CHAPTER 6

FOREIGN INFLOW
OF CAPITAL AND
FOREIGN EXCHANGE
MANAGEMENT
FOREIGN INFLOW OF CAPITAL AND FOREIGN EXCHANGE MANAGEMENT

6.0 INTRODUCTION

Foreign capital inflow has been an engine of growth in many countries during the last two decades. It is necessary to supplement the domestic capital resource base of a country. The phenomenon appeared in a predominant way for the developing countries since 1990s. India is not an exception to that. Under the structural reform programme the process of integrating Indian economy with global economy along with convergence of capital flows has been gradually liberalized. As a result, the country allowed foreign entities to come in with their investment. However, the entry of foreign capital was not unrestricted. We have established our national priorities and earmarked certain sectors in which foreign capital inflow was desirable in order to foster the pace of economic growth on a sustainable manner in the long run. The policy makers and planners have therefore chalked out a road map supplemented by some regulatory framework to ensure the meaningful utilization of the foreign capital to serve the best interest of our national economy. The regulatory norms in the hands of the regulatory
agencies like RBI, SEBI, Foreign Investment Promotion Board (FIPB) have been strengthened in order to check the possible adversities that might occur on account of inflow of foreign capital. In opening out door to the foreign capital inflow the economic policy and agenda have strictly adhered to the constitutional obligation of the political administration that comes to governance in the national capital. We as a nation are committed to conform to attaining economic growth with social justice, supplement the national resource with foreign capital attaining balanced regional growth and national dispersal of foreign capital mixed as a dose of joint venture, collaborative venture, and working in tandem under the tenet of Public – Private Partnership (PPP).

The flight of foreign capital not only carries the foreign capital for the host nation but at the same time it brings the sophisticated technology, the management technique and the risk associated in managing such foreign capital by the Central Banking Authorities (CBA) in the host nation. The CBA finds it difficult to maintain the purchasing power parity and domestic stability in financial management and currency compatibility.
6.1 INFLOW OF FDI IN TERMS OF DOLLAR

Now we examine the inflow of dollar currency in Indian economy during the recent period. We shall further examine the sources of such inflow of foreign currency and its eventual impact on our domestic economy.

During January – August, 2010 India attracted Foreign Direct Investment (FDI) worth 13.85 billion dollar. For the 2010 – 11 full financial year, the inflow declined to 19.42 billion dollar from 25.83 billion dollar in 2009 – 10.

So far as the source of inflow is concerned, Mauritius is the single largest investor in India owing to advantages of the Double Tax Avoidance Agreement (DTAA); this is followed by Singapore, the USA, the UK, the Netherlands, Japan, Germany and the UAE. The sectors that attracted the maximum FDI during the first eight months of this year include financial and non – financial services, telecom, housing and real estate, construction and power.

During our research investigation, it has been revealed that DTAA treaty is misused for round tripping; because it provides for capital gains tax only in the country of residence of the investor. A person routing investments through the Mauritius to India does not pay
tax and as such income is tax – exempt under the domestic laws of Mauritius.

Bulk of the FDI inflows between April, 2000 and January, 2011 was via Mauritius based companies. During this period FDI from Mauritius stood at Rs 2,69,395 crore registering 41% of the total FDI (Source The Telegraph dated 29th October, 2011).

6.2. CHANGES IN GOVERNMENT POLICY

In order to tune with the pressure of foreign agencies and institutions bringing FDI there has been the change in the Government stand. In September 2011, the Industry Ministry had ruled that put and call options in equity in portfolio market should be treated as foreign debt for India and not FDI.

Now let us explain the mechanism of put option and call option. A put option gives the buyers of a security the right to sell back at an agreed price and in a pre – determined time frame. While a call option gives the sellers of a security the rights to buy back the security under similar terms. However, the Industry Ministry on October 31, 2011 dropped the provision in the face of stiff opposition from foreign investors, particularly private equity players. The Industry Department
has now deleted the aforesaid provision. If put and call options in equity were treated as debt, they would have to meet the tougher norms for External Commercial Borrowings (ECBs) [Source, The telegraph dated 1 November, 2011].

