

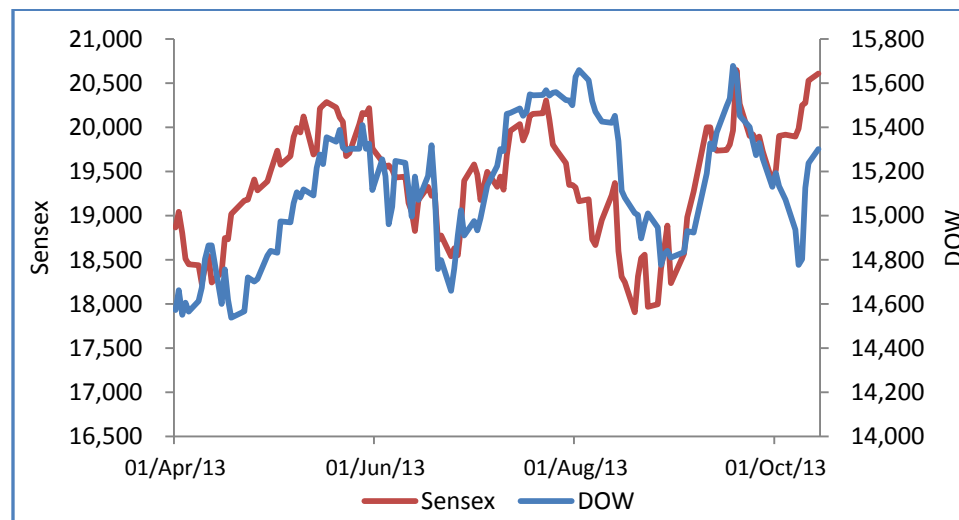
Forex Inflows through FIIs in FY14

Volatility has been no stranger to global and domestic markets this year; both markets having been subject to a number of headwinds time and again.

On the one hand, are the advanced economies that have witnessed new policy interventions be it on the monetary and/or fiscal side. Take for instance, Japan that embarked on its unconventional monetary easing stance to draw the economy out of a long-entrenched deflationary scenario; and the US of course, which had once considered tapering of its asset-purchase programme but refrained and is now faced with an added challenge of raising the debt ceiling of its government, which expires in two days time on October 17, 2013. The Euro-zone, as well in continuing with its accommodative monetary policy stance has still not completely broken out of the muted growth cycle. Advanced economies, have for more than two years now, been providing easy liquidity to their own economies; yet undoubtedly, some funds have found their way to more attractive emerging market economies. Hence, when the fear of one of the largest liquidity provider (the Federal Reserve) cutting back on its programme came to govern market sentiment, risk appetite shrunk substantially.

Emerging market economies (EMEs) have also had their own set of problems – spiking inflation, slowing growth, withdrawal of foreign funds and/or unfavourable currency movements and weakening of their external balances consequent on developments in advanced economies. The threat of an impending strike on Syria by the US has only made financial markets more risk averse, particularly towards EMEs. India, as is the case with other EMEs, has also been adversely affected. Exhibit 1 charts the performance of Sensex (index value) vis-à-vis the DOW Jones for the period April 1, 2013 to October 11, 2013. Reactions on the Sensex clearly appear to be more pronounced on the domestic bourse when compared with the DOW though the direction is generally similar. In-tandem movements appear to have emerged in more recent trading sessions once again.

