The Sensex, the Rupee, the FIIs and the RBI

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There is a sense of panic gripping financial markets in India. The immediate causes are a combined slide of indices of stock markets and of the rupee vis-à-vis the US dollar. For market players accustomed to what has been an almost continuous bull run and rise in market valuations (barring hiccups in 2022 and early 2023), which took the Bombay Stock Exchange Sensex from a low of less than 26,000 in March 2020 to a peak above 85,000 in September 2024, the recent decline of that index to less than 76,000 by mid-February is cause for concern (Chart 1).

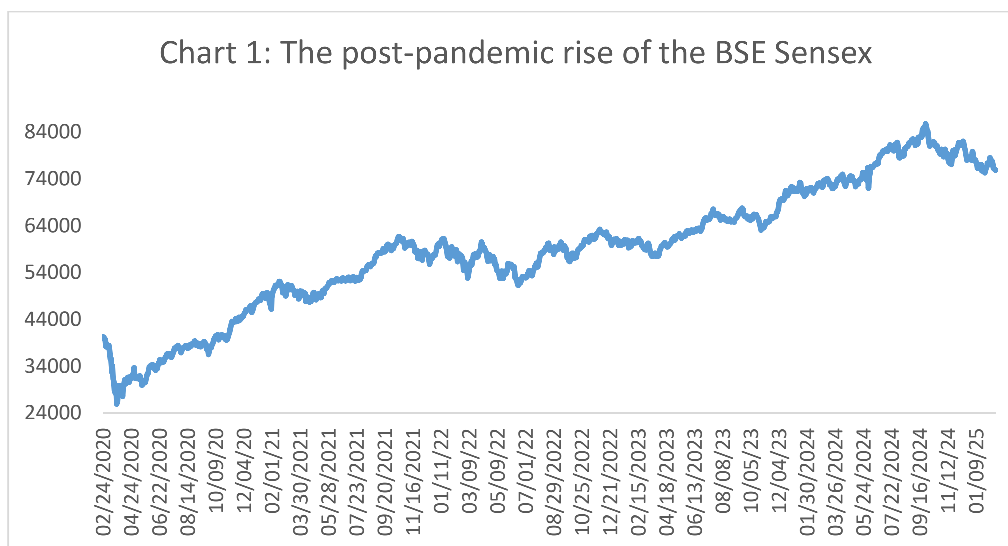
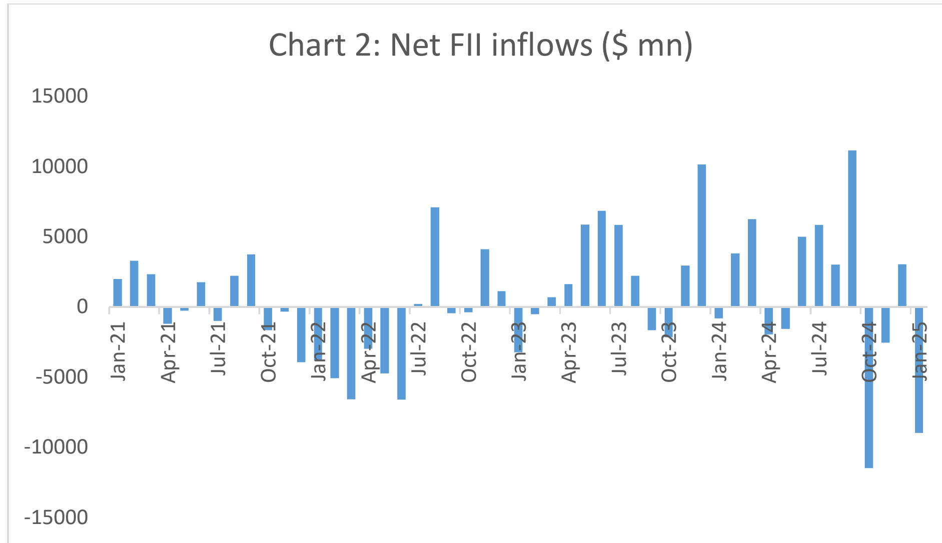
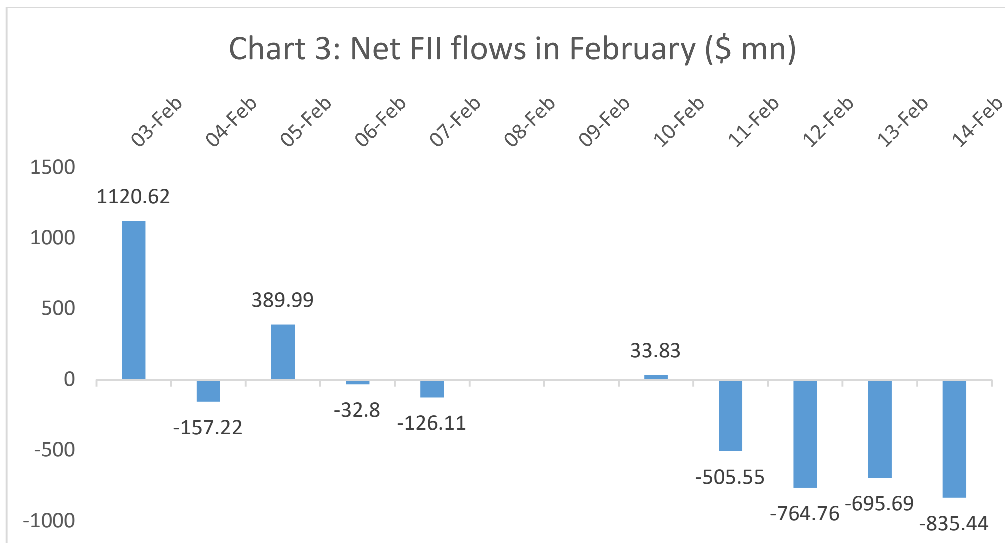


