Foreign institutional investments: A catalyst to foreign exchange reserves-an Indian perspective analysis

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ABSTRACT

After the economic reforms, India welcomed the foreign investments with certain restrictions and regulations. Emerging countries like India, hardly suffering from capital insufficiency to develop their infrastructure and to fund the projects. Foreign investments especially foreign direct investment and foreign institutional investments financially and technically aiding India. Foreign institutional investors are pretty different from the other foreign investments as they are highly volatile in nature and most diversified means of equity investments. They bring their capital in their domestic currency and let the hosting country to reserves foreign currency reserves to attempt its short-term obligations like payments for imports and short-term debt and loans across the globe. This paper made an attempt to calculate the strength of the relationship of FII with Indian foreign exchange reserves.

1. Introduction

Emerging economies like India hardly suffering from capital insufficiency to develop infrastructure and boost its exports. Since few decades, India suffering from current account deficit comprised of excessive imports than exports. India has to pay much more than its earnings. This situation forcing India to hold reserves in bundles of foreign currency with its central bank. Foreign exchange reserves consist of foreign currency assets and gold reserves, Special Drawing Rights (SDR), reserve trench. Composition of these reserves will be planned according to the requirements and strategies of a country. These are generally governed by the Central bank of the country. An important characteristic of foreign reserves is that they can be made readily available in order to fulfill the countries' demands. Countries have a need for holding reserves, although they may have different reasons for holding them. Reserves can be a formal backing for the domestic currency in order to provide confidence in the domestic currency. They are also used as a tool of exchange rate and monetary policy. (Nugee, 2009; IMF, 2004). The composition of Indian forex reserves is dominated by the currency assets rather than Gold reserves, SDR and reserve trench. Sometimes countries that have a shortage of foreign exchange reserves become a target of currency speculation or attacks. foreign exchange reserves or its ratio to GDP and other factors is strongly related to economic activity or sound economic growth. Foreign exchange reserves are strongly related to the credibility of policy authorities and the economy. (**Yutaka Kurihara,2016).**

Post economic reforms shown that India getting foreign currency frequently by the means of foreign capital. Both Foreign Direct Investment and Foreign Institutional Investors playing a vital role to flow foreign currencies in to Indian capital market. Among these two, FII is seems to be more weather sensitive as they leave the market even with the smell of fluctuations in the market atmosphere. They were allowed to India to invest through the stock markets since 1992. They are efficient professionals with whom India witnessed a bright and enriched vertical and horizontal growth especially in stock markets. It is an acceptable statement that India became an emerging economy with this foreign capital aid. As a result, Indian stock market Bombay Stock Exchange (BSE) stood in top ten position with respect to the total market capitalization across the globe. But the only demerit of these investors is they suddenly withdraw their investments from the markets and become net sellers causing stock market volatility. These withdrawals involve bundle of foreign currencies reversing to their domestic countries causing damage to the reserve ratio in India. This paper will helpful to acquire relation between the FII and Indian forex reserves. The money put in to reserves is the money that could be contributing to global aggregate demand. It could be used to stimulate the global economy. Instead of spending the money on consumption or investing the money, government simply lock it up" (Joseph Stiglitz 2007, making globalization work).

2. Objectives

- To study the trend of forex reserves in India in post economic period
- To analyze the impact of Foreign Institutional Investments on Forex reserves of India

3. Research methodology

To fulfill the research objectives, FII investments are collected from SEBI annual reports in its official website and Forex reserves had been collected from RBI annual reports. As FIIs were started their investments after post economic reforms, post economic reforms period had chosen for the study period. Correlation test has been chosen to study the relation between FII and Forex reserves, percentage method chosen for the composition of Forex reserves and graphs were drawn using excel sheet.

