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Foreign Capital Flows in India: Determinants and Developments

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Abstract: The theoretical influences in support of foreign capital flows are relatively substantial. By affording the prospect of using the world market, an open capital account permits both savers and investors to differentiate their portfolios to maximize returns and minimize risks. Capital flows could also hypothetically improve emerging financial markets, encourages financial disciplines, provides modern technologies, modern management practices, and employment opportunities and reduce the borrowing costs both for the government and corporations. Additionally, it is significant for developing countries like India to channel the gap of savings and investment rate. On offhand side, on the other hand, capital flows are known to be pro cyclical and they complicate the macroeconomic management. In these circumstances, the present paper makes an attempt to study the various features of foreign capital flows into India along with their determinants. It concludes that the size of net capital inflows to India has increased significantly in the post reform period. The movement of capital inflows in recent years clearly indicates that capital inflows in India are highly volatile. The Government of India has been continuously proceeding for economic reforms and is quiet, assured to secure legislation to allow more foreign investment in various sectors.

Keywords: FDI, FPI, FII, Depository Receipts, Commercial Borrowings, Macroeconomic Effects, Volatility.

I. INTRODUCTION

Foreign capital has significant role for every national economy regardless of its level of development. For the developed countries, it is necessary to support sustainable development. For the developing countries, it is used to increase accumulation and rate of investments to create conditions for more intensive economic growth. For the transition countries, it is useful to carry out the reforms and cross to open economy (Edwards, 2004), to cross the past long term problems and to create conditions for stable and continuous growth of GDP (Razin, 2001), as well as integration into the world economy (Boskovska, 2006; Lensik, 1999). But, capital flows from developed to developing countries are worth studying for a number of reasons. Capital inflow can help developing countries with economic development by furnishing them with the necessary capital and technology. Capital flows contribute in filling the resource gap in countries where domestic savings are inadequate to finance investment.

Neoclassical economists support the view that capital inflows are beneficial because they create new resources for capital accumulation and stimulate growth in developing economies with capital shortage. Capital inflows allow the recipient country to invest and consume more than it produces when the marginal productivity of capital within its borders is higher than in the capital-rich regions of the world. Foreign capital can finance investment and stimulate economic growth, thus helping increase the standard of living in the developing world. Capital flows can increase welfare by enabling household to smooth out their consumption over time and achieve higher levels of consumption. Capital flows can help developing countries achieve a better international diversification of their portfolios and also provide support for pension funds and retirement accounts into the twenty-first century.

Capital inflows facilitate the attainment of the millennium development goals (MDGs) and the objective of national economic, empowerment and development strategy (NEEDs). As the economy becomes more open and integrated with the rest of the world, capital flows will contribute significantly to the transformation of the developing economy (Levin, 2001). However, large capital inflows can also have less desirable macroeconomic effects, including rapid monetary expansion, inflationary pressures, and real exchange rate appreciation and widening current account deficits. Hence, a surge in inflows of the magnitudes seen in recent years may pose serious dilemmas and tradeoffs for economic policy, especially in the present environment of high capital mobility. History has also shown that the global factors affecting foreign investment tend to have an important cyclical component, which has given rise to repeated booms and busts in capital inflows.

II. Review of Literature

Pati et al (1999) stated that the liberalization reforms which were started in post nineties era had been responded well by the foreign investment in India which was evident in the form of good foreign capital flows. The study also revealed that in order to attract more foreign capital flows, political stability would be very important, and to attract FPI, a good depository system, shorter settlement period, efficient custodial services and transparent stock market trading etc. would play an important role.

Kohli et al (2003) analyzed that the whole world including India had witnessed significant changes in the composition and direction of capital flows during the last decade (1990-2001). As per the study, it was revealed that private capital flows had dominated overall capital flow components. Such developments had created a good amount of interest amongst the economists and academicians to understand and analyze the trends of foreign capital flows, and had also motivated them to create an environment where it became desirable for the government to bring in important policy changes.

Chakrabarti et. al (2001) analyzed the inter relationship between FII flows, on one hand and equity returns in India in the Indian context, on the other. The study revealed that after the world faced the Asian crisis and info-tech bubble assumed serious proportions internationally in the year 1998-99, there was a sharp decline of FII flows. The study found that there was a positive correlation between the stock returns and the flows of FII.

