Vulnerability of Capital Markets to FPI flows

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1. With the current GDP of India at around USD 2.7 trillion, India is one of the largest emerging market economies in the world. The external sector (in terms of exports and imports) of the country's balance sheet constitutes almost a third of the country's GDP. It is also well recognized that India is a well-diversified economy, with productive capacity spread across several sectors of the economy. With significant size of the diversified external sector, and with large-scale dependence on oil imports, the policy makers have to closely monitor the trends in the country's Current Account deficit (CAD) so as to ensure that the CAD is adequately funded by the capital account.

2. The country's CAD has been in a manageable range of close to 1.5 to 2 percent for the last few years, after touching a precarious high of 4.8 percent in the year 2012-13. With the US announcing the withdrawal of Quantitative Easing (QE) on May 22, 2013, the markets took special note of the alarmingly high CAD and the financial markets in the country got into a turmoil. The policy makers had to roll out a series of measures in 2013 to quell the volatility in the market and bring the Indian currency back to stable trajectory.

3. Prime amongst the measures initiated in 2013 was the opening of a special RBI window to swap the FCNR deposits at a rate far benign compared to the prevailing market rates. This encouraged good amount of capital inflows of about USD 34 billion and it went a long way in stabilizing the currency and funding the CAD. The above recapitulation of 2013 events is mainly to stress the importance of foreign capital inflows for the Indian economy. Thus the country's acute dependence on foreign capital flows cannot be overemphasized.

4. The major types of flows on India's capital account consists of :

a. Foreign portfolio flows
b. Foreign direct investment
c. External Commercial borrowing
d. Non Resident Indian deposits

5. There have been intense debates in the past on India's approach to Capital Account convertibility (CAC), its pros and cons, sequencing, timing and the macroeconomic landscape needed to usher in CAC. It is by now well accepted, across various hues of policy makers that CAC is not a big-bang event to be announced one fine morning, but more a process spread across the continuum of time.

6. As a part of this process, India has been gradually opening up its capital markets for foreign flows. While there are not many fetters placed on overall foreign flows into the equity segment of Indian capital markets (except for ceilings on foreign investments in listed companies), the fixed income market (that is, the Government and corporate bond markets) faces several restrictions in terms of overall quantum, residual maturity, etc. There are oft-repeated questions from analysts as to why India practices this dichotomous approach towards equity markets and bond markets. The allied question is – are these markets differently vulnerable to vicissitudes in foreign flows ? While the short answer to this question is an emphatic NO, the real reason lies in the fact that the policy makers have a greater tolerance for equity market volatility compared to bond market volatility, as bond market volatility involves the most critical economic variable, that is, the interest rates, which is close to the hearts of monetary authorities. And hence the reasons for adopting an ultra-cautious approach towards the bond markets.

7. With increasing foreign flows into India, how vulnerable India has become to capital flows? While it is not my intention to do an econometric analysis of the vulnerability here, I will trace the reasons and implications of vulnerability by way of anecdotal evidence and reasoning. With more than USD 250 billion of flows cumulatively into equity and debt segments (the market value of which will be significantly higher), FPIs' stakes in our capital markets are very substantial. Their entry and exit from our markets on account of any global or domestic developments, particularly if on a collective basis, tend to be quite impactful. It is not just that the extent of their purchases and sales matter in creating gyrations in the market – the impact actually travels far beyond that. There are many market players who watch the FPI moves very closely in the market and align their moves in the market in a similar fashion, believing that the FPIs are savvy and well-informed investors. Hence, any FPI move tends to have a cascading impact on the market on the sentiments and such swings in sentiments shapes the market moves for the next few days. Any global event signaling risk aversion towards emerging markets gets transmitted to India through the medium of FPIs. In short, the FPIs have become a potent risk transmission medium.

8. Such vulnerabilities are common to both equity and debt segments and, as stated before, the policy makers allow themselves a greater room for tolerance for the equity market gyrations than that of bond markets. Having said this, we cannot remain oblivious of the recent trends (say, in the last 4 to 5 years) when we have witnessed the equity markets standing up strongly to FPI pull-outs. This phenomenon owes its origins to the increasing punch-power of the domestic institutional investors (DIIs). Significant amongst the DIIs is the Mutual Funds, which have been growing at a rapid pace in the last decade. The AUM of the MF industry has quadrupled in the last 6 years and with this heft, the MFs are able to pull their weight to spot gold in the market when the FPIs are in exit mode. So is the case with Insurance and pension funds. In summary, one needs to take note of the recent trends in the markets, where the DIIs are able to offer counter-strength to FPIs and are able to function as effective offsets. However, it may be wrong to jump to a conclusion from here that the DIIs are always sitting on the opposite side of FPIs. There are several events where the two may have similar views and, as a result, such events may have unidirectional impact on the markets (for example, fall out of NBFC crisis, perceived liquidity shortage in the market, etc.). But, where an event is dominantly foreign with relatively less domestic impact, the DIIs have important role to play vis-à-vis the FPIs.

9. In the case of bond markets, a prolonged period of volatility has an impact of blunting the monetary policy transmission mechanism, affecting the efficacy of the rate signals from RBI. In other words, the monetary authority's objective of containing inflation or supporting growth will get cold-shouldered by the market volatility. Hence, if the FPIs exit (or enter) in droves, the resultant volatility in bond markets play havoc with the intended rate structure contemplated by the Central Bank.

10. To conclude, the FPIs have a vital role to play in India in bridging the CAD, but in an environment of volatility, there is a need for strong domestic market forces to counteract any moves by one individual segment of market stakeholders, for the greater good of the market. In other words, the need for deep and vibrant markets in all asset classes in India is paramount and it is necessary for all market stakeholders to work towards realizing this objective.

11. Finally, a word about Indian Government raising borrowings abroad. If FPIs invest in Rupee debt in India, at the time of their sudden exit, there are two factors which come into play : interest rates and exchange rates. Both these rates come under pressure and the RBI will have to play a stabilizing role in both these markets. Unlike this, if India were to float a sovereign bond, the exchange rate will not get impacted by sale pressure on such bonds. It is only the interest rate which will come under pressure. To that extent, the problem becomes simpler for RBI to deal with.