CHAPTER 7

SUMMARY AND CONCLUSION

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India launched a programme of economic policy reforms in response to a fiscal and balance of payment crisis in July 1991. Foreign investment had played a very limited role in India’s economy prior to 1991. India followed a fairly restrictive foreign private investment policy until 1991- relying more on bilateral and multilateral loans with long maturities. As part of the economic reforms initiated from 1991, the attitude of the government changed dramatically towards foreign investment. The realization that it was the mode of financing the trade and current account deficits through commercial borrowings that led to the crisis, prompted the policy makers to rethink about the mode of financing the deficits. The Rangarajan Committee recommended a switch from debt creating capital flows to non-debt creating capital flows like FDI and FPI.

The opening up of the Indian economy to foreign investment from 1991 led to massive capital flows into the country. Cumulative foreign investment inflows from August 1991 to March 2009 have been to the tune of $220222 million. Out of this total, the share of foreign direct investment was 64.64 per cent whereas the balance 35.35 per cent was the contribution of foreign portfolio investment. The foreign exchange reserves which fell to less than $1 billion and was hardly sufficient for meeting two weeks imports in July 1991 touched an all time record high of $313.5 billion in April 2008. The current account of India’s balance of payments which was continuously in deficit during 23 years met with a surplus during the three years 2001-04. India became a net creditor to the IMF under the Financial Transaction Plan (FTP) in 2004-05 and extended a financial assistance to the tune of $93.5 million.

1990s were characterized by a surge in capital flows to the developing countries. Global financial conditions and domestic policies have changed a lot
during the last two decades. The adoption of a market determined exchange rate and lower interest rates have drastically reduced the incentive to resort to short-term external borrowing. The Government also has taken steps to accelerate the development of domestic capital market and foreign exchange markets. These developments, along with the shift from debt finance to non-debt creating capital flows have contributed to a marked improvement in the sources of external financing. Foreign investment inflows have macroeconomic repercussions changing the dynamics of balance of payments, composition of capital inflows, foreign exchange markets, money supply and foreign exchange reserves. The present study is an attempt to examine and explore these issues and problems.

The main objectives of the study are the following:

1. To examine the trends and structural changes in foreign investment from an international perspective.
2. To study the trends in foreign investments in India in the post reform period.
3. To analyse the change in the structural composition of foreign investments.
4. To study the impact of foreign investments on Indian economy with particular reference to the composition of capital inflows, sources of financing the current account deficit, foreign exchange reserves and exchange rate.

The study is based on the following hypotheses.

i. Foreign portfolio investment is the most volatile of all forms of capital inflows.

ii. The policy reform to encourage non-debt creating flows in the post-reform period was successful.

iii. The dollar rupee nominal exchange rate is a market determined one since 1993.

The period of the study is 1991-92 to 2008-09. The study is done at the international and national level. The geography of international investment is analysed from the global perspective while foreign investment in the Indian context is studied at the national level.

The trends and structural changes in foreign investment from an international perspective is done on the basis of inward and outward FDI stocks and flows, top ten sources and host nations of FDI, FDI flows to developing, emerging and the ASEAN-5 economies, sectoral and industrial distribution of FDI, modes of FDI entry and FPI inflows. The trends in foreign investments and the change in the structural composition of foreign investments in India in the post reform period is done on the basis of compound annual growth rates of total foreign investment, FDI, FPI, realization rate, sources and direction of FDI inflows.

The impact of foreign investment on the composition of capital inflows is analysed based on a comparison of annual time series data for the 20 years in the pre-reform period and 18 years in the post-reform period. The impact of foreign investment on foreign exchange reserves is assessed based on annual time series data. The impact of foreign investment on the exchange rate is analysed based on
annual time series data for the 16 years in the post-reform period. The different exchange rate concepts used are nominal exchange rate between rupee and dollar, the nominal effective exchange rate (NEER) and the real effective exchange rate (REER).

Quarterly time series data for 72 quarters from the Q₁/1991 to Q₄/2008 are used in the estimation of volatility of capital inflows, impact of foreign investment on current account balance and foreign currency assets and ratio statistics was used for the estimation.

The study is done on the basis of analytical tools like linear trend, graphs, pie diagrams, compound growth rates, averages and percentage analysis. Correlation, regression, inter-quartile range and ratio statistics have also been used wherever relevant. The important findings of the study are summarized below.