Kohli et al (2001) analyzed the trends and the composition of flows of foreign capital into Indian capital market and examined the effect of foreign capital flows on the important macroeconomic variables in the country. The paper also examined the policy responses of Indian Government to these capital flows. The author discovered that the foreign capital flows had a substantial impact on the real appreciation of the economy and it had also augmented the domestic money supply.

Rai and Bhanumurthy (2004) tried to examine the factors and determinants affected FII flows in India. The authors found that risk and inflation in a domestic country (like Indian economy) and return in a foreign market (like USA economy) have an adverse impact on the FII flows, whereas risk and inflation in foreign country (like USA economy) and yield in domestic country (like Indian economy) would have a positive impact on the FII flows.

Shah and Patnaik (2005) discovered the cause and effect relationship of the majorly observed features of India's capital flows. The study observed that currency pegging (i.e. fixation of ER of currency by comparing its value with a single currency value) as capital flows had shaped the currency regime; and the currency regime, in turn, had shaped capital flows.

Kumar et al (2006) investigated the FIIs and mutual funds participation in the Indian secondary market. The study tried to establish the relationship between the investment trends by the major institutional investors and the stock market movements. The author outlined the major developments in Indian stock market which were responsible for the rising trends in the FII flows.

Sikdar et al (2006) studied the relationship between foreign capital flows (FDI, FPI) and other economic variables during 1997 to 2003. The study observed that under the regime of liberalization policy, the outcomes were highly surprising. Dependence on foreign aid had come down drastically. And funds in the form of Foreign Portfolio Investment (FPI), Foreign Direct Investment (FDI), external commercial borrowings and non- resident Indians deposits had come to be recognized as the major sources of capital flows in India as concluded by this study. *Prasanna et al (2008)* used the data of 27 companies in the year 2008 attempted to analyze the preferences of FIIs for the companies. The paper concluded that there was a positive correlation between FIIs preference and the company's structure, corporate performance, its share returns and price earnings ratio. This meant that the factors like company performance, its organizational structure, the returns on its share and the P-E ratio proved to be important determinants for FIIs in their investment decision making.

Rajput & Thaker (2008) tried to measure the relationship amongst all these variables and their predictive power. This research was undertaken especially under the light of third generation reforms initiated in India. The study observed that in a more globalized world, ER, FII and Stock Index were the important economic variables and reflected the underlying strength and stability of business and economy as a whole.

Sehgal and Tripathi (2009) made a genuine attempt to analyze the investment strategies of FIIs. The period under consideration was from 2000 to 2006. The study exclusively investigated the question that while investing, what investment strategies had been used by FIIs. It tried to find answer as to whether it was trading strategy or herding strategy or positive feedback strategy used by FIIs. It also tried to investigate whether these trading strategies were found suitable in the Indian economic environment.

III. Objectives

1. To study the features and the determinants of the Capital Inflows in India.
2. To analyze the macroeconomic effects of the Capital Inflows.
3. To examine the trends of the Capital Inflows in India in recent years.

IV. Conceptual Framework of Capital Inflows

The capital, in financial terms, refers to those funds which are used for investment. In a physical sense, capital means all capital equipment, plant, machinery, etc. which is used in the production process. Thus, finances are to be used through savings and used for buildings, plants and equipment's for use in production. In other words, savings and investments are two acts which create capital. When residents of a country provide their savings for investment, their capital is called Domestic Capital and owned by residents. But when the investment is made either directly by the non-residents, institutions or governments this is called capital inflows (Foreign capital) and owned by non-residents. Thus, for e.g., *Campa Cola* company represents domestic capital, whereas *Coca Cola* represents foreign capital. The non-residents may provide funds for investments by way of equity, loans, and grants or make direct investment. Foreign capital flows fall into five principal categories: foreign direct investment (FDI), foreign portfolio investment (FPI), depository receipts (DRs), external commercial borrowing (ECBs), and non-residents receipts (NRDs).

