Foreign Investor Appetite

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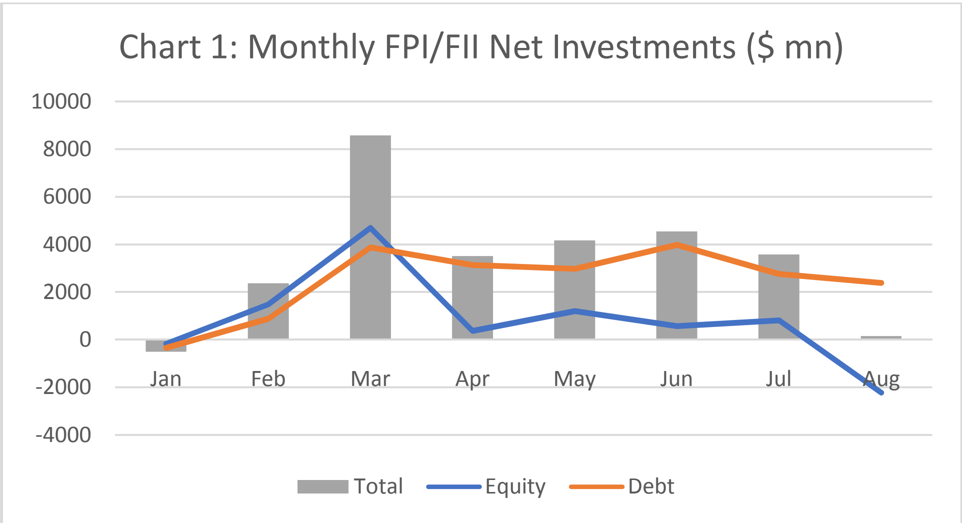
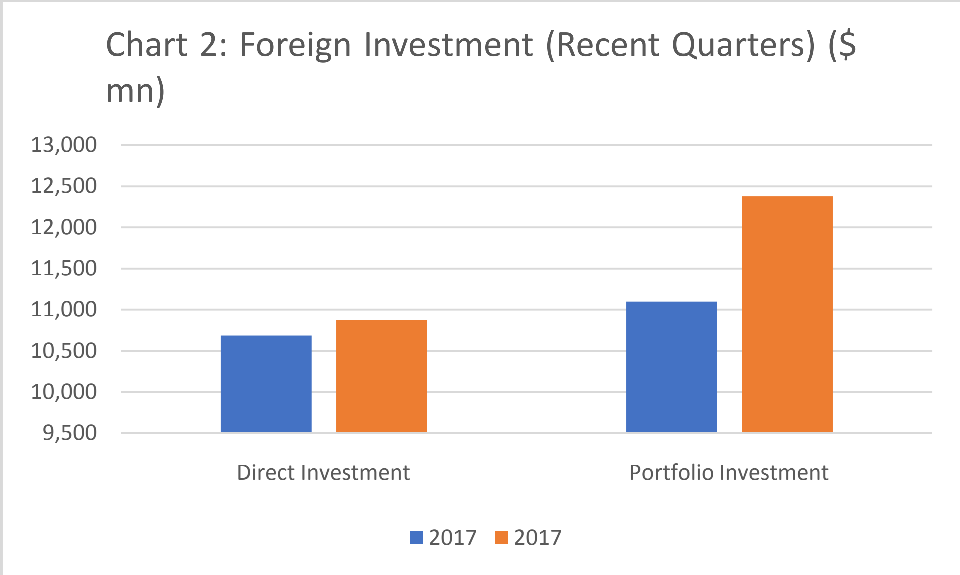
The sharp rise in foreign investment inflows into India in recent months, which has strengthened the rupee, has diverted attention from two disturbing features of the inflow: its composition and its volatility. The issue of volatility was underlined when inflows of foreign institutional investment rose from a negative $512 million in January 2017 to $8.6 billion in March this year, only to fall and fluctuate between $3.5 and $4.5 billion, before collapsing once more to $158 million in August (Chart 1). However, these changes have not given cause for concern because debt flows in recent times have been large and more stable. As a result, on average inflows into India are more than needed to finance the current account deficit kept under control because of low commodity, especially oil, prices. Though projected to rise in this financial year because of a rise in the trade deficit, the current account deficit stood at a comfortable 0.7 per cent of GDP in 2016-17. As a result foreign exchange reserves still high and rising.



So for those upbeat about the performance of India's debt and equity markets the August performance is only a blip. Not without reason. As Chart 2 shows, the average level of portfolio flows into equity and debt markets has risen over the two quarters ending April-June 2017. With direct investment flows stable, aggregate foreign investment flows have also risen. But a longer term picture (Chart 3) does suggest that while direct investment has been on the rise, portfolio investment flows have been extremely volatile.

In fact, what has been noteworthy in recent times is the appetite for bonds, especially government, but also corporate bonds. In the case of sovereign bonds the reasons are obvious—they are secure, offer high returns by international standards and investors believe that the rupee would hold and not depreciate fast, eroding returns in foreign exchange terms. If these conditions continue to hold they are an attractive target.