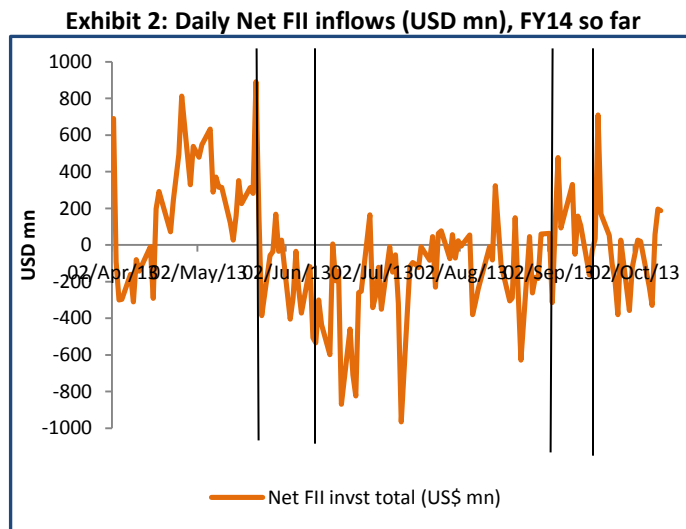
Exhibit 1: Sensex vis-à-vis the DOW



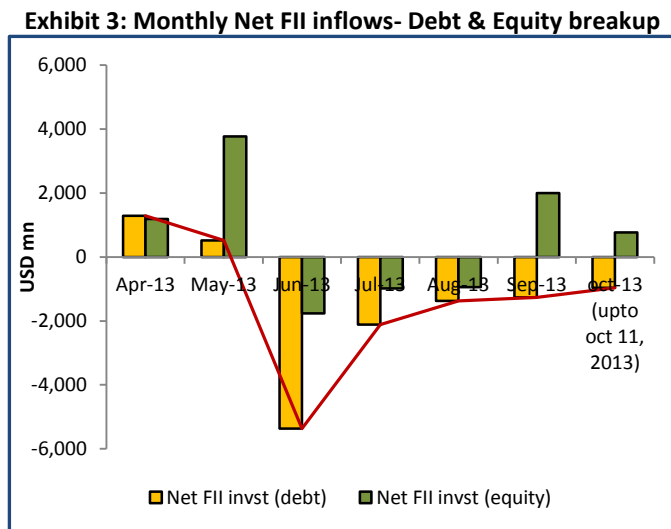
Source: BSE, CNN Money

Trend in FIIs inflows

A major factor contributing to the sharp volatility in the Sensex is the withdrawal of foreign institutional investors (FIIs) from local market assets.



Source: SEBI



Source: SEBI

Trends in FIIs are seen to track – firstly, announcements of the Fed on tapering and secondly, developments in the domestic economy.

- On May 22, 2013, the Fed gave its first few hints on considering a tapering of its monthly \$85 bn open-ended asset-purchase programme. Markets undoubtedly went into a tizzy – with stock markets falling, GSec yields rising and FIIs withdrawing funds across EMEs, including India.
- On June 19, 2013, came the clarification on tapering. With the release of minutes of the meeting of the Fed, it became clear that tapering was contingent on the Fed's medium-term unemployment rate target of 7.0% and long-term target of 6.5%. Unemployment rate in the US at that time around stood close to 7.7%, way above the desired levels. While the comfort of being away from targets and hence, the Fed likely refraining from tapering helped markets pick in following trading sessions, the possibility of tapering in near future persisted. This kept markets from rising robustly. In fact, the positive net investment position of FIIs in May had turned negative in June and remained so with marginal improvement in coming months.
- In the interim, India released its first quarter GDP numbers. Clocking the lowest quarterly growth of 4.4% in Q1 FY14, FIIs viewed this as further weakening of domestic fundamentals, coupled with deterioration in the country's current account deficit (CAD). In particular, the debt segment in FIIs accordingly registered more withdrawals than the equity space.
- In the absence of any other new developments and uncertainty continuing to prevail, FIIs either withdrew or remained on the sidelines over the following two months, until August 2013.
- From a few days prior to September 4, 2013, when Dr. Raghuram Rajan took over as the new RBI Governor, markets began to register minor improvements. Measures on curbing gold imports, managing liquidity conditions and government initiatives to secure foreign investments coupled with the entry of a new RBI Governor positively impacted the rupee. The currency after consistently depreciating all the way to nearly Rs

69 to a dollar mark began a reversal in its trend, appreciating thereafter (*rupee movement discussed in following section*).