1: Foreign Direct Investment: Investment that is made to acquire a controlling interest (usually 10 percent of voting stock) in an enterprise operating in a country other than that of the investor. The investor gets an effective voice in the management of the company. Most concretely, it may take the form of buying or constructing a factory in a foreign country or adding improvements to such a facility, in the form of property, plants, or equipment. FDI is calculated to include all kinds of capital contributions, such as the purchases of stocks, as well as the reinvestment of earnings by a wholly owned company incorporated abroad (subsidiary), and the lending of funds to a foreign subsidiary or branch. The reinvestment of earnings and transfer of assets between a parent company and its subsidiary often constitutes a significant part of FDI calculations. According to the United Nations Conference on Trade and Development (UNCTAD), the global expansion of FDI is currently being driven by over 64,000 transnational corporations with more than 800,000 foreign affiliates, generating 53 million jobs. An Indian company may receive FDI under the two routes Automatic Route and Government Route.

2: Foreign Portfolio Investment: It consists of Depository Receipts (DR), Foreign Institutional Investment (FII) in debt and equity (direct purchase of shares). The major institutional investors are mutual funds; asset management companies (AMCs), pension funds and insurance companies. The Reserve Bank of India monitors the ceilings on FII/NRI/PIO investments in Indian companies on a daily basis.

3: Depository Receipts: These are equity instruments issued outside the country to nonresident investors by authorized overseas depository banks. DRs issued in the USA are American Depository Receipts (ADR), those issued elsewhere is Global Depository Receipts (GDR). Foreign Currency Convertible Bonds (FCCBs) are subscribed to by nonresidents in foreign Currency and are convertible into ordinary shares of the issuing companies. Among the emerging economies, India ranks first in terms of the value of DR issued.

4: Foreign Institutional Investment: The term foreign institutional investment denotes all those investors or investment companies that are not located within the territory of the country in which they are investing. These are actually the outsiders in the financial markets of the particular company. Foreign institutional investment is a common term in the financial sector of India. International institutional investors must register with the Securities and Exchange Board of India to participate in the market. One of the major market regulations pertaining to FIIs involves placing limits on FII ownership in Indian companies.

5: External Commercial Borrowings: It includes commercial bank loans, buyer's credit, suppliers' credits, fixed and floating rate bonds (without convertibility) and borrowings from multilateral financial institutions such as an International Financial Corporation (IFC) and Asian Development Bank (ADB). Euro-issues include Euro-convertible bonds and GDRs. In India, External Commercial Borrowings are being permitted by the Government for providing an additional source of funds to Indian corporates and PSUs for financing expansion of existing capacity and as well as for fresh investment, to augment the resources available domestically. ECBs can be used for any purpose (rupee-related expenditure as well as imports) except for investment in the stock market and speculation in real estate.

6: Nonresident Deposits: Deposits made in domestic banks by nonresident citizens of a country. Capital flows can be classified as either *debt finance or equity finance*. Debt finance (bonds and bank loans) requires repayment of interest and principal in contractually fixed amounts. In equity finance, in contrast, foreign investors hold shares or have direct control of companies. Repayments in the form of profits and dividends are of variable amount depending on performance.

V. MACROECONOMIC EFFECTS IN CAPITAL INFLOW

Capital inflows are necessary for macroeconomic stability as capital inflows affect a wide range of macroeconomic variables such as exchange rates, interest rates, foreign exchange reserves, domestic monetary conditions as well as saving and investments.

Fitz Gerald (1998) theoretically argues that higher capital inflows lower interest rates, which helps increase investment and economic growth. Some commonly observed effects of the capital inflows that have been documented in the studies (Calvo *et al.*, 1994; Calvo and Reinhart, 2000; Hutchison, 2002; Ito, 2006; Jitter, 2003; Kaminsky, 2003 amongst others) include real exchange rate appreciation, stock market and real estate boom, reserve accumulation, monetary expansion as well as effect on production and consumption. Macroeconomic effect of the renewal of foreign lending to developing countries described as:

First, a substantial portion of the surge in capital inflows has been channeled to accumulation of Foreign exchange reserves.

Second, in most countries the capital inflows have been associated with widening current account deficits.

Third, as one would expect for the fall in national saving, there has been a rise in private consumption spending. While disaggregated data on consumption are not available for most of the developing countries, the import data suggest the consumption boom is heavily driven by rising imports of durable goods.