Chart 1: The post-pandemic rise of the BSE Sensex

Rather than treat the recent decline as a much-needed correction that many had said was inevitable, there is a strong strand of official and market opinion attributing the trend to uncertainties created by statements from the Trump stable. This argument ignores the fact that the decline has been driven largely by the exit of foreign institutional investors (FIIs) from the market. Since September 2023, in 8 out of 17 months FIIs sold more than they purchased in equity and bond markets (Chart 2). In three of the four months ending January 2025, there was a net outflow of FII capital. The volume of such outflows was unusually high at $11.5 billion in October 2024 and $9 billion in January 2025.

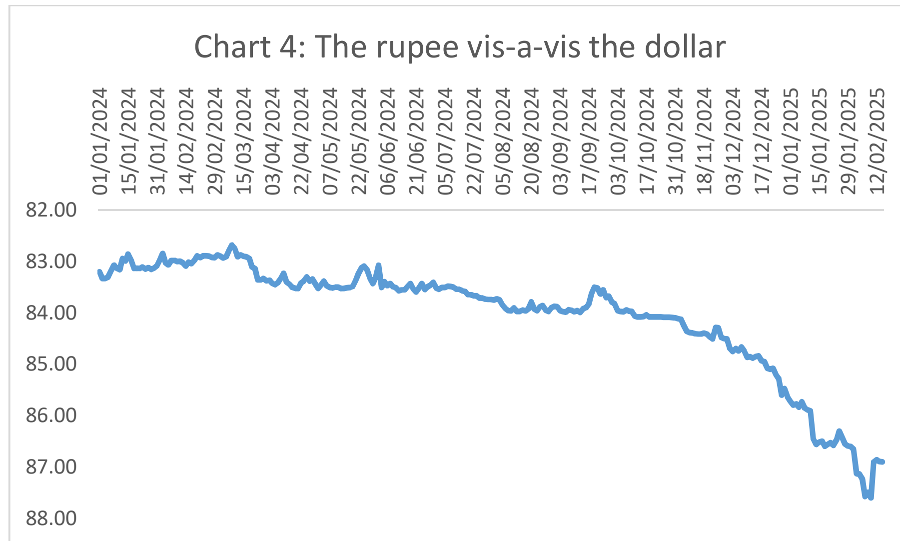


The outflows have persisted through the first half of February (Chart 3), with net outflows being negative in all days excepting two till the 14th of February. Net outflows have amounted to as much as a half to more than three-quarters of a billion per day over 11-14 February. Such outflows revive memories of 2021 and 2022, when net outflows were recorded in consecutive months, reining in the bull run that the market had then been experiencing over almost two years.



The drivers of FII exit in 2022 were fears that the Federal Reserve would begin unwinding the quantitative easing and retreat from maintaining new zero policy interest rates, that had helped quickly turn around markets following the downturn prompted by the COVID-19 pandemic. This time too it is developments in US monetary policy (the decision of the Fed to slow the pace of interest rate reduction) and in US markets (reflected in rising bond yields), besides the strengthening of the US dollar following the threats and actual decisions taken by Trump and his advisors to impose tariffs on imports into America from some of its leading trading partners. There is every reason to believe that these drivers of a reversion of FII flows would remain in

place, given that the underlying policies were the part of the campaign that brought Trump to power. There is only so much that domestic financial institutions can do to neutralise the effects of FII outflows, since they and the retail investors they have inspired or drawn into the market through mutual fund investment are burning their fingers and would likely choose to book available profits or cut losses and exit in favour of other instruments.



If the issue were merely a loss of the momentum among bull investors whose activities were responsible for the so-called "dream run" in Indian markets, there should be little cause for worry for decision makers either in the Finance Ministry or in the Reserve Bank of India. But the problem is these financial market trends have been accompanied by a steep depreciation of the rupee. The recent depreciation is much larger and has occurred much faster than the long-run depreciation of the rupee resulting from India's chronic deficits in the current account of the balance of payments. In fact, that long run tendency has been moderated since the turn of the last century by the large inflows of foreign financial capital into India's markets. If the rupee has recently been depreciating at a higher-than-normal pace, that is not primarily driven by India-specific factors but results from the appreciation of the dollar referred to above. The contributing India-specific factor is the reticence of the RBI to intervene more strongly than it does in foreign exchange markets and sell dollars from its reserves, to moderate, stall or reverse the rupee's decline.

This reticence of the central bank also has a rationale. The rupee is depreciating vis-à-vis the dollar to a lesser extent and slower than is the case with currencies of other similarly placed less developed countries who are also India's competitors in dollar-denominated export markets. If India does not allow a simultaneous depreciation of the rupee, even if not to fully match that of other currencies, it would lose out in export markets.

But a depreciation of the rupee is not good news for foreign institutional investors, who would have to convert into dollars the rupees they get from sale of the financial assets they hold to book any profits they have made. This means that if the rupee depreciates more than normal, foreign investors may find one more reason, besides developments at home, to exit Indian

markets. If that hastens the pace of exit, the rupee's depreciation would accelerate, setting off a vicious spiral. That could also spell losses in financial markets that affect the solvency of financial institutions, including the liberalised banking system that is exposed to these markets in multiple ways.

Clearly, the RBI is faced with a difficult task. It must allow the rupee to depreciate against the dollar to protect the competitiveness of India's exports. But it must intervene to ensure that the depreciation is not of a magnitude and/or occurs at a pace that affects foreign investor sentiment adversely, because that can accelerate the pace of depreciation.

This potential for factors that explain the stock market decline to trigger developments that can precipitate a combination of currency and financial market crises is the real problem. And underlying that problem is the hugely increased presence of foreign financial capital in India's market. That consequence of financial liberalisation cannot be easily corrected.

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