indian currency kept on depreciating till August 2013.

The rest of the paper is organized right from starting with the introduction, pattern of FII inflow, history about rupee's journey since independence and reasons for its depreciation. Tools of analysis, data, and empirical evidences are discussed. After findings article concludes the paper.

## **Introduction**

Foreign Institutional investors (FIIs) are entities established or incorporated outside India and make proposals for investments in India. These investment proposals by the FIIs are made on behalf of sub accounts, which may include foreign corporate, individuals, funds etc. In order to act as a banker to the FIIs, the RBI has designated banks that are authorised to deal with them. The biggest source through which FIIs invest is the issuance of Participatory Notes (P-Notes), which are also known as Offshore Derivatives. India opened its stock market to foreign investors in September 1992 since 1993, received portfolio investment from foreigners in the form of foreign institutional investment in equities. This has become one of the main channels of FII in India for foreigners. In order to trade in Indian equity market foreign corporations need to register with SEBI as Foreign Institutional Investor (FII). One who propose to invest their proprietary funds or on behalf of & quot; broad based & quot; funds or of foreign corporate and individuals and belong to any of the under given categories can be registered for FII. Pension Funds Mutual Funds Investment Trust Insurance or reinsurance companies Endowment Funds University Funds Foundations or Charitable Trusts or Charitable Societies who propose to invest on their own behalf, and Asset Management Companies Nominee Companies Institutional Portfolio Managers Trustees Power of Attorney Holders Bank An application for registration has to be made in Form A, the format of which is provided in the SEBI(FII) Regulations, 1995 and submitted with documents in duplicate addressed to SEBI as well as to Reserve Bank of India (RBI). The eligibility criteria for above is as per the Regulation 6 of SEBI (FII) Regulations, 1995. Current financial instruments are available for FII investments Securities in primary and secondary markets including shares, debentures and warrants of companies, unlisted, listed or to be listed on a recognized stock exchange in India; Units of mutual funds; Dated Government Securities; Derivatives traded on a recognized stock exchange ; Commercial papers.

In this paper an attempt has made to the analysis of FII inflow in India from the period 2000 to 2013 with explanation why rupee kept on depreciating.

### **Research Methodology**

The present study has been undertaken with a conduct of empirical analysis of status of FII in India. The present study is of analytical nature and it is both exploratory and descriptive in nature. The study is based upon secondary data for the span of period of 13 years since 2000 to 2013. The relevant secondary data are collected from various publications of govt. of India; RBI, SEBI, NSE, News papers (Times of India, Financial Express, Economic Times, The Hindu etc.), journals and websites. Time series analysis has been conducted to have an empirical idea about the status of FII in India and reasons for depreciating Indian rupee.

### **Objective of the study**

FII has been recognized as an important driver for economic growth and development. It is also responsible of issues of flexible exchange rate. The objective of this study is

- To depict the scenario of FII in India till 2013.
- Why rupee kept on depreciating despite strong FII.

### **Trends of FII Inflow in India**

In 90s the Government of India stepped into Liberalization and economic reforms to bring rapid and substantial economic growth and moved towards globalization of the economy. India has developed framework allowing foreign investors to participate in Indian securities market. Portfolio investments by foreign institutional investors were permitted in Indian capital market for the first time. The trend of FII inflow since 2000 can be represented in the following table

**Table 1: FII activity for the years**

Year	Gross Purchase (Cr)	Gross Sale (Cr)	Net Investment (Cr)	Cummulative Investment (\$Mn)
2012	669,184.40	540,823.90	128,360.70	24,372.19
2011	611,055.60	613,770.80	-2,714.20	-357.83
2010	766,283.20	633,017.10	133,266.80	29,361.83
2009	624,239.70	540,814.70	83,424.20	17,458.14
2008	721,607.00	774,594.30	-52,987.40	-11,974.30
2007	814,877.90	743,392.00	71,486.30	17,655.80
2006	475,624.90	439,084.10	36,540.20	8,107.00
2005	286,021.40	238,840.90	47,181.90	10,706.30
2004	185,672.00	146,706.80	38,965.80	8,669.80
2003	94,412.00	63,953.50	30,459.00	6,627.60
2002	46,479.10	42,849.80	3,629.60	749.50
2001	51,761.20	38,651.00	13,128.20	2,806.40
2000	74,791.50	68,421.60	6,370.08	1,532.60