Fourth, in almost all the countries examined, there is rapid growth in the money supply in both nominal and real terms. This follows logically, enough, from the acceleration in economic activity observed in the receiving countries and in some instances, including Argentina, Brazil, Chile and Mexico from a reduction in the opportunity cost of holding money, as domestic inflation was reduced. However, several countries have demonstrated that it was possible, even in the face of large capital inflows (at least in the short run), for the central bank to curb the acceleration in the growth of the money supply.

Fifth, the surge in portfolio flows to the Asian and Latin American countries was accompanied by sharp increases in stock and real estate prices. In addition, most of the countries that experienced a substantial real exchange rate appreciation had ongoing inflation stabilization plans during the inflow period.

VI. Capital Flows into India

International capital flows such as direct and portfolio flows has a huge contribution to influence the economic behavior of the developing countries positively. Prof. John P. Lewis pointed out, "*that almost every developed country of the world in its developing stage had made the use of foreign capital to make up the deficiency of domestic savings".*

In the seventeenth and eighteenth century England borrowed from Holland and in the nineteenth and twentieth century England gave loans to almost every other country. United State of America, today the wealthiest country of the world, had borrowed heavily in the nineteenth century. The half century prior to the First World War was a period uniquely favorable to the free movement of international capital. Even before 1914, certain changes were taking place in the character and in the industrial distribution of the international capital movements. The war not only accelerated this process by dramatically altering the position of lending participants, but heralded an era which eventually had a fundamental effect on the whole climate of international capital movements. In the twenties, however, there were few signs of upheaval to come and, by 1929; the total investment debt was of the same order as that in 1913.

The 1970s witnessed a remarkable boom of capital flows to emerging economies. The dramatic surge in international capital flows was triggered by the oil shock in 1973-1974, the growth of the Eurodollar market and the remarkable increase in bank lending during 1979-1981. Latin America was the main recipient of this heavy capital inflow, with capital flows to the region peaking at US $44 billion in 1981. Overall, capital inflows to this region, which mostly took the form of syndicated bank loans, reached about 6 % of the region's gross domestic product (GDP). The pace of international lending came to an abrupt end in 1982 with the hike in world real interest rates to levels not seen since the 1930s. Suddenly, emerging countries became the pariahs of international capital markets and they were not only excluded from voluntary capital markets, but also forced to run a current - account surplus to repay their foreign debts. By the late 1980s, there was a revival of international lending. While flows to Latin America made a tremendous comeback, capital inflows to Asia also surged, with capital flows increasing tenfold from their averages in the early 1980s. India is a developing country, like many other developing countries, international capital flows has significant potential benefits of the Indian economy. The problems of foreign investment in India have been an issue of outstanding importance ever since the days of the East India Company and added significance after Indian Independence in 1947. In the 1950s and 1960s, the dominant form of foreign capital was foreign aid, mainly through government to government transfer of resources. In the late 1960s and early 1970s, foreign direct investment (FDI) came into prominence.

The dominant form of foreign capital in the 1970s was the foreign private loan (FPL). In the late 1970s, there was hardly any new foreign investment in India: indeed, some firms left the country. Inflows of private capital remained meager in the 1980s: they averaged less than $0.2 billion per year from 1985 to 1990. In the 1990s, as part of wide ranging liberalization of the economy, fresh foreign investment was invited on a range of industries. Inflows to India rose steadily through the 1990s, exceeding $6 billion in 1996-97. The fresh inflows were primarily as portfolio capital in the early years (that is, diversified equity holdings not associated with managerial control), but increasingly, they have come as foreign direct investment (equity investment associated with managerial control). Though dampened by the global financial crises after 1997, net direct investment flows to India remain positive. Under the liberalized foreign exchange transactions regime, the results were dramatic. The liberalization of portfolio investment led to a surge in inflow of capital for investment (Mody and Murshid, 2002) in the primary and secondary market (Dash and Sumanjeet, 2005) for Indian equity and corporate and subsequently sovereign bond market.