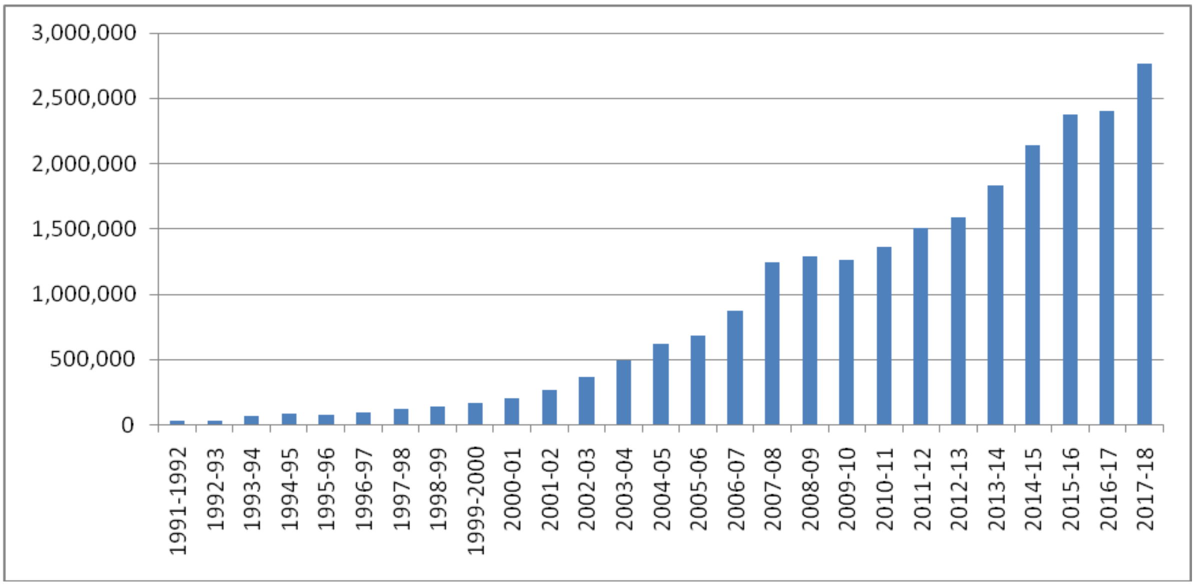
4. Data analysis and interpretation

Table:1 Indian forex reserves -post economic reforms scenario

year	Forex reserves during post economic reforms in Cr.Rs	Current account deficit (in Cr.Rs)
1991-1992	23,850	-2235
1992-93	30,744	-12764
1993-94	60,420	-3634
1994-95	79,780	-10583
1995-96	74,384	-19646
1996-97	94,932	-16,282
1997-98	1,15,905	20,883
1998-99	1,38,005	-16,789
1999-2000	1,65,913	-17,999
2000-01	1,97,204	-11,431
2001-02	2,64,036	6,719
2002-03	3,61,470	19,987
2003-04	4,90,129	39,638
2004-05	6,19,116	-24,786
2005-06	6,76,387	-46,856
2006-07	8,68,222	-44,383
2007-08	12,37,965	-68,914
2008-09	12,83,865	-127631
2009-10	12,59,665	-180626
2010-11	13,61,013	-202532
2011-12	15,06,130	-3,760,000
2012-13	15,88,420	-4796000
2013-14	18,28,380	-187136
2014-15	21,37,640	-163313
2015-16	23,78,740	-143762
2016-17	23,98,200	-96916
2017-18	27,60,850	-314126

Source: www.dbie.com

Graphical representation:



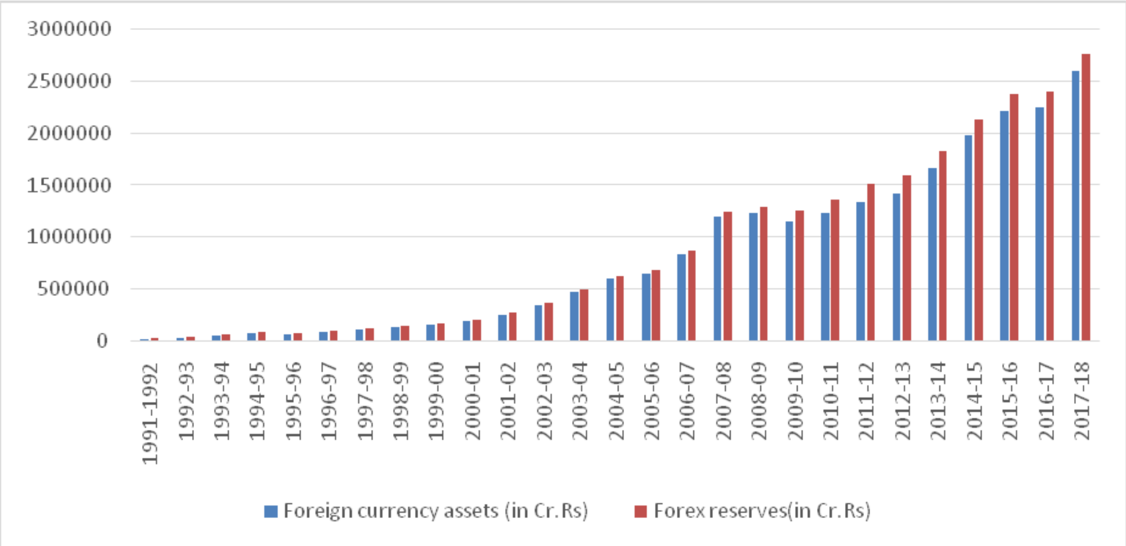
It is evident from the above cluster column graph, that Indian forex reserves are following a non-linear trend and the trend is repeating for every five years. A significant growth in the forex reserves has achieved and it is gradually increasing. Pre-economic reforms period is a symbol of balance of payment crisis, slowly tends to mortgage gold reserves of India with the IMF in order to get loans to pay for short term debt and to come over the current account deficit. During the financial crisis 2008, India seems to be not that much affected. If we observe the data provided by RBI, forex reserves growth during period is positive and it is nearly 57,000 cr.Rs.

Table-2: composition of Foreign currency assets in total Foreign exchange reserves

Financial year	Foreign currency assets (in Cr.Rs)	Forex reserves (in Cr.Rs)	% of Foreign Currency Assets in Forex reserves	fc assets growth %
1991-1992	14578	23,850	61.12	…………..
1992-93	20140	30,744	65.50	38.15
1993-94	47287	60,420	78.26	134.79
1994-95	66005	79,780	82.73	39.58
1995-96	58446	74,384	78.57	-11.45
1996-97	80368	94,932	84.65	37.50
1997-98	102507	1,15,905	88.44	27.54
1998-99	125412	1,38,005	90.87	22.34
1999-00	152924	1,65,913	92.17	21.93

2000-01	184482	1,97,204	93.54	20.63
2001-02	249118	2,64,036	94.35	35.03
2002-03	341476	3,61,470	94.46	37.07
2003-04	466215	4,90,129	95.12	36.52
2004-05	593121	6,19,116	95.80	27.22
2005-06	647327	6,76,387	95.70	9.13
2006-07	836597	8,68,222	96.35	29.23
2007-08	1196023	12,37,965	96.61	42.96
2008-09	1230066	12,83,865	95.80	2.84
2009-10	1149650	12,59,665	91.26	-6.53
2010-11	1224883	13,61,013	89.99	6.54
2011-12	1330511	15,06,130	88.33	8.62
2012-13	1412630	15,88,420	88.93	6.17
2013-14	1660910	18,28,380	90.84	17.57
2014-15	1985460	21,37,640	92.88	19.54
2015-16	2219060	23,78,740	93.28	11.76
2016-17	2244940	23,98,200	93.60	1.16
2017-18	2597570	27,60,850	94.08	15.70

Source: researcher compilation on RBI database



5. Discussion

About 89% of Indian forex reserves comprised of foreign currency assets. About 8-9% of the remaining comprised of gold and the micro portions of the remaining is the reserve trench and SDR. Developing countries like china are more prone to store gold as priority reserve than currency reserves. India in pre-economic reforms faced balance of payment crisis frequently due to various reasons. war conditions, excessive need for imports and sustainability, India pledged sometimes its gold reserves with IMF to get loan for payments. This may be the strong reason behind the economic reforms to liberalize its policies in allowing the foreign investments. Due to these stabilized reforms, India somewhat not that much affected by global financial crisis 2008(US subprime crisis).

