Courting Risk: Policy Manoeuvres on FII Inflows

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The evidence is stark and incontrovertible. In the period since April 2003, India has witnessed an extraordinary surge in foreign institutional investments. Having averaged $1776 million a year during 1993-94 to 1997-98, net FII investment dipped to an average of $295 million during 1997-99, influenced no doubt by the Southeast Asian crisis. The average rose again to $1829 million during 1999-2000 to 2001-02 only to fall $377 million in 2002-03. The surge began immediately thereafter and has yet to come to an end. Inflows averaged $9599 million a year during 2003-05 and are estimated at $9429 million during the first nine months of 2005-06. Going by data from the Securities and Exchange Board of India (SEBI), while cumulative net FII flows into India since the liberalisation of rules governing such flows in the early 1990s till end-March 2003 amounted to $15,804 million, the *increment* in cumulative value between that date and the end of December 2005 was $25,267 million.

It is not surprising that the period of surge in FII investments was also one when, despite fluctuations, the stock market has been extremely buoyant. The market in India lacks width and depth, with few investors, few companies whose shares are actively traded, and a small proportion of those shares available for trading. Hence any new capital inflow does trigger price increases. The Bombay Sensex rose from 3727 on March 3, 2003 to 5054 on July 22, 2004, and then on to 6017 on November 17, 2004, 7077 on June 21, 2005, 8073 on November 2, 2005 and 9323 on December 30, 2005. The implied price increases of more than 80 per cent over a 17-month period and 50 per cent over just more than a year are indeed remarkable. Market observers, the financial media and a range of analysts have concurred that FII investments have been an important force, even if not always the only one, driving markets to their unprecedented highs.

Underlying the current FII and stock market surge is, of course, a continuous process of liberalisation of the rules governing such investment: its sources, its ambit, the caps it was subject to and the tax laws pertaining to it. It could, however, be argued that the liberalisation began in the early 1990s, but this surge is a new phenomenon which must be related to the returns now available to investors that make it worth their while to exploit the opportunity offered by liberalisation. The point, however, is that while the good profit performance of domestic firms may partly explain the high returns of recent times, there were other factors that may have been more crucial. To start with, current account surpluses, higher remittances and rising inflows on account of exports of software services had ensured a strengthening of the Indian rupee, despite the RBI’s effort to manage the exchange rate with large purchases of foreign currency. A stronger rupee implies better returns in dollar terms, encouraging foreign investors looking for capital gains. This possibly even triggered a speculative surge in inflows because of expectations that the rupee would rise even further. Given the role of FII investments in increasing the supply of foreign exchange, such expectations tend to be self-fulfilling at least for a period of time.

Returns on stockmarket investment were also hiked through state policy. Just before the FII surge began, and influenced perhaps by the sharp fall in net FII investments in 2002-

03, the then Finance Minister declared in the Budget for 2003-04: “In order to give a further fillip to the capital markets, it is now proposed to exempt all listed equities that are acquired on or after March 1, 2003, and sold after the lapse of a year, or more, from the incidence of capital gains tax. Long term capital gains tax will, therefore, not hereafter apply to such transactions. This proposal should facilitate investment in equities.” Long term capital gains tax was being levied at the rate of 10 per cent up to that point of time. The surge was no doubt facilitated by this significant concession.

Once the FII increase resulting from these factors triggered a boom in stock prices, expectations of further price increases took over, and the incentive to benefit from untaxed capital gains was only strengthened. In the circumstances, there is reason to believe that the herd instinct so typical of financial investors played a role in sustaining the boom, with a rush of investors into the country. The number of FIIs registered in India stood at 502 at the end of March 2003, many of whom had registered immediately after the rules were liberalised to permit their entry. As many as 353 FIIs had registered by the end of March 1996. The second spike in FII registration is more recent. Thus, the number of FIIs registered in the country rose by 321 between end 2002-03 and end of December 2005, when the figure touched 823.

Even a cursory assessment of recent developments would, therefore, lead to three tentative conclusions. First, that FII investment does seem volatile even when annual average figures are considered. Second, while an initial promise of high returns triggered FII interest, speculative objectives and the herd instinct have played a role in keeping investment high and the markets buoyant. And, third, given the massive and concentrated inflows in recent times there are reasons to be concerned with their macroeconomic implications and the danger of an equally sudden reversal.