VII. TRENDS IN INDIA

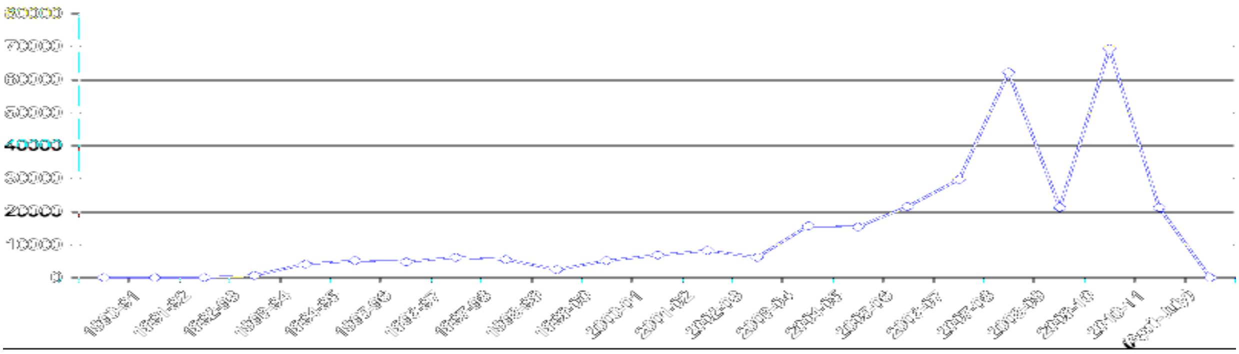
During the early phase of planning era, the national policy towards foreign capital did recognize the need of foreign capital, but decided not to permit it a dominant position. Consequently, foreign collaboration had to keep their equity within the ceiling of 49 per cent and allow the Indian counterpart a majority stake. Moreover, foreign collaborations were to be permitted in priority areas, more especially those in which India had not developed capabilities. But in an overall sense, India's policy towards foreign collaborations remained restrictive and selective. Consequently, during 1948 to 1960, a total of 1,080 foreign collaborations were approved and during the next decade (1961-70), a total of 2, 475 foreign collaborations were approved. During 1971-80 and 1981-90 the collaborations were 3,041 and 7,436 respectively.

Table 1.1: Foreign Collaboration Approvals in Pre-Reform Period

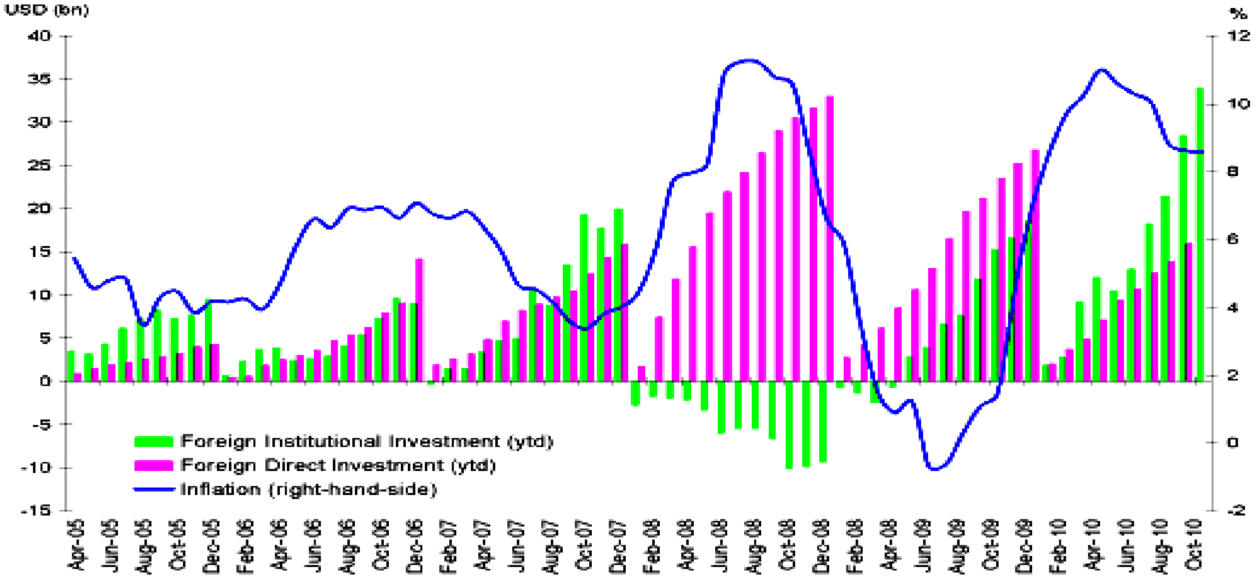
Period	Technical Collaboration Agreement	Foreign Collaboration Agreement	Total number of Foreign Collaboration
1948-60	1,080	-	1,080
1961-70	1,675	800	2,475
1971-80	2,623	418	3,041
1981-90	5,595	1,841	7,436
Total	10,973	3,059	14,032