Source: SEBI

Empirical evidence of this paper reveals that there is a positive and significant FII inflow into India. After controlling for other factors, exchange rate does not have any statistically significant effect of net FII inflows. However, “*Spread*” has a statistically significant and positive effect on net FII inflows. The announcement of QE-II in the US led to higher inflows into India, this paper offers the following explanations. By July 2010, it was evident that the recovery in the US economy had weakened significantly. A large part of this slowdown was attributed to lower than expected growth in consumer spending and the consequent sluggishness in output and employment generation. This led to the speculation that a fresh round of monetary easing policies were in the offing. Market participants anticipated a fresh round monetary policy action in the US by August 2010 [BIS 2010 & Gagnon (2010)]. This speculation gained more ground on August 27, 2010 when Ben Bernanke, Chairman of the Fed, delivered a speech at Jackson Hole stating that in view of the slowdown in recovery, the Fed was open to using a variety of tools to provide additional stimulus which could include

additional purchase of longer term securities. This led to increased flow of capital into emerging economics (BIS 2010). However, results suggest that FII flows have indeed fallen in the period after November 3, 2010. One explanation is that since the markets had already anticipated and factored in the effect of QE in their behaviour, they were not surprised by the announcement of QE-II on November 3, 2010.

By the second week of November 2010, sovereign debt problems had become apparent in some of the Euro-zone economies particularly Ireland (BIS 2010). This led to a FII outflows from India to safer markets. Political tensions between North and South Korea accentuated this trend in November 2010. High inflation and the related fear of policy rate hike by Reserve Bank of India marred market sentiments for much of December 2010 and January 2011. Successive policy rates hikes by the RBI since January 2011 due to stubbornly high inflation did little to uplift the market sentiment. Rise in crude oil price due to political tensions in the Middle East and North Africa Region (MENA) in February 2011 suppressed sentiments in the Indian equity markets. Greece, once again, came under the scanner due to its sovereign debt debacle and the fiscal solidity of the peripheral Euro zone economies came to the fore in May and June 2011. All these things put together led to a fall in the stock market indices in India and hence could have led FII to withdraw from the Indian stock market. After the year 2011 in 2012 FII inflow increased.

We can analyse the FII inflow for the year 2013 separately, coming to next section of the paper for devaluation of Indian rupee.

**Table 2: FII activity for the year 2013**

Month	Gross Purchase (Cr)	Gross Sale (Cr)	Net Investment (Cr)	Cummulative Investment (\$Mn)
January 2013	77,858.80	55,799.80	22,059.20	4,059.32
February 2013	78,888.30	54,449.10	24,439.30	4,575.56
March 2013	66,766.60	57,642.70	9,124.30	1,675.48
April 2013	61,007.30	55,593.10	5,414.10	1,000.27
May 2013	74,468.90	52,300.40	22,168.60	4,067.42
June 2013	55,321.40	66,348.50	-11,026.90	-1,852.15
July 2013	60,371.00	66,624.20	-6,253.30	-1,042.88
August 2013	69,308.40	75,231.10	-5,922.50	-902.51
September 2013	37,854.70	31,561.20	6,293.50	974.07

Source: NSE

Compared to the year 2012, since January 2013 the net investment increased to 22,059.20 Cr and 24,439.30 in the month of February. For the month March and April it was low compared to next month. In May, foreign institutional investors (FIIs) were gross buyers of shares worth Rs 74,469 crore, while they sold equities amounting to Rs 52,300 crore, translating into a net inflow of Rs 22,168 crore (\$4.04 billion), according to the data available with market regulator SEBI. This was the highest net investment by FIIs in stocks since February, when they had infused Rs 24,439 crore. Apart from equity, FIIs have also poured in Rs 5,969 crore (\$1.2 million) in the debt market last month taking the total investment to Rs 24,047 crore (\$4.5 billion) in the segment so far this year. As on May 31, the number of registered FIIs in the country stood at 1,758 and total number of sub-accounts were 6,404 during the same period. Foreign institutional investors are still investing large sums in Indian equities despite the prolonged economic slowdown and the falling rupee. The net inflow figures in January-July 2013 as well the increase in the number of FIIs registered with the Securities and Exchange Board of India. Foreign institutional investors are still investing large sums in Indian equities despite the prolonged economic slowdown and the falling rupee. Foreign

institutional investors poured more money into Indian equities in the financial year ending March 2013 than they have in any year since they were permitted to invest in these, 21 years ago. They were net buyers by Rs 1.4 lakh crore during the year, according to data from the stock market regulator, the Securities and Exchange Board of India. This is higher than both FY10 and FY11, both of which saw net inflows of Rs 1.1 lakh crore.