There have been too many instances in East Asia, Latin America, Turkey and elsewhere where a financial crisis was preceded by a surge in capital flows other than foreign direct investment and a simultaneous boom in stock and/or real estate markets. Independent of their inclinations, the exact causal mechanisms they identify and where they place the burden of blame, analysts of those periodic crises have accepted the reality that liberalised financial markets are prone to boom-bust cycles. Hence, even if the ongoing India-boom is seen by some as being “different” and “warranted by fundamentals”, there remains ample room for caution. Most booms were seen as signs of strength rather than vulnerability, till they went bust.

The case for vulnerability to speculative attacks is strengthened because of the growing presence in India of institutions like Hedge Funds, which are not regulated in their home countries and resort to speculation in search of quick and large returns. These hedge funds, among other investors, exploit the route offered by sub-accounts and opaque instruments like participatory notes to invest in the Indian market. Since FIIs permitted to register in India include asset management companies and incorporated/institutional portfolio managers, the 1992 guidelines allowed them to invest on behalf of clients who themselves are not registered in the country. These clients are the ‘sub-accounts’ of registered FIIs. Participatory notes are instruments sold by FIIs registered in the country to clients abroad that are derivatives linked to an underlying security traded in the domestic market. These derivatives not only allow the foreign clients of the FIIs to earn incomes from trading in the domestic market, but to trade these notes themselves in international markets. By the end of August 1995, the value of equity and debt instruments underlying participatory notes that had been issued by FIIs amounted to Rs. 78,390 crore or 47 per cent of cumulative net FII investment. Through these routes, entities not expected to play a role in the Indian market can have a significant influence on market movements. In October 2003, *The Economist* reported that: “Although a few hedge funds had invested in India soon after the country began liberalising its financial markets in the early 1990s, their interest has surged recently. Industry sources estimate that perhaps 25-30 per cent of all foreign equity investments are now held by hedge funds.”

The problem does not end here. For some time now, the capital surge has been eroding the ability of the central bank to pursue its monetary policy objectives. The foreign exchange assets of the central bank rose sharply, from $42.3 billion at the end of March 2001 to 54.1 billion at the end of March 2002, $76.1 billion at the end of March 2003, $113 billion at the end of March 2004 and $142 billion at the end of March 2005. The process of reserve accumulation is the result of the pressure on the central bank to purchase foreign currency in order to shore up demand and dampen the effects on the rupee of excess supplies of foreign currency. In India’s liberalized foreign exchange markets, excess supply leads to an appreciation of the rupee, which in turn undermines the competitiveness of India’s exports. Since improved export competitiveness and an increase in exports is a leading objective of economic liberalisation, the persistence of a tendency towards rupee appreciation would imply that the reform process is internally contradictory. Not surprisingly the RBI and the government have been keen to dampen, if not stall, appreciation.

Unfortunately, the RBI’s ability to persist with this policy without eroding its ability to control domestic money supply is increasingly under threat. Increases in the foreign exchange assets of the central bank amount to an increase in reserve money and therefore in money supply, unless the RBI manages to neutralise increased reserve holding by retrenching other assets. If that does not happen the overhang of liquidity in the system increases substantially, affecting the RBI’s ability to pursue its monetary policy objectives. Till recently the RBI has been avoiding this problem through its sterilisation policy, which involves the sale of its holdings of central government securities to match increases in its foreign exchange assets. But even this option has now more or less run out. Net Reserve Bank Credit to the government, reflecting the RBI’s holding of government securities, had fallen from Rs. 1,67,308 crore at the end of May 2001 to Rs. 4,626 crore by December 10, 2004. There was little by way of sterilisation instruments available with the RBI.

There are two consequences of these developments. First, the monetary policy of the central bank that had been delinked from the fiscal policy initiatives of the state by foreclosing monetisation of government debt is no more independent. More or less autonomous capital flows influence the reserves position of the central bank and therefore the level of money supply, unless the central bank chooses to leave the exchange rate unmanaged, which it cannot. This implies that the central bank is not in a position to use monetary levers to influence domestic economic variables. Secondly, the country is subject to a drain of foreign exchange inasmuch as there is substantial difference between the repatriable returns earned by foreign investors and the foreign exchange returns earned by the Reserve Bank of India on the investments of its reserves in relatively liquid assets. While partial solutions to this problem can be sought in mechanisms like the Market Stabilisation Scheme (which places government securities in a market stabilisation facility that increases the interest costs borne by the government), it is now increasingly clear that the real option in the current situation is to either curb inflows of foreign capital or encourage outflows of foreign exchange.