7.1 SUMMARY

One of the objectives of the study was to examine the trends and structural changes in foreign investment from an international perspective. The study shows that the geographic pattern of global FDI has changed in various ways during the past eighteen years. The share of developed countries in global inward and outward FDI stock and flows declined whereas the share of developing countries increased, particularly that of Asia during this period. The European Union today accounts for almost half of global inward and outward stocks and flows. The importance of the United States in both inward and outward FDI flows and stocks has declined over the period. Industrialized countries as a group are overwhelmingly the home and host countries of direct investments. Hong Kong and China are the two nations from the developing world that entered the list of top ten host nations of foreign direct investment.

Developing countries have gained in importance as recipients of FDI in terms of both inward flows and stocks. Their share in total world inflows rose from 26 per cent in 1991 to 36.6 per cent in 2008, though the performance of the
different regional groups was uneven. China is the number one nation in receiving FDI among the developing nations whereas India is the fourth largest host nation. Asia is the largest source of outflows from the developing region accounting for three-fourth of all developing-country FDI outflows. Africa accounted for 3.18 per cent of all developing-country FDI outflows in 2008.

The share of ASEAN-5 in world FDI inflows showed a falling trend whereas both inward and outward FDI flows of the emerging economies exhibited a rising trend. India’s share in FDI flows to emerging economies increased sharply from 2.93 per cent in 1991 to 26.44 per cent in 2008. China, on the contrary, experienced a sharp fall in its share from 90.71 per cent in 1991 to 68.93 per cent in 2008.

The most important change in the sectoral and industrial pattern of FDI over the past eighteen years has been the shift towards services accompanied by a decline in the share of FDI in natural resources and manufacturing. The share of developed countries in global cross border Mergers and Acquisitions declined from 89.15 per cent to 81.97 per cent and that of developing countries increased from 10.66 to 14.98 per cent during 1990-2008. Asia is the largest developing region accounting for more than 64.91 per cent of all developing-country Mergers and Acquisitions in 2008. The most important change in the sectoral and industrial pattern of cross border Mergers and Acquisitions over the past eighteen years has been an increase in the share of the primary sector accompanied by a decline in the share of manufacturing and services. The share of both the developed countries and developing countries in the total number of greenfield projects increased during the period. The manufacturing sector accounted for nearly half (47.80) of the greenfield investment projects followed by services sector (45.63 per cent) whereas the primary sector accounted for only 6.57 per cent of all greenfield projects in the world in 2008.
Equity capital is the largest component of FDI financing followed by intra-company loans and reinvested earnings. A comparison of the inward performance index by region in 1990 and 2005 shows that developed economies as a group was not able to perform like the developing economies and South East Europe and the CIS. The European Union, Latin America and the Caribbean and the Asian countries improved their performance based on the index during this period. Among the emerging economies India and Bangladesh were the two nations that improved their rankings over the period.

A comparison of the ASEAN-5 nations based on the inward FDI Potential Index in 1990 and 2006 showed that Malaysia, Philippines and Singapore improved their rankings over the period whereas Indonesia and Thailand went down the ladder. Among the emerging economies Bangladesh, China and India improved their rankings. Compared to the FDI Performance Index ranking (106) India has a relatively high FDI Potential Index ranking of 84.

The geographic pattern of global FPI has also changed during the past eighteen years. The share of advanced economies in world FPI inflows increased while the share of the emerging and developing economies in world inflows decreased. The share of advanced economies in world FPI inflows increased from 73.97 per cent in 1994 to 92.92 per cent in 2007 which crossed the 100 per cent mark in 2008. This is attributed to the FPI outflows from the emerging and developing economies. The share of the emerging and developing economies in world FPI inflows decreased from 24.40 per cent in 1994 to 6.23 per cent in 2007.

Foreign portfolio inflows into the ASEAN-5 economies increased from $ 40 million in 1991 to a record high of $ 44720 million in 2007. The ASEAN-5 economies experienced FPI outflows in 2008 which was to the tune of $ 30410 million. Among the ASEAN-5 nations, Singapore and Thailand were the largest recipients of FPI. Emerging economies too experienced increasing FPI inflows.
The aggregate FPI flows to the emerging economies turned negative in 2008 which is solely attributed to the FPI outflows from the Indian economy.

China and India accounted for an impressive share of FPI inflows to the emerging economies. The aggregate amount of FPI inflows to the Chinese economy during 1991-2008 was to the tune of $1 45806 million whereas India received $81058 million during the same period. The lone year in which FPI flows to the Chinese economy turned negative was in 1999 whereas India experienced FPI outflows in 1998 and 2008.

An overview of the foreign investment policy in India reveals the fact that policy changes were introduced in India not in one go but it was a gradualist one. Even after the completion of nearly two decades, reform measures are still continuing which is an indication of the fact that reforms are never ending and an unfinished business in the agenda of the Government of India. It is also a sign of the fact that India is treading very cautiously ahead on the road of reforms.

