Policy brief

35003 | September 2013

Ila Patnaik, Ajay Shah
and Nirvikar Singh

International
Growth Centre

Does Foreign Institutional Investment in India Increase Financial Vulnerability?

An Empirical Investigation Using an Event Study Approach

In brief

- The implications of financial globalization on emerging markets have become an important area of concern for policy makers due to concerns about financial vulnerability..
- This study provides empirical analysis on possible risks of capital inflows and outflows of India.
- Policymakers are less concerned with academic questions of market efficiency than they are with market behaviour under stressed conditions.
- No serious evidence of negative effects of 'hot money' on the stock market is found in India, but this does not preclude different result for other countries or in different time periods
- Empirical results for India show that policymakers may need to worry less about the destabilizing effects of foreign portfolio flows on Indian financial markets, or the exchange rate.
- The main message of our analysis is not suggest the wisdom of a paricular policy set, but to illustrate the value of detailed empirical analysis as a precursor to any policymaking.

DIRECTED BY LSE UNIVERSITY OF OXFORD

FUNDED BY UKaid from the British people

Motivation

"Policymakers can find it useful to know if foreign investors have a major impact on domestic markets through large inflows or outflows"

Emerging market policy makers have been concerned about the financial stability implications of financial globalization. These concerns are typically focused on behavior under stressed conditions. For example, it would be helpful to understand if tail events in the home country trigger off extreme responses by foreign investors – are foreign investors `fair weather friends'? Policymakers can find it useful to know if foreign investors have a major impact on domestic markets through large inflows or outflows – are they 'big fish in a small pond'? Another possibility worth exploring is whether extreme events in world markets induce extreme behavior by foreign investors, thus making them vectors of crisis transmission.

Policy Impact

To take India as an example, both the Finance Minister and the Governor of the Reserve Bank of India have made statements over the last three years concerning possible policy adjustments toward foreign portfolio flows into India. Both have also stated that capital inflows are a valuable input for India's future growth for example in areas such as infrastructure. This research provides empirical analysis on possible risks of inflows and outflows, and can be a concrete input into policy decisions.

Audience

The policy audience for this research consists of senior macroeconomic policymakers in emerging markets, for example, in India, the Finance Ministry and the Reserve Bank of India.

Policy Implications

Conceptual tools for assessing financial stability

Policy makers in emerging markets are less concerned with academic questions of market efficiency than with they are with market behavior under stressed conditions, whether 'efficient' or not. As an example, it is possible that a large exit by foreign investors in the aftermath of a domestic crisis brings prices closer to fundamental value. In the eyes of the existing finance literature on foreign investors, this would be viewed as a case where foreign investors are `stabilizing' since they restore market efficiency. However, policy makers in emerging markets would, nonetheless, be concerned about the financial stability implications of such behavior.

"The empirical methodology of our paper provides a flexible tool for evaluating the impacts of equity investment by foreign investors on domestic markets"

Empirical tools for measuring domestic impacts of foreign investor behavior

The empirical methodology of our paper provides a flexible tool for evaluating the impacts of equity investment by foreign investors on domestic markets. The methodology imposes few structural constraints, allowing the data to speak for itself. In the example of India, no serious evidence of negative effects of 'hot money' on the stock market is found, but this does not preclude different results for other economies or other time periods.

"The Finance Minister and the Governor of the Reserve Bank of India have made statements over the last three years concerning possible policy adjustments toward foreign portfolio flows into India"

Specific implications for India

The empirical results for India suggest that policymakers may need to worry relatively less about the destabilizing effects of foreign portfolio flows on Indian financial markets, or on the exchange rate, when they are conceptualizing policy and framing responses toward various forms of foreign capital.

Implementation

The main message of our analysis is not to suggest the wisdom of a particular policy or set of policies, so implementation of specific policies is not an implication of this work. Instead, the research is meant to illustrate the value of detailed empirical analysis as a precursor to any policymaking.

Dissemination

Finance ministers, finance ministry officials, central bankers and central bank officials in emerging markets

Further Readings

Chakrabarti, Rajesh (2006), Foreign Institutional Investment, in Basu, Kaushik, and Annemie Maertens, eds. (2010). The Concise Oxford Companion to Economics in India. New Delhi: Oxford University Press.

Patnaik, Ila and Ajay Shah (2012), Did the Indian capital controls work as a tool of macroeconomic policy? IMF Economic Review, 60, 439-464.

Shah, Ajay and Ila Patnaik (2007), India's experience with Capital Flows: The Elusive Quest for a Sustainable Current Account Deficit, in Capital Controls and capital flows in emerging economies: Policies, practices, and consequences, NBER and University of Chicago Press. Ed. Sebastian Edwards.

Shah, Ajay and Ila Patnaik (2011), India's financial globalization, in Encyclopedia of Financial Globalization, Ed. Gerard Capiro, Elsevier, 2011.

About the authors

Ila Patnaik is a Professor at the National Institute of Public Finance and Policy. Prior to this, she worked at National Council of Applied Economic Research, ICRIER and as Economics Editor at the Indian Express. Her main area of research is open economy macroeconomics, including issues related to capital flows, the exchange rate regime, monetary policy, business cycles and the financial sector in the context of opening of the capital account.

Nirvikar Singh holds the Sarbjit Singh Aurora Chair of Sikh and Punjabi Studies at UCSC. He is a member of the Advisory Group to the Finance Minister of India on G-20 matters. He has previously served as Director of the Santa Cruz Center for International Economics, Co-Director of the Center for Global, International and Regional Studies, Special Advisor to the Chancellor, and Consultant to the Chief Economic Adviser, Ministry of Finance, Government of India. Professor Singh's current research topics include entrepreneurship, information technology and development, electronic commerce, business strategy, political economy, federalism, economic growth and the Indian economy.

Ajay Shah studied at IIT, Bombay and USC, Los Angeles. He has held positions at the Centre for Monitoring Indian Economy (Bombay), Indira Gandhi Institute for Development Research (Bombay) and the Ministry of Finance, and now works at NIPFP. His research interests include policy issues on Indian economic growth, open economy macroeconomics, public finance, financial economics and pensions. In the past decade, he was extensively involved in the policy process in the reforms of the equity market and the New Pension System.

The International Growth Centre (IGC) aims to promote sustainable growth in developing countries by providing demand-led policy advice based on frontier research.

Find out more about
our work on our website
www.theigc.org

For media or communications
enquiries, please contact
mail@theigc.org

Follow us on Twitter
@the_igc

International Growth Centre,
London School of Economic
and Political Science,
Houghton Street,
London WC2A 2AE

International
Growth Centre

Designed by soapbox.co.uk