It is revealed from the table that 78 per cent of total agreements (14,032) were technical collaboration agreements and only 22 percent were related to direct foreign investment. With the introduction of the reform process in the early 1990s and after the announcement of New Industrial Policy, 1991, India has witnessed a significant increase in cross-border capital flows, a trend that represents a clear break from the previous two decades.

The trends in Capital flows into India follow the same momentum as that for other emerging markets. India has high domestic savings to GDP and, prima facie, some may argue that the damage from the reversal in capital inflows should be negligible, but clearly, the recent trend indicates that is not the case. The trend of net capital into India can also be shown as:



The above figure reveals that in the post reform period there has been a remarkable increase in foreign capital. It is also important to note that capital inflows increased extensively since 2005. However, capital inflows resumed during 2007-08 to 2008-09 as a consequence of a global system awash with liquidity. Presently, while most "emerging markets" in Latin America and Asia are expressing concern about and responding with capital controls to the surge in foreign capital inflows into their financial markets, policymakers in India are more optimistic and are declaring that the country can absorb far more than the net capital inflows it currently attracts. India needs to increase the long term investments to expand the economy stronger, foreign direct investment (FDI), although short term capital inflows from foreign institutional investor investments (FII) are rising quickly. The net FII recorded US$34 billion in the 10 month period since January 2010. However, the long term investment of FDI dropped to US$16 billion in the period from January to September 2010, down from US$21 billion for the same period last year.



Economists are concerned that the spike in foreign investment could cause an asset price bubble if policymakers failed to keep inflationary pressures and the widening current account deficit under control. The inflation rate reached double digits since March 2010, although it eased a little to 8.8% in August and to 8.6% in October. To boost the economic growth to double-digit levels by increasing its investment, India also has to be aware of the risks such as those pointed out by concerned economists.

VIII. Determinants of Foreign Capital Inflows in India

The factors that encourage or hinder international flows of capital can categorize into those that are external to the economies receiving the flow and the factors internal to those economies. For small open economies fluctuations in the world interest rates are a key factor inducing capital flows. Other external factors include terms of trade developments, the international business cycle and its impact on profit opportunities and any regulatory changes that affect the international diversification of investment portfolio at the main financial centers. Internal factors are most often related to domestic policy. These factors depend on the nature of foreign capital. To study these factors in a systematic manner, it is imperative to understand the determinants of FDI and FPI separately.

IX. Determinants of FDI

Now-a-days, virtually all countries are actively seeking to attract FDI, because of the expected favorable effect on income generation from capital inflows, advanced technology, management skills and market know-how. It would be useful to review the key determinants and factors of FDI based on the theories of international investment. There has been extensive research on the determinants of FDI. In general, the decision to invest abroad is taken by transnational companies (TNCs) if they can combine their ownership-specific advantages to the location-specific advantages of host countries through internalization. Three broad factors determine the location of FDI: the policies of host countries, the proactive measures countries adopt to promote and facilitate investment, and the characteristics of their economies.

The host country determinants are closely linked with the role of national policies and especially the liberalization of policies, a key factor in globalization, as FDI determinants. Location- specific determinants have a crucial influence on a host country's inflow of FDI. The relative importance of different location-specific determinants depend on at least three aspects of investment: the motive for investment (e.g., Resources, market or efficiency-seeking), the type of investment (e.g., services or manufacturing), and the size of the investors (small and medium MNEs or large MNEs) (UNCTAD 1998). As a consequence of globalization and economic integration, one of the most important traditional FDI determinants, the size of national markets, has decreased in importance. At the same time, cost differences between locations, the quality of infrastructure, the ease of doing business and the availability of skills have become more important (UNCTAD 1996). Traditional economic determinants, such as natural resources and national market size for manufacturing products sheltered from international competition by high tariffs or quotas, still play an important role in attracting FDI by a number of developing and developed countries as well as economies in transition (e.g., India, China, Australia and Kazakhstan).

