Capital Inflows in India

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Over the last few years, India has emerged as a major destination for foreign investors to direct their funds. A promising growth story, wide range of opportunities and investment avenues, huge consumer market and good returns on investment, have all been attracting features of the Indian economy for external capital funds to flow in. This article looks at a very important segment of foreign funds, namely, Foreign Institutional Investors (FIIs) – which has emerged as an important source of funding that has provided support to an increasing current account deficit.

Trends in FIIs

Barring the years of the financial crisis in 2008-09 and weakening of domestic fundamentals in 2011-12 that have caused aberrations in the trend of net investments position of FIIs, capital inflows through this route have been robust.

While FII investments are perceived as hot money flows that can retract very easily to exit the country, they also reflect global investor perceptions and confidence in a country. Indeed, despite 2012-13 being a difficult year for India's economy, global investors continued to load investments into India. FY13 ended with more than US$ 31 billion coming into the country through the FII mode alone, which can definitely be interpreted as sanguine for the Indian economy. In a way such FII flows over the years reinforce the faith of investors in the Indian story.

What has caused FIIs to fly in?

For one, the Government of India since September 2012, has announced and undertaken a slew of policy reforms. In an economy that is facing domestic stress and global headwinds these policy reform initiatives, (be it deregulation of diesel, liberalisation of FDI norms to open up new sectors to foreign investors or banking sector reforms), have re-instilled a sense of faith in the legislative and administrative power of the State. This boosted sentiments in the financial markets space. With domestic bourses registering increased trading activity in the latter part of the year, equity markets have once again picked up. Accordingly, portfolio investments in the equity space also moved higher than the US$ 25 billion mark in Fy13.

However, foreign investments through the debt route have not been as strong as the equity ones - after consistently rising for three years (FY10-FY12); they slid in FY13. The debt segment is of particular relevance as it attracts relatively longer-term capital, which may also be used for development of infrastructure in a growing economy like India. In all, portfolio investments in debt instruments, through successive revisions in upper limits, have been increased to a maximum of US$ 76.5 billion (Rs 3.7 lakh crore). As of March 31, 2013, about 59% of the aggregate cap has been acquired by various entities (mostly in corporate debt and some government debt). Furthermore, of the available aggregate limit, US$ 12 billion is dedicated for corporate debt investments in long-term infrastructure. However, disappointingly enough no such acquisitions of limits were registered in the infra-space in FY13. The government must accordingly, continue its proactive stance of expanding limits available specifically to FIIs in the debt segment, to attract more long-term funds into the economy. With greater liberalisation and improved economic prospects, capital inflows through this route are bound to recover.

Secondly, FIIs, especially in the last three years, have been able to extract better returns on investments in emerging market economies like India. Vastly different interest-rate regimes between advanced and emerging economies have allowed for arbitrage opportunities in portfolios of foreign investors. High interest rates in India relative to near-zero ones in countries like US and UK have helped attract funds towards local markets and offset the negative impact of temporary weakening of domestic macroeconomic conditions. Thirdly, highly accommodative monetary policy stance adopted by advanced countries has left excess funds to flow freely to developing countries. For instance, the US Federal Reserve under its quantitative easing programme has regularly been pumping huge sums into the economy through buyback of treasury and mortgage-backed securities (QE1 and QE2 for US$ 600 billion, QE3 open-ended buyback of US$ 40 billion per month and lately, QE4 - another open-ended buyback of US$ 85 billion of securities per month since December 2012). While the primary objective has been to stimulate the US economy and free up credit flows, it has undeniably led to flow of capital towards emerging markets. The European Central Bank (ECB) joined the club by announcing an unlimited bond buyback programme in September 2012 to aid revival of struggling Euro-zone economies. The latest member in the pursuance of easy monetary regimes is Japan. In a bid to climb out of deep-rooted deflationary environment, Japan has announced a US$ 7.6 billion bond-buyback programme. This would again mean that investors in these economies would seek to lift assets from other countries in search of better yields.

How has it helped India?

Greater capital inflows have had an obvious benefit for India in terms of bridging the economy's funding gap. The Twelfth Five Year Plan, pegs infrastructure funding requirement alone at US$ 1 trillion, set aside other financing needs of capital formation. Domestic markets (investors, corporates and the government) would face difficulty in meeting these needs and external capital inflows have been and would be of great help here.

Moreover, these capital inflows have helped supplement the country's balance of payments and counterbalance stress on the current account of deficit. Indeed, the financial account of the country saw net accretions in FY13 (US$ 71 billion, during the period April-December), primarily due to surge in FII inflows (coupled with increased remittances and short-term credits). This has also helped enhance forex reserves of the country along with providing a cushion to the currently depreciating rupee, preventing it from falling too dramatically.

Would it last?

One can zero-in on this 'wall of money' flooding emerging markets as the current driver for FII inflows into India. As quantitative easing increases across advanced countries, India stands to gain from FII inflows that would positively impact its external economy fundamentals (BoP, exchange rate and reserves). Depending on the game plan of advanced economies (the US itself, for instance has pledged to provide stimulus until at least 2014, ECB has not commented on a close-date and Japan has just about started), the coming year or two would bring with it some comfort on the external sector for India; which is good news.

Once this wall fades away, India, like all emerging markets, would once again have to rely on its real growth essentials in order to attract foreign funds. It may be conjectured that the country would move out of its low growth phase this year and it would not be very difficult to maintain the promising returns on investment that it currently offers.

A potential threat however, is an impending asset bubble as accurate price discovery gets hampered with such a flood of money that can see quick and sudden withdrawals with changes in global dynamics. India has just about successfully contained its high inflation scenario; although price pressures persist (be it rise in prices of primary articles or fuel). Dealing with a distorted asset price situation would create imbalances in the domestic financial regime. Here, monetary and fiscal authorities would have to keep a keen eye on price forces.

With the government announcing proactive policies to ensure a favourable investment climate for foreign investors (such as creation of Infrastructure Debt Fund as announced in the last couple of budgets) 'hot money flows' can easily be converted to credible long-term investments and thereby, continue to assure momentum in flow of foreign funds into the country.