### **Reasons for strong FII inflow in India**

- Foreign investors have immense faith in Indian financial markets. The fact is substantiated through statistics which show that they pumped massive US\$ 10 billion in Indian markets in January-March 2013 quarter. Moreover, FII ownership in top 500 companies is highest at 21.2 per cent for the reported quarter. It increased by 1.28 per cent in the January-March quarter alone and 2.87 per cent in 2012-13.
- Moreover, value of FII inflows stood at US\$ 25.8 billion for the financial year ending March 2013, the second best ever. Data compiled by Citi Research and the Centre for Monitoring Indian Economy indicated that the value of FII portfolio stood at \$236.2 billion.
- The number of registered FIIs in India stood at 1,757 in FY 2012-13 while the number of FII sub-accounts rose to 6,335, from 6,322 at the end of 2011-12.
- Foreign investors are pouring money into Indian stock market due to global liquidity.
- Besides, slew of reform measures taken by the government in September 2012, also helped boost sentiment towards India.
- In the past four years there has been more than \$41 trillion worth of FII funds invested in India. This has been one of the major reasons on the bull market witnessing

unprecedented growth with the BSE Sensex rising 221% in absolute terms in this span.

### **Rupee's journey since independence**

The Indian rupee, which was on a par with the American currency at the time of Independence in 1947, has depreciated by a little more than 65 times against the greenback in the past 66 years. The rupee touched its historic record low of below 65 (intraday) against the dollar in August mid week on sluggish local stocks and continued dollar demand from importers. The currency has witnessed huge volatility in the past two years. This volatility became severe in the past three months affecting major macro-economic data, including growth, inflation, trade and investment. Managing volatility in the currency markets has become a big challenge for policymakers. Despite of a series of measures taken by the central bank as well as the government to curb the volatility in the markets, the rupee continues to depreciate. This rupee depreciation is badly hurting the Indian economy. It is fuelling inflation and has hurt economic growth.

The Indian currency has witnessed a slippery journey since Independence. Many geopolitical and economic developments have affected its movement in the last 66 years. When India got freedom on August 15, 1947, the value of the rupee was on a par with the American dollar. There were no foreign borrowings on India's balance sheet. To finance welfare and development activities, especially with the introduction of the Five-Year Plan in 1951, the government started external borrowings. This required the devaluation of the rupee.

After independence, India had chosen to adopt a fixed rate currency regime. The rupee was pegged at 4.79 against a dollar between 1948 and 1966. Two consecutive wars, one with China in 1962 and another one with Pakistan in 1965; resulted in a huge deficit on India's

budget, forcing the government to devalue the currency to 7.57 against the dollar. The rupee's link with the British currency was broken in 1971 and it was linked directly to the US dollar.

In 1975, value of the Indian rupee was pegged at 8.39 against a dollar.

In 1985, it was further devalued to 12 against a dollar.

In 1991, India faced a serious balance of payment crisis and was forced to sharply devalue its currency. The country was in the grip of high inflation, low growth and the foreign reserves were not even worth to meet three weeks of imports. Under these situations, the currency was devalued to 17.90 against a dollar.

1993 was very important. This year currency was let free to flow with the market sentiments. The exchange rate was freed to be determined by the market, with provisions of intervention by the central bank under the situation of extreme volatility. This year, the currency was devalued to 31.37 against a dollar. The rupee traded in the range of 40-50 between 2000 and 2010.

It was mostly at around 45 against a dollar. It touched a high of 39 in 2007.

The Indian currency has gradually depreciated since the global 2008 economic crisis.

Liberalising the currency regime led to a sharp jump in foreign investment inflows and boosted the economic growth

### **Present Scenario**

Year: 2012

- Jan 51.199382
- Feb 49.157835
- Mar 50.341695

- Apr 51.704700
- May 54.335202
- Jun 55.935722
- Jul 55.378541
- Aug 55.534110

In the week gone by in the month of August 2013, the Indian rupee extended falls to a new low of 65.50 to the dollar as heavy demand from importers along with weak domestic equities continued to weigh on sentiment.