- Additionally, the Fed on September 18, 2013 decided not to taper its asset-purchase programme, until such time that the US economy and unemployment rate thereof, moved into comfort zone. Taking this as a positive cue, FIIs investments (debt and equity) in September and October so far (until October 11, 2013) have registered improvement.

Table 1: Improvement in Net FII inflows (USD mn)

Net FII investments	June	July	Aug	Sept	Oct*
Debt	-5,366	-2,111	-1,379	-1,260	-964
Equity	-1,764	-986	-947	1,994	770
Total	-7,130	-3,097	-2,325	734	-194

Source: SEBI

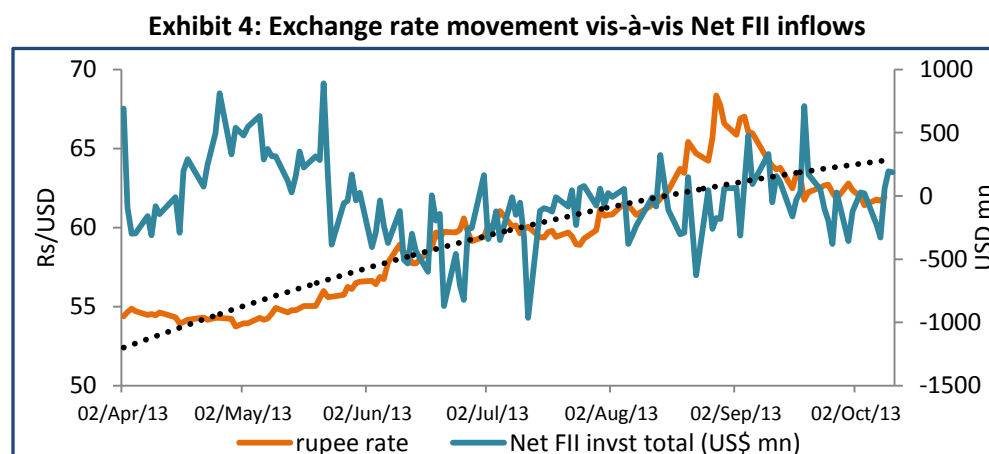
*until Oct 11, 2013

A rather clear point that emerges here is subdued FII activity in the debt space. India as of March 31, 2013 permitted FII participation in debt segment to the tune of USD 76.5 bn (Rs 3,71,062 crore). The debt utilisation status of FII investments stood at just 51.2% of available limit, as on March 31, 2013; with investment weighted towards government debt rather than corporate debt. The limit of USD 76.5 bn is split as USD 25 bn in government debt and USD 51.5 bn in corporate debt (including infra funds). Given the scenario this year, it would be little surprising that this limit for FII investments remains relatively unutilized in FY14 as well.

The government is seen to be taking additional effort at attracting more foreign investments to boost its capital account; the most recent one being lobbying for inclusion of India in the JPMorgan debt index. Inclusion of Indian financial assets in global indices is expected to enhance foreign capital inflows; although the success of these measures remains to be seen in the rest of the year. Perhaps, the debt segment might see only marginal increases in inflows, but the equity inflows could increase. This in turn, could help shore up forex reserves for the country.

Behaviour of Rupee

With FIIs withdrawing from Indian investments, the rupee has been hit hard this year. Exhibit 4 charts the exchange rate (RBI reference rate) vis-à-vis net FII inflows.



Source: RBI, SEBI

Taking the lowest value of Rs 53.74 to a dollar (as on April 30, 2013) and highest of Rs 68.36 to a dollar (as on August 28, 2013), the rupee has seen the sharpest depreciation of more than 27.0% (p-o-p) this year, at peak. In FY14 so far (April 2, 2013 to October 15, 2013) the rupee has depreciated 13.4%.

Since Dr. Rajan has taken over as RBI Governor, the rupee has reversed its trend, appreciating 7.3% (September 4, 2013 to October 15, 2013). This strengthening of the rupee has been supported by the partial revert on some of the temporary measures announced by RBI, postponement of tapering by the Fed, improvement in Indian trade data and improvement in FII inflows to the country.

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