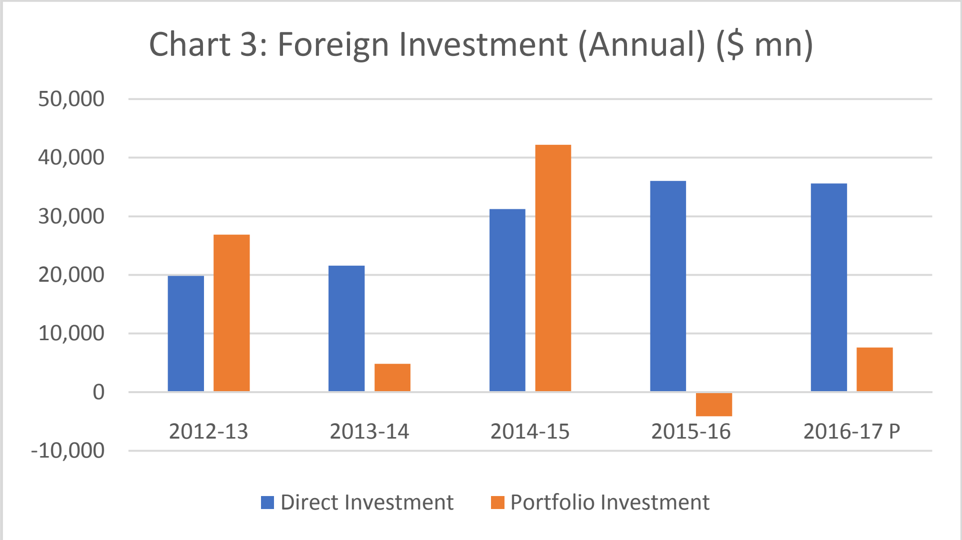
In addition investor appetite has increased because of limited availability of bonds. The Reserve Bank of India sets ceilings on maximum foreign investments in the bond market. Ceilings are constantly breached in the case of government bonds, and are periodically raised. It was only after demonetization last year that investors pulled out of sovereign bonds, reducing investments to 70-80 per cent till May this year. Since then investors have been pushing investments again to the maximum permissible level.



Corporate bonds, seen as risky, have in the past attracted less investor attention. But matters have been changing in recent months. As quotas available for government bonds have been exhausted, portfolio investors have displayed an interest in corporate bonds. After a sharp rise in the volume of investment relative to the ceiling during 2014-15, that ratio settled in 70-80 per cent range till May. But since then investment in corporate bonds have also risen to touch the ceilings. On September 8, 2017, 99.58 per cent of the upper limit of central government securities of Rs. 187,700 crore and 99.68 per cent of the $51 billion limit on corporate bond purchases by FPIs had been exhausted. A significant share of corporate bonds purchased are from public sector corporations, possibly influence by the perception that there is implicit sovereign backing for such bonds.

These trends are of significance since according to Bloomberg and Aberdeen Asset Management foreigners own less than 8 per cent of corporate and government debt in India, as compared to 30 per cent in Indonesia and Malaysia. That is, there is much room for further foreign investment penetration if the government chooses to relax its ceilings. The fact that it does not only whets the appetite of investors.

As of now India's central bank is being cautious, relaxing ceilings carefully, and more recently reserving as much as 75 per cent of the increase in limits for long term investors. Earlier 60 per cent of the increases in limit were reserved for these investors. The case for such caution is obvious. Interest rate differentials are an important reason for foreign investor interest, with investment being predicated on the belief (or bet) that the rupee would not depreciate. In fact, as capital flows in, the rupee could strengthen, triggering exchange rate speculation and raising the possibility of a bust and collapse of the currency. So there are two reasons why the whole process can unwind. First, the interest rate differential can narrow because of changes at the source, as happens when the US Federal Reserve changes its interest rate policy, precipitating a retreat of investors. Second, currency depreciation can encourage capital flight. So the larger the accumulated stock of foreign investment, the greater would be the outflow and the resulting damage.



In the case of corporate debt this can have even more severe consequences, since that debt is in foreign currency. Rupee depreciation increases the rupee costs of debt service in the form of interest payments and amortization, imposing heavy burdens on the firm concerned. If this leads to default and enforced liquidation it could trigger asset price deflation as well, accelerating the downward slide and the exit of capital.

The implications of these factors are obvious. Increased activity in the bond market while sought after as a means to mobilise long term finance can also be a source of volatility. This would be truer when the inflow is not driven largely by conditions in host country economies, but those in the source country, especially monetary policy in the latter. The resulting supply side push would mean that if the host country government does not impose binding constraints on the volume of inflows,continuous inflows result in the accumulation of large stocks of foreign investments, increasingly vulnerability despite caution.

See in this light, while the RBI's caution is creditable, its tendency to succumb to pressures and revise ceilings periodically may not be appropriate. Since India does not need much of these inflows to finance its trade deficit, the better policy may be to keep binding ceilings in place, so that the volatility resulting from extraneous developments does not disrupt the domestic economy.

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