The second and third objectives of the study were to analyse the trends in foreign investments in India in the post reform period and to study the change in the structural composition of foreign investments. An analysis of the trend and pattern of foreign investment in India in the post-reform period revealed many interesting facts. The compound annual growth rate of total foreign investment was 34.84 per cent, while that of FDI was 39.08 per cent and that of FPI 61.51 per cent. FDI contributed 64.65 per cent to total foreign investment whereas the contribution of FPI was only 35.35 per cent. India’s share in global FDI flows increased from 0.10 per cent in 1991 to 2.45 per cent in 2008. The FDI realization rate was 94 per cent.

There are two main channels for the entry of FDI into India: the SIA/FIPB route and the RBI Automatic Approval route. From the inception of economic reforms in India in 1991 until the year 2002, most of the FDI came through the
government route. Thereafter the government eased foreign investment regulations leading to a spurt in FDI coming through the RBI route.

An analysis of the sources and direction of FDI shows that Mauritius is the leading investing nation in India, followed by Singapore and USA. Investors based in many countries have taken advantage of the India-Mauritius bilateral tax treaty to set up holding companies in Mauritius which subsequently invest in India, thus reducing their tax obligations.

The service sector has been the primary destination of FDI in India since 1991. The other destinations for FDI were computer software and hardware, construction activities and housing and real estate. From the mid-1990s, India has been an important destination for investment in offshoring services such as software, call centers, and other business process outsourcing. For example, in 2009 more than one-fourth of the world IT offshoring market is centered in India.

In the manufacturing sector, electrical equipment, transportation industry, fuels, chemicals, drugs and pharmaceuticals received most of the investment. In the services sector, financial services constitute almost half of the total foreign direct investment followed by banking. Maharashtra, New Delhi, Karnataka, Gujarat and Tamil Nadu have been the largest recipients of FDI in terms of cumulative FDI inflows. Equity capital is the most important component of FDI, followed by reinvested earnings and other capital.

An analysis of the portfolio investment shows that it has taken a quantum leap in recent years especially after 2003-04. Portfolio investment was negative to the tune of $ 61 million in 1998-99 which is attributed to the East Asian currency crisis. It was negative to the tune of $13855 million in 2008-09 on account of the global financial crisis. The composition of portfolio investment shows that FIIs contribution was 66.31 per cent, while 31.71 per cent came through GDR/ADR issues and the balance 1.98 per cent through offshore funds. The compound annual growth rate of foreign institutional investment was 93.73 per cent, that of
GDR/ADR 10.36 per cent and 30.92 per cent in the case of offshore funds. The investment pattern of the FII shows that 82.92 per cent of the investment was in equities and the balance of 17.08 per cent in debt during 2001-09.

The fourth and the most important objective was to study the impact of foreign investments on Indian economy with particular reference to foreign exchange reserves, exchange rate, balance of payments, composition of capital inflows and sources of external financing. One of the hypotheses used in the study was that foreign portfolio investment was the most volatile of all forms of capital inflows. This hypothesis was tested based on quarterly balance of payments data for 72 quarters from the Q1/1991 to Q4/2008 and inter-quartile range was used for the estimation. The four components are foreign direct investment, foreign portfolio investment, debt and official flows. The ranking of volatility of the four components of capital flows appears to be Official Flows > Debt Flows > FPI > FDI. Thus the study shows that foreign portfolio investment is the second stable flow among the capital flows into the Indian economy. Based on this result, we reject the hypothesis that portfolio investment is the most volatile of all forms of capital flows. Official flows are most volatile of all forms of capital inflows to the Indian economy during 1991-2008.

The impact of foreign investment on the composition of capital inflows was analysed based on a comparison of annual time series data for the 21 years in the pre-reform period and 18 years in the post-reform period. In the pre-reform period, India’s reliance on external flows was mainly restricted to multilateral and bilateral concessional finance in the 1970. Subsequently, however, in the context of a widening current account deficit during the 1980s, India supplemented this traditional external source of financing with recourse to external commercial loans including short term borrowings and deposits from non-resident Indians (NRIs). The total amount of foreign investment received by India during the 21 year period was only US $ 1865 million.
An analysis of the net capital inflows to India shows that apart from an increase in size, capital inflows have undergone a compositional shift from predominantly official and private debt flows to non-debt creating flows in the post reform period. This is an indication of the fact that the policy reform in India to encourage non-debt creating flows in the aftermath of the balance of payments crisis was a success story. Thus we accept the second hypothesis that the policy reform to encourage non-debt creating flows in the post-reform period was successful. Although non-debt creating inflows, particularly private foreign investments have gained in importance, there is also a significant rise in the debt creating inflows in the last three years mainly on account of a rise in external commercial borrowings by Indian corporates.