Informed by the global experience the RBI has been making a case for caution. It has pointed to the problems created by volatile capital inflows for exchange rate and monetary management. It has flagged the dangers associated with investments through the sub-account or participatory note (PN) routes, which can be exploited by unregulated and/or unidentified entities involved in take-over bids, money laundering or short-term speculation. And it called for policies that can reduce the vulnerability associated with volatility.

It must be said to the credit of the UPA that currently rules the country that it had sensed these tendencies quite early, so that its National Common Minimum Programme declared that "FIIs will continue to be encouraged while the vulnerability of the financial system to the flow of speculative capital will be reduced." In keeping with that perception, the Prime Minister constituted an Expert Group to provide an action plan to meet that commitment. The committee's constitution was officially notified on November 2, 2004 and it was to submit its report by November 30, 2004. The Group actually submitted its report a year later in November 2005.

If the gravity of its content is the yardstick to go by, there would be no reason to take note of this report. Filled with assertions, it reads more like a pamphlet advocating financial liberalisation than the report of a group of experts. And where there are indications of expertise, these amount to no more than an excessively selective review of related literature, which is often not even woven into the flow of the report's argument. There have been many other reports dealing with similar issues emanating from agencies like the Reserve Bank of India in which policy-makers may fruitfully invest their reading time. However, because this report emanates from the Finance Ministry and includes a note of dissent from the representative of the RBI, which substantially distances the central bank from the contents of the report, it partly reflects both the trend of thought and the tensions which prevail in the corridors of decision-making. It is the source not the content that warrants giving it attention.

From the discussion of recent trends with regard to FII movements it should be clear that by the time the Group was constituted and definitely by the time the Group submitted its report, the issue of encouraging FIIs was of little significance, with the problem being one of managing the surge in such flows. Yet the thrust of the whole report is on encouraging FII flows and not dealing with vulnerability. The emphasis seems to be on ensuring that no corrective policies are adopted and that the process of liberalisation is continued with. To quote the report: "While there is indeed the issue of timing the policy of encouragement appropriately, to avoid the pitfalls of throwing the baby with the bath water, there can not be a turnaround from the avowed policy of gradual liberalisation. Any recommendation made today should be consistent with the broad strategy of further liberalisation, and not look like or be a rollback of reforms."

On what grounds then does the expert group justify its case for further encouragement rather than increased regulation? To start with, there are arguments extolling the virtues of foreign institutional investment, each of which needs examination. Prime among these is the view that FII investments help increase stock prices and therefore reduce the cost of equity capital. It is unclear exactly how this occurs. FII investments in themselves do not increase earnings. So if FII investments that raise prices are warranted by fundamentals, earnings should be high and price-earnings ratios should be low. If these earnings are not being paid out as dividends then the expectation should be that earnings would rise from their current levels, so that capital gains can be booked. This makes the investment inherently speculative.

In any case, the price increase occurs mainly in the secondary market, and does not directly contribute to additional equity for investment unless new shares are issued at higher prices. This has indeed been true of some large firms which have been able to mobilise large sums through the premium at which they are able to issue additional equity. But, unlike the case during the scam-induced stock market boom of the early 1990s, the recent boom or any of the mini-booms that occurred in between did not see successful IPO issues by smaller or new firms. In essence, therefore, the effect of the stock price boom is to transfer surpluses from investors to large corporates through the so called cheap-equity route. To the extent that the investors are small savers, this amounts to a form of forced saving, leveraged through speculation.

The second argument advanced in favour of FII investment is that, like FDI, it is a safe and sustainable mechanism of funding the current account deficit. Elsewhere the report suggests that because of "infirmities of Indian indirect taxes and transportation infrastructure", FDI flows to India have remained small relative to China. While sweeping generalisations of this kind need not detain us here, it must be noted that the FII surge to India occurred precisely at a time when India did not need these flows to finance her balance of payments. In the event, as noted above much of this foreign exchange was added to India's reserves.

Finally, FII investments are supported on the grounds that FII participation in domestic capital markets often leads to sound corporate governance practices, improved efficiency and better shareholder value. One only needs to refer to the innumerable instances of fraudulent accounting practices, conflict of interest and manipulation involving FII principals periodically reported from their home country markets, to make light of this claim.

