Chapter 14
An Empirical Analysis of FII Movement and Currency Value in India

Saurabh Sen
Sunbeam College for Women, India

Ruchi Sen
Sunbeam College for Women, India

ABSTRACT
India opened its stock market to foreign investors in September 1992 and has received portfolio investment from foreigners in the form of foreign institutional investment in equities and other markets including derivatives. It has emerged as one of the most influential groups to play a critical role in the overall performance of the Indian economy. The liberalization of FII flows into the Indian capital market since 1993 has had a significant impact on the economy. With increased volatility in exchange rate and to mitigate the risk arising out of excess volatility, currency futures were introduced in India in 2008, which is considered a second important structural change. This chapter examines the impact of the Foreign Institutional Investors (FIIs) on the exchange rate and analyzes the relationship between FII and Indian Rupee-US Dollar exchange rates.

INTRODUCTION
Institutional investors are organizations which pool large sums of money and invest those sums in securities, real property and other investment assets. They can also include operating companies which decide to invest their profits to some degree in these types of assets (Ahluwalia, 2011).

Typical investors include banks, insurance companies, retirement or pension funds, hedge funds, investment advisors and mutual funds. Their role in the economy is to act as highly specialized investors on behalf of others (Agarwal, 1997). For instance, an ordinary person will have a pension from his employer. The employer gives that person’s pension contributions to a fund. The fund will buy shares in a company, or some other financial product. Funds are useful because they will hold a broad portfolio of investments in many companies. This spreads risk, so if one company

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fails, it will be only a small part of the whole fund’s investment (Basu & Maertens, 2007).

Figure 1 exhibits foreign investments in the country which can take the form of investments in listed companies (i.e., FII investments), investments in listed/unlisted companies other than through stock exchanges (i.e., through the foreign direct investment or private equity/foreign venture capital investment route), investments through American Depository Receipts/Global Depository Receipts (ADR/GDR), or investments by non-resident Indians (NRIs) and Persons of Indian Origin (PIOs) in various forms.

**EVIOLUTION OF POLICY FRAMEWORK ON FIIs**

Until the 1980s, India’s development strategy was focused on self-reliance and import-substitution. Current account deficits were financed largely through debt flows and official development assistance (Chakraborty, 2007). There was a general disinclination towards foreign investment or private commercial flows. Since the initiation of the reform process in the early 1990s, however, India’s policy stance has changed substantially, with a focus on harnessing the growing global foreign direct investment (FDI) and portfolio flows (Chakrabarti, 2001). The broad approach to reforms in the external sector after the Gulf crisis was delineated in the Report of the High Level Committee on Balance of payments recommended, inter alia, a compositional shift in capital flows away from debt to non-debt creating flows, the strict regulation of external commercial borrowings, especially short-term debt, the discouragement of volatile elements of flows from non-resident Indians (NRIs), the gradual liberalization of outflows, and the disintermediation of the government in the flow of external assistance (Kishore, 1997). After the launch of the reforms in the early 1990s, there was a gradual shift towards capital account convertibility (Agarwal, 1997). From September 14, 1992, FIIs and overseas corporate bodies (OCBs) were permitted to invest in financial instruments, with suitable restrictions. The policy framework for permitting FII investment was provided under the Government of India’s guidelines, vide a press note dated September 14, 1992, which enjoined...