Exit of Foreign Portfolio Investors

For Prelims: Capital Market, Inflation, FPI, US Federal Reserve, Reserve Bank of India, Monetary Policy

For Mains: Significance of FPI, Effect of Exit of FPI on Indian Economy, RBI's Monetary Policy, Effect of US Federal Reserve on Indian Economy

Why in News?

June 2022 witnessed the **worst Foreign Portfolio Investor (FPI)** selloff since March 2020 when India announced a **nationwide lockdown** at Rs. 50,000 crore.

- June was also the ninth on the trot that FPIs had sold net of their assets i.e. sold more than they had purchased.

What Do We Mean by Foreign Portfolio Investors?

- **About:**
    - Foreign portfolio investors are those that invest funds in markets outside of their home turf.
        - Examples of FPIs include stocks, **bonds**, **mutual funds**, **exchange traded funds**, American Depositary Receipts (ADRs), and Global Depositary Receipts (GDRs).
    - FPI is part of a country's **capital account** and is shown on its **Balance of Payments (BOP).**
        - The BOP measures the amount of money flowing from one country to other countries over one monetary year.
    - They are generally not active shareholders and do not exert any control over the companies whose shares they hold.
    - **The Securities and Exchange Board of India (SEBI)** brought new **FPI Regulations, 2019**, replacing the erstwhile FPI Regulations of 2014.
    - FPI is often referred to as **"hot money"** because of its tendency to flee at the first signs of trouble in an economy. FPI is more liquid, volatile and therefore riskier than FDI.
- **Significance of FPI:**
    - **Accessibility to International Credit:**
        - Investors may be **able to reach an increased amount of credit** in foreign countries, enabling the investor to utilize more leverage and generate a higher return on their equity investment.
    - **Increases the Liquidity of Domestic Capital Markets:**
        - As markets become more liquid, **they become more profound and broader,** and a more comprehensive range of investments can be financed.
        - As a result, **investors can invest with confidence** knowing that they can promptly manage their portfolios or sell their financial securities if access to their savings is required.
    - **Promotes the Development of Equity Markets:**
        - Increased competition for financing leads to rewarding superior performance, prospects, and corporate governance.

        - As the market's liquidity and functionality evolve, equity prices will become value-relevant for investors, ultimately driving market efficiency.

How Big are FPI In India?

- FPIs are the largest non-promoter shareholders in the Indian market and their investment decisions have a huge bearing on the stock prices and overall direction of the market.
- Holding of FPIs (in value terms) in companies listed on **National Stock Exchange** stood at Rs. 51.99 lakh crore as on 31st March 2022, a decrease of 3.36% from Rs. 53.80 lakh crore as on 31st December 2021 due to the sustained sell-off since October 2021.
- FPIs hold sizeable stakes in private banks, tech companies and big caps like Reliance Industries.
- The US accounts for a major chunk of FPI investments at Rs. 17.57 lakh crore as of May 2022, followed by Mauritius Rs. 5.24 lakh crore, Singapore Rs. 4.25 lakh crore and Luxembourg Rs. 3.58 lakh crore, according to data available from the National Securities Depository Ltd (NSDL).

What Factors Encourage FPI Moves?

- **Economic Growth:**
    - Promise of attractive returns on the back of **economic growth** draws investors including FPIs into a country's markets.
    - As per data from the National Securities Depositories Ltd. (NDSL), FPIs brought in about Rs. 3,682 crore in 2002.
        - This grew to Rs. 1.79 lakh crore in 2010. This correlates with the concurrent expansion of economic output in that period, despite the 2008 global financial crisis which saw FPI selloffs in that timeframe in the country
    - Likewise, **FPIs withdrew Rs.1.18 lakh crore in March 2020 alone** — the month when India announced a nationwide lockdown, triggering concerns around economic growth.
- **US Federal Reserve:**
    - Rate hikes by the **Federal Reserve** affects not only the US economy, but also shapes the macroeconomic outlook and exerts a certain degree of influence on the **monetary policies** in other emerging economies.
    - **Correlation of Federal Reserve & Indian Markets:**
        - **Emerging economies such as India tend to have higher inflation** and higher interest rates than those in developed countries such as the US and many of the (primarily Western) European nations.
        - As a result, financial institutions, particularly **Foreign Institutional Investors (FIIs)** would want to borrow money in the US at low interest rates in dollar terms and then invest that money in **government bonds** of emerging countries such as India in local currency terms to earn a higher rate of interest.
        - When the US Federal raises its domestic interest rates, the difference between the interest rates of the two countries decreases.
            - This makes India less attractive for the currency carry trade, consequently, some of the money may be expected to move out of the Indian markets and flow back to the US.