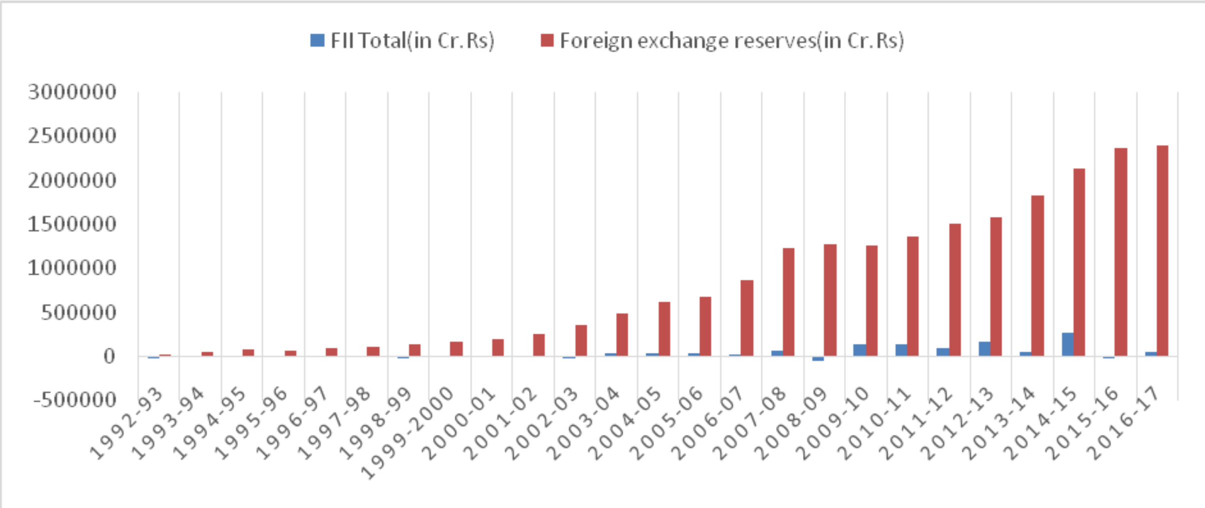
Table-3:

Financial year	FII Total (in Cr.Rs)	Foreign exchange reserves (in Cr.Rs)
1992-93	13	30744
1993-94	5127	60420
1994-95	4796	79780
1995-96	6942	74384
1996-97	8575	94932
1997-98	5958	115905
1998-99	-1584	138005
1999-2000	10122	165913
2000-01	9933	197204

2001-02	8763	264036
2002-03	2689	361470
2003-04	45765	490129
2004-05	45881	619116
2005-06	41467	676387
2006-07	30840	868222
2007-08	66179	1237965
2008-09	-45811	1283865
2009-10	142658	1259665
2010-11	146438	1361013
2011-12	93726	1506130
2012-13	168367	1588420
2013-14	51649	1828380
2014-15	277461	2137640
2015-16	-18176	2378740
2016-17	48411	2398200

Source: www.sebi.org

Graphical presentation of FII and Indian forex reserve in post economic reforms:



The graph illustrates a significant coincidence in the trend of FII and forex reserves. The philosophy behind the existence literature is that FII encourage the accumulation of forex reserves through their inflows in to Indian economy. Some of the researches shown that Forex reserves is one of the determinants of FII. The reason behind this is, FII can step in to the country where they feel safe to their investments and easy norms for profit earnings. The recent history of India showing efficient forex reserves to pay for foreign investors in return. This made them to choose India as the best destination to hold their investments. If we observe the FII and Forex reserves during the period 2008-09, they were slightly affected but not adversely. But FII were alternately investing and alternately withdrawing from the market.

6. Analysis of correlation between FII and forex reserves

The relation between FII and Forex reserves can be tested by using Karl Pearson's coefficient of correlation. The value of coefficient of correlation (r) gives the strength and direction of relation among the variables. Here calculated value of r is +0.53. it implies there is a significant positive relation exists between FII and forex reserves. It furtherly articulate that FII and Forex reserves move together in the same direction.

7. Conclusion

Foreign Institutional investments are the backbone for developing economies. They pump huge amounts of capital in to Indian markets and causing accumulation of foreign currency available to pay day to day obligations of the hosting country. Meanwhile they are creating high fluctuations in the market movements causing volatility. Most of FII are quick decision makers and efficient professional market analysts. It is essential to amend the government initiations much effectively in order to hold these investments for the long term. This will benefit the macroeconomic stability of India.

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