Now similarly we examine the implication of change in FDI rules. Wholly owned foreign non-banking finance companies (NBFC’s) that brought in 50 million dollar as capital were allowed to set up any number of subsidiaries for specific activities without bringing in additional capital. The FDI guidelines embodied in press note 4 of 2009 took away this right mandating that Indian companies that receive downstream investments from foreign companies have to comply with relevant sectoral conditions including minimum capitalization. The net effect of the policy was that 100% foreign owned NBFCs that had already brought in 50 million dollar of capital had to capitalize their downstream NBFCs subsidiaries all over again. Moreover, the legal provisions require them to have separate entities for different activities. For example, an NBFCs cannot carry out portfolio management service and housing finance activity under the same legal structure. For every activity a separate subsidiary has to be set up.
6.3. INTERNATIONAL FACTORS EXERTING INFLUENCE ON CURRENCY MANAGEMENT

During the course of our research enquiry we have observed that currency management is not confined within the factors of domestic economy alone. There are some reasons attributed to externalities which have a direct bearing on domestic currency management. Some of these reasons we are describing hereunder.

The IMF member nations and their central banks, for instance, do not manage currencies which function as full floats. The Reserve Bank of India should have sold dollar more aggressively to remove excessive speculation in dollar currency. As a central banking authority it is supposed to properly trade off between demand supply currency matrix.

- The RBI should have allowed corporate to take more dollar loans and foreign portfolio managers be encouraged to invest more in local bonds. This would prevent speculation in dollar currency.

- The US dollar index gained a less than 4% since August 8, 2011 owing to US debt downgrade the US economy. This resulted in a new phase of volatility. In contrast we notice that the Euro fell
3% between August, 8 and November, 11 of 2011, the rupee fell 10% on average against dollar. We are not sure whether the rupee’s depreciation against dollar can be attributed to the dollar’s gain globally.

- Galloping inflation and high crude oil price had driven oil companies to raise petrol prices. The hike in petrol price in the Middle East has forced New Delhi Authorities to buy more dollars for crude oil. In the domestic front the price of petrol, diesel and cooking gas have been raised. This has a direct influence on our inflation management, domestic price stability management and also managing the purchasing power of rupee currency.

- The bulk demand for dollar come from corporate oil payment to Iran, defence pay out, regular oil purchase and foreign institutional investors (FIIs) outflow. On the other hand, capital inflow declined with the increase in global risk aversion. The RBI officials might have thought that the outflow on account of Iran and inflow from a large high profile FDI deal would offset each other. But unfortunately they did not occur and the dollar faced a challenge from Euro in the Euro land.
• The sharp slide in the rupee could have been tempered if the RBI had supplied dollar to the market and they could have demand for dollar from oil companies and public sector units off the market (Sugata Ghosh: Did RBI Goof up on the Dollar, the Economic times dated 14th November, 2011).

• Rupee depreciated against dollar at the level of Rs. 50 a dollar on October 21, 2011. It may have the following consequences:
   a) It could exacerbate inflationary pressure by making oil imports costlier. The depreciation of the rupee impacts our import bill.
   b) While the falling rupee would help exporters, it would swell oil subsidies as the country imports nearly 80% of its fuel needs.
   c) The government has budgeted to spend Rs. 4,30,000 crore on subsidies in 2011–12, mostly for fuel, fertilizers and food.

EPILOGUE

Having considered the aforesaid issues in course of our research survey we draw the following inferences:
The foreign direct investment brings in foreign capital and technology in investment in productive activities in plant and machineries and other manufacturing sectors. This inflow supplements our domestic capital requirement and the amount is invested in domestic economy. On the other hand, foreign institutional investment is deployed in portfolio investment in order to garner capital appreciation from securities market. This kind of inflow is risky because the amount may not remain within the country. Further, the profit from securities transaction is again repatriated by converting rupee in dollar in their native countries. Hence we find that both the central banking authorities and the Foreign Investment Promotion Board (FIPB) of the government do work in harmony for ensuring a balanced inflow of foreign currency without in any way destabilizing the sectoral balance and basic financial structure of the domestic economy. However, this is a necessary condition but not sufficient for attaining a balancing act for any economy universally.