Why have FPIs been selling India holdings?

- **Post Pandemic Effects:**
    - Post Pandemic, recovery in the Indian economy has been uneven.
    - The **second wave of the Covid-19** pandemic in 2021 devastated lives and livelihoods.
        - The economy stuttered again when a third, albeit less severe, wave saw the spread of the **Omicron variant** early in 2021.
    - In addition, the return of pent-up demand in economies worldwide as the pandemic subsided created problems as the pace of recovery caught suppliers off guard, contributing to supplyside shortages.
        - **Pent-up demand describes a rapid increase in demand for a service or product,** usually following a period of subdued spending.
- **Russia Ukraine Conflict:**

    - Sunflower and wheat supplies from these **two nations** were impacted, leading to a rise in global prices for these crops.
        - As supplies in general tightened across the globe, commodity prices too rose and overall inflation accelerated.
        - India witnessed a quickening pace in price rise that stayed above the **Reserve Bank's** upper comfort level of 6% for five months running, touching 7.8% in April, before receding to a slightly less aggressive 7.04% in the subsequent month.
    - The S&P Global India Manufacturing **Purchasing Managers' Index (PMI)** slid to 53.9 in June — the lowest level in nine months — from 54.6 in the previous month. Experts attribute this to inflation pressures, which also dampened business confidence sentiment to a 27 month low in June, as per survey based findings.
- **US Federal Reserve:**
    - Recently, the US Federal Reserve announced the most aggressive interest rate increase in almost 30 years, raising the benchmark borrowing rate by 0.75% points in its battle against surging **inflation.**
        - When the differential between the interest rates in the U.S. and other markets narrows, and if such an occurrence is accompanied by the strengthening of the dollar, then the ability of investors to realize healthy returns is impacted.
    - If the Dollar strengthens against the Rupee, then an investor is able to realize fewer Dollars for a given quantum of Rupee assets liquidated.
    - Investors tend to exit assets seen as 'risky' such as in emerging markets like India, Brazil or South Africa.
        - Indeed, the Rupee has been **depreciating** against the Dollar.
        - The rupee touched its record low of 79.33 against the greenback in July 2022.

What Impact Does an FPI Selloff Have?

- **Local Currency:**
    - When FPIs sell their holdings and repatriate funds back to their home markets, the local currency takes a beating.
        - Investors sell rupees in exchange for their home market currency.
        - As supply of the rupee in the market rises, its value declines.
        - As a result, we have to shell out more funds to import the same unit of goods.
- **On Exports & Imports:**
    - India being one of the largest **crude oil** importers of the world.
    - A weaker rupee vis-à-vis a dollar results in more expensive imports of crude oil that may put cost-driven inflationary push across the whole economy and especially in those sectors that are highly sensitive to crude oil price movements.
    - India's exports on the other hand, notably IT and IT-enabled services – will benefit to some extent from a stronger dollar with respect to the rupee.
        - However, the same benefit may not fully accrue to exporters due to strong competition in the export market.
- **Reserves:**
    - India's **foreign exchange reserves** have fallen USD46 billion in the last nine months to USD596.45 billion as on 10th June 2022, mainly due to the dollar appreciation and FPI withdrawals.
- **Other Effects:**
    - Foreign investors pulling out can result in a **decline in stocks and equity mutual fund investments.**
    - A lower rupee against the dollar keeps import bills higher, pushing inflation even higher than it is now.
        - Higher inflation is detrimental to the overall market. If the rupee does not strengthen, FPI outflows will continue, which is another negative.
        - Travellers and students studying abroad will have to shell out more rupees to buy dollars from banks.

UPSC Civil Services Exam, Previous Year Questions (PYQ)

Q. Which of the following is issued by registered foreign portfolio investors to overseas

investors who want to be part of the Indian stock market without registering themselves directly?

(a) Certificate of Deposit
(b) Commercial Paper
(c) Promissory Note
(d) Participatory Note

Ans: (d)

Exp:

- A Participatory Note or P-note is an instrument issued by a registered Foreign Institutional Investor (FII) to an overseas investor who wishes to invest in Indian stock markets without registering themselves with the market regulator, the Securities and Exchange Board of India (SEBI).
- A Certificate of Deposit is a savings certificate with a fixed maturity date and specified fixed interest rate that can be issued in any denomination aside from minimum investment requirements.
- Commercial Paper is an unsecured money market instrument issued in the form of a Promissory Note. It was introduced in India in 1990 with a view to enable highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors.
- A Promissory Note is a financial instrument that contains a written promise by one party (the note's issuer or maker) to pay another party (the note's payee) a definite sum of money, either on demand or at a specified future date.
- **Therefore, option (d) is the correct answer.**

Source: TH