While the authors of the report stretch themselves in this fashion to advocate the cause of the FIIs, they virtually dismiss all arguments that point to the dangers involved in the growing presence of FIIs in Indian markets. Herding is not a problem because, FIIs are ostensibly observed to be involved in buying and selling at the same time. Vulnerability is not an issue ostensibly because there has never been an occasion when more than a billion dollars flowed out in one month. The fact that there has not been any previous period except the last three years when FII investments anywhere near an annual $9-10 billion Indian has entered Indian markets is conveniently ignored. Similarly, the problem of opaqueness of sub-accounts and PNs is set aside by suggesting that FIIs should be "obliged" to report on the identity of their investment sources. And since all modern market economies have ostensibly evolved policies to reconcile prudent monetary management with the benefits of a liberal capital account, there is seen to be no scope for diffidence in India.

Having set the stage with these assertions, the report goes on to advocate measures that would further encourage FII investments. Thus, it recommends that FII investment and FDI must be treated separately, and the cap on FII investment "if any" reckoned over and above prescribed FDI caps. The danger that takeover efforts may be strengthened through opaque means such as sub-accounts and PNs must be dealt with by requiring the reporting of clients holding such positions. However, the current dispensation with regard to participatory notes should continue. Any policy with regard to the operation of Hedge Funds should be postponed till such time as regulatory mechanisms are introduced in the US and elsewhere and these are studied. FIIs should be given operational flexibility by allowing them the freedom to switch between equity and debt investments, so that they can pursue more "balanced" strategies. Finally, since with the growing presence of FIIs in the market there is a shortage of good quality equity, disinvestment of profitable public sector equity, as in the case of Gas Authority of India Ltd. (GAIL), Oil and Natural Gas Corporation (ONGC) and National Thermal Power Corporation (NTPC), must be resorted to! At least to the knowledge of this author this is the first time such a bizarre argument in favour of disinvestment of public sector units (PSUs) has been advanced.

All these are clearly aimed at encouraging more FII investment flow. But what does the report say about vulnerability? To the extent that it matters, here too more liberalisation is the answer. In the view of the experts: "The participation of domestic pension funds in the equity market would augment the diversity of views on the market. This would also end the anomaly of the existing situation where foreign pension funds are extensive users of the Indian equity market but domestic pension funds are not." That will socialise the cost of dealing with unrecognised vulnerability, by making a section of the middle class bear a part of the burden of seeking to promote the "irrational exuberance" that seems to characterise the market.

Fortunately, the RBI has not been taken in by this euphoria. In its own sober fashion it makes the following points: (i) that the Expert Group's report does not address the macroeconomic implications of volatility of capital flows and the fall-out of excessive inflows and outflows for macroeconomic management and suggest appropriate measures to deal with the problem; (ii) that a special group should be constituted on a priority basis to address these issues comprehensively; (iii) that in view of the growing international concern regarding the origin and source of investment funds flowing into the country, the issue of participatory notes should not be permitted (since trading of these PNs will lead to multi-layering) and hedge funds, which by their very nature cannot be subject to regulation, registered with SEBI should be examined for deregistration; (iv) that the government should continue with its policy of keeping separate FII and FDI limits; (v) that the requirement of special resolutions to be passed by both the shareholders (in an EGM) and the board of a company for enhancing the FII limit beyond 24 per cent, wherever applicable under the present policy guidelines should continue, and in cases like retail trading, where FDI is not allowed and the limit for FII investments is 24 percent, that limit should not be increased; and (vi) that it would not be appropriate to permit FII to treat debt securities (both government and corporate debt) as an investment avenue and a ceiling on the total stock of FII investment in debt should be retained.

In sum, the RBI, conscious of the problems created by volatility and the surge in FII inflows, has virtually disowned much of the report, which now reflects a Finance Ministry view. The fact that the so-called Expert Group was loaded with members from the Finance Ministry seems to explain its failure to accommodate the legitimate concerns of the central bank which is charged with managing the balance of payments and the exchange rate. And the desire of the Finance Ministry to continue to impose it views is reflected in the recommendation that the Department of Economic Affairs should initiate a research program on “Capital flows and India's Financial Sector: Learning from theory, international experience, and Indian evidence”. Given the circumstances, this seems to be nothing more than the launch of another effort to offer an apology for international speculators operating in India’s stock and debt markets, ignoring the views of the central bank.