

Quadrant II - Notes

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Impact of Foreign Portfolio Investment on Capital Markets and the Exchange Rate

Foreign Portfolio Investment

- Foreign portfolio investment (FPI) consists of securities and other financial assets held by investors in another country.
- It does not provide the investor with direct ownership of a company's assets and is relatively liquid depending on the volatility of the market.
- Along with foreign direct investment (FDI), FPI is one of the common ways to invest in an overseas economy.
- FDI and FPI are both important sources of funding for most economies.

Capital Market

- Capital market is a market where buyers and sellers engage in trade of financial securities like bonds, stocks, etc. This market trades mostly in long-term securities. Capital market consists of primary markets and secondary markets.

Exchange Rate

- An exchange rate is the value of a country's currency vs. that of another country or economic zone. Most exchange rates are free-floating and will rise or fall based on supply and demand in the market.

Impact of FPI on Capital Markets

- FPI provides an upward thrust to the domestic stock market which has an impact on the price earnings ratios of the firm. i.e. a higher price earnings ratio leads to a lower cost of finance which in turn will lead to a higher amount of investment.
- The lower cost of the capital will encourage new equity shares thus FPI stimulates and acts as a catalyst in development of the domestic stock market which faces competition from foreign financial institutions.
- The internationalization makes the market more liquid.
- It raises the domestic savings rate and improves capital formation.
- Greater efficiency in allocation capital, risk sharing and institutions.
- Exchange rate volatility and FPI affect each other.
- A stable exchange rate would attract foreign investment whereas a highly volatile exchange rate would discourage foreign investment.

Impact of FPI on Exchange Rate

- The FPI influences the exchange rate through inflow and outflow of capital.
- The substantial share that FPI has in foreign investment and capital flows is a major reason for the volatility of exchange rate.
- An outflow of FPI may lead to depreciation of the rupee, with foreigners selling rupee for foreign currency, similarly an inflow may lead to appreciation of the rupee as investors will now be buying rupee for foreign currency.

Summary

- Foreign portfolio investment (FPI) consists of securities and other financial assets held by investors in another country.
- It raises the domestic savings rate and improves capital formation.
- A stable exchange rate would attract foreign investment whereas a highly volatile exchange rate would discourage foreign investment.