The impact of foreign investment on the current account deficit is analysed based on a comparison of annual time series data for the 20 years in the pre-reform period and 18 years in the post-reform period. We also use quarterly time series data for 72 quarters from the Q1/1991 to Q4/2008 and ratio statistics was used for the estimation. Our analysis showed that during the twenty year period ranging from 1970-71 to 1990-91, external assistance was the major source of financing the CAD which accounted for 43.94 per cent. External commercial borrowing contributed 26.23 per cent while the contribution of NRI deposits was to the tune of 26.36 per cent. Foreign investment contributed 3.47 per cent to the CAD. Since external assistance, external commercial borrowings, trade credits and non-repatriable component of NRI deposits constitute the major portion of the external debt in India, it is clear that the financing of the current account over the period based on external savings led to a very sharp increase in the external debt of India.

After the initiation of economic reforms in India in 1991, the current account of our balance of payments was in deficit in all the years except for three years: 2001-02, 2002-03 and 2003-04. The total current account deficit during 1991-92 to 2008-09 was to the tune of $81.62 billion. During the same period,
total foreign investment was $220.22 billion out of which FDI was equal to $142.36 billion and FPI to the tune of $77.86 billion. This means that the entire current account was financed by FDI during this period.

The impact of foreign investment on the foreign exchange reserves is analysed based on annual time series data for the 18 years in the post-reform period. We also use quarterly time series data for 72 quarters from the Q1/1991 to Q4/2008 and ratio statistics is used for the estimation. The main sources of foreign exchange reserves in India are inflows of foreign investment, external commercial borrowings and deposits by non-resident Indians. Our analysis showed that during 1991-92 to 2008-09 foreign investment contributed 61.59 per cent to the accretion in foreign exchange reserves. The contribution of portfolio investment was 31.51 per cent while FDI contributed 30.08 per cent. External commercial borrowings contributed 27.06 per cent while that of NRI deposits was 13.53 per cent. The ratio statistics used to analyse the impact of foreign investment on foreign currency assets shows that the variance of FPI to foreign currency assets is higher than the variance of FDI to foreign currency assets.

The impact of foreign investment on the exchange rate is analysed based on annual time series data for the 18 years in the post-reform period. The different exchange rate concepts used are nominal exchange rate between rupee and dollar, the nominal effective exchange rate (NEER) and the real effective exchange rate (REER).

In January 1993 the exchange rate became fully ‘market determined’. We tested the hypothesis that the dollar rupee nominal exchange rate is a market determined one since 1993 based on the annual variation in the dollar-rupee nominal exchange rate. Our analysis shows that the market was not allowed to determine the exchange rate of the rupee. This is evident from the fact that along with the surge in capital inflows, the rupee depreciated continuously during 1993-94 to 2002-03. A reversal of the rupee depreciation happened only in
2003-04. Even though large capital inflows tended to exert an appreciating
power on the rupee, the RBI intervention resulted in a continuous depreciation
of the rupee for the fear that any nominal appreciation of the rupee could have
eroded India’s export competitiveness. Thus we reject the hypothesis that the
dollar rupee nominal exchange rate is a market determined one since 1993.

We have also examined the changes in the exchange rate in terms of real
effective exchange rates and nominal effective exchange rates. In terms of real
effective exchange rates while the REER (6 currency trade based indices)
appreciated by 4.44 per cent, the REER (36 currency trade based indices) recorded
a depreciation of 5.88 per cent during the period 1993-94 to 2008-09. In terms of
nominal effective exchange rates, while the NEER (36 currency trade based
indices) recorded a depreciation of 16.08 per cent the NEER (6 currency trade
based indices) depreciated by a whopping 54.94 per cent, during the period
1993-94 to 2008-09.

7.2 CONCLUSION

India is the second largest country in the world and its economy has been
growing at one of the fastest rates in the world. India was able to move to a high
growth trajectory due to the initiation of the economic reforms which were
launched in response to a fiscal and balance of payments crisis in 1991. Foreign
investment had played a very limited role in India’s economy before the crisis.
India followed a fairly restrictive foreign private investment policy until then. As
part of the economic reforms, the attitude of the government changed dramatically
towards foreign investment-both direct and portfolio. A major feature of economic
reforms has been a progressive liberalisation of external capital flows, especially
non-debt creating ones like foreign direct investment and foreign portfolio
investment. Portfolio investment is a new phenomenon that came to occupy a
place in the capital account only after 1992-93.
Liberalisation of foreign investment policy regime was a major component of India’s economic reforms. There was a dramatic jump in foreign investment inflows in the post liberalisation period