Foreign Institutional Investment (FII)

6.68. Compared to FDI, FII inflows into the Indian economy were not one of the leading varieties of capital flows until 2003-04. In the aftermath of the 1997 East Asian crisis, such flows had actually become net outflows in 1998-99 (Figure 6.3 and Table 6.2). While there was a modest recovery in 1999-2000, languishing FII flows steadily declined to US$377 million in 2002-03. However, the years 2003-04 and 2004-05, have been remarkably robust years for such flows. Beginning from 1993-94, till 2002-03, the highest share of FII (net) flows in total foreign investment inflows was recorded at 43.5 per cent in 1995-96. During 2003-04 and 2004-05, their share shot up to 79.4 per cent and 68.2 per cent, respectively, indicating the significant contribution being made by FII investment to the capital account in recent years.

6.69. During the current year so far, FII investment has maintained the healthy trends of the previous two years. After recording a modest inflow of US$435 million in April-June 2005, FII inflows shot up nine times to reach US$3.8 billion during July-September 2005. At the end of the first half of the current year, FII inflows at US$4.2 billion are just over 50 per cent of their last year level. During 2004-05, the surge in FII flows had actually occurred in the second half of the year, when such flows were US$7.9 billion compared to only US$339 million in April-September 2004-05. If FII flows record the kind of growth in the second half of the current year as they did in the corresponding period of the previous year, then the overall foreign investment inflows during the current year will increase sharply.

6.70 The acceleration in volume of FII inflows in recent years has drawn attention to whether India's capital account is becoming increasingly dominated by 'hot money' – a phrase commonly, but incorrectly, used for describing FII flows – given the tendency of such flows to suddenly reverse direction in response to adverse market sentiments and precipitating large capital outflows. While theoretically 'herd' behaviour by FIIs and concomitant withdrawal cannot be ruled out, such possibilities are limited if the fundamentals are strong, the market is well-regulated and the participants are mainly pension funds, life insurance companies and mutual funds, which are more involved with longer term investments. Right now, the Indian capital market is not only buoyant, but is also endowed with a strong regulatory framework, which is conducive to greater longer term FII participation. Furthermore, stable flows (i.e. all forms of capital flows excluding portfolio flows and short term credits) still accounted for around 60 per cent of total capital flows in 2004-05. Thus, notwithstanding a quantum jump in volume of FII flows in recent years, low levels of short- term debt as a proportion of total external debt and adequate reserve coverage mitigate the risk of potential reversals.