The economic determinants related to large markets, trade barriers and non-tradable services are still at work and account for a large share of worldwide FDI flows. Although FDI remains strongly driven by its traditional determinants, the relative importance of different locational determinants for competitiveness-enhancing FDI is shifting. While low-cost labour remains a locational advantage, the increasingly sought-after advantages are competitive combinations of wages, skills and productivity (UNCTAD 1998).

With the creation of regional integration frameworks (e.g., ASEAN), access to the regional market supersedes access to national markets as an important FDI determinant. This also depends on how well the country is integrated into the regional bloc in terms of policy harmonization as well as physical accessibility, which gives policy determinants an increasing importance. For foreign investors, the host country policies on the repatriation of profits and capital and access to foreign exchange for the import of intermediaries, raw materials and technology are particularly important.

X. Determinants of FPI

The determinants driving portfolio investors are more complex, involving the interactions of factors related to external environment, investors' strategies and specific host country determinants. As many developing countries and countries in transition have embarked on a process of investors were able to allocate their savings has grown substantially over the last ten years. In parallel, the tremendous growth of investible assets managed by institutional investors in OECD countries has flooded international capital markets with liquidity. For example in 1998, the total net assets of OECD pension funds were estimated at around 11 trillion US$ (14% of which were cross-border investment), while total assets of mutual funds in the world exceeded 8 trillion US$ (with US funds alone accounting for more than 5 trillion US$). Accompanied by rapid financial innovation, the combination of these events produced change in investor strategies as well as a re-allocation of funds towards emerging markets. There are two key factors which explain the increased interest, until the Asian crisis, of international investors towards emerging markets as a group: potentially higher returns and the benefits of diversification. Once the decision is taken to invest in emerging markets, some host country determinants are of critical importance for fixed income investors and are of minor importance to equity investors and vice-versa.

Host country determinants: Determinants of FPI can be put into two groups: economic determinants and policy/regulatory determinants. Economic determinants are not directly linked to policies aimed at attracting foreign portfolio flows. Instead, they are a reflection of the general health of the economy, the potential for the firms operating in such a business environment to earn profits, and to obtain a satisfactory return on fixed income investment. Investors will typically focus on the factors such as i: *High economic growth rate*, ii: *Exchange rate stability, iii: Macroeconomic stability, iv: Level of foreign exchange reserves, v: Health of domestic banking system, vi: Stock and bond market liquidity, vii: Real interest rates.*

Some of the above factors will be of more importance to equity investors and others to fixed income investors. On the other hand, the degree of bond market liquidity and the level of real interest rates will be of particular importance for fixed income investors. Although the amount of portfolio capital invested in emerging markets has increased countries which are associated with sound macro-economic policies and relatively high growth rates.

XI. CONCLUSION

Foreign capital has a key role to play in the economic development of India. There are several ways in which capital flows and economic growth are related. However, impact of capital flows on economic growth ultimately depends on their being stable and less volatile. Indian government has been continuously proceeding for economic reforms and is quiet assured to secure legislation to allow more foreign investment in various sectors. The size of net capital inflows to India has increased significantly in the post reform period. It is also important to note that capital inflows increased extensively since 2005. However, capital inflows declined during 2007-08 to 2008-09 as a consequence of global financial crisis. The movement of capital inflows clearly indicates that capital inflows in India are highly volatile. In fact, India has experienced both sudden increase and sudden declines of capital flows. Various studies explored that both excess and sudden declines (siphoning-off) of capital inflows are harmful for an economy. But sudden declines in capital inflows are more harmful as sudden declines of capital inflows may lead any economy into insolvency and affect the various macroeconomic variables. Therefore, effective buttressing of these capital inflows is a key economic policy issue today. Countries with sound macroeconomic policies and well-functioning institutions are in the best position to reap the benefits of capital flows and minimize the risks. India's inability to deal with capital inflows is partly a result of the government doing less of what it should do more of, and doing more of what it should do less of. There is precious little in terms of economic reforms, but the government has gone to great lengths to encourage more capital inflows.

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