Weakness was also seen after Federal Reserve minutes hinted that the United States was on course to begin tapering stimulus as early as next month.

Moreover, continuing its slide, the rupee also made all time low against British pound and breached the 102-mark on local bourses.

With this, British pound has become the first major foreign currency to cross 100 levels against rupee.

However, steps taken by the RBI and the government to curb volatility in the exchange rate have had little effect so far.

### **Reasons for Depreciation**

Since July last year, the Indian rupee has fallen by more than 27% against the US dollar, one of the biggest declines among Asian currencies. Here are main reasons for the steady slump in the value of India's currency despite strong FII inflow

- Since India imports more goods (in value terms) than it exports, it results in a huge imbalance in trade, or what is called a trade deficit. In the financial year ending March 2012, the deficit zoomed to \$185bn (£118bn) compared with the original estimate of \$160bn. The trade deficit may be slightly lower in 2012-13, due to falling global crude prices and recent government curbs on gold imports.
- The present downfall of the market too is influenced as these FIIs are taking out some of their invested money. For long-term value investors, there's little because for worry but short term traders are adversely getting affected by the role of FIIs are playing at the present.
- Although India has become an attractive destination which can woo foreign capital as well as money from non-resident citizens, it is not enough to make up for the trade deficit.
- In 2011-12, India received foreign direct investment of more than \$30bn, in addition to a net inflow of \$18bn from foreign institutional investors in stocks and bonds.
- But uncertainty about India's commitment to economic reforms, retrospective taxes, and policy paralysis within the government have forced foreigners to either postpone their investment decisions, or take money out of Indian stock markets.
- The country's current account deficit - a broader measure of the trade deficit - has also ballooned due to the above reasons. In 2011-12, this deficit was more than \$74bn, a huge jump from less than \$46bn a year ago. In 2012-13, it may be even higher at \$77bn. The result is that India's foreign exchange reserves have dropped from a peak of \$320bn in September 2011 to \$290bn now.

- In such a situation, more people tend to sell rupees to buy dollars (or any other foreign currency that they require). Importers scamp for dollars to cater for their needs to buy goods abroad. Exporters cannot bring in enough dollars; in fact, they keep their foreign earnings abroad as they expect the rupee to fall further. Meanwhile, foreign investors increase the demand for dollars as they convert their rupee assets into dollars to take their money out. This demand-supply gap between the dollar and the rupee leads to devaluation.
- This trend is accentuated by low growth and high inflation in India. After annual economic growth of nearly 9% in 2009-10 and 2010-11, the country is likely to grow at 6.5% in 2011-12.
- Couple this with high inflation due to high food and fuel prices. The rate of inflation may rise this year to double digits if the government is unable to curb its fiscal deficit.
- The Reserve Bank of India's bid to sell dollars in the open market to restrict the rupee slide has failed in the past few weeks and months. This has complicated the situation further. Once currency traders and speculators realise that India's central bank is unable to manage its exchange rate, and reduce the adverse impact on its currency, they may enter the market in a big way to sell the rupee. As a result, the rupee may devalue more than it should.

### **Findings and Conclusion**

From the above explained reasons it is very clear that FII is only the factor responsible for depreciating Indian rupee. With FII and other factors Indian rupee kept on devaluating. The main reason causing the rupee to fall is the immense strength of the Dollar Index. The record setting performance of US equities and the improvement in the labor market has made

Americans more optimistic about the outlook for the US economy; thereby spurring greater hopes of QE tapering. The US dollar is looking like gold these days because the Federal Reserve is in a very different position. The Federal Reserve is talking about tapering asset purchases at a time when European officials are considering more aggressive monetary easing measures such as negative deposit rates. The rupee is also feeling the pinch of the recession in the Euro zone. The euro, which was seen holding the key level of 1.30, has dropped lower to 1.28 levels on the back of deterioration in the local economic data. With the reduction in exports and an increase in imports, on one side the current account deficit has increased while on the other, the fiscal deficit is also expected to be above the comfort levels due to increased subsidy. A slowdown in the global economy has adversely reduced the demand for Indian goods. The falling commodity prices on the other hand have increased imports resulting in an imbalance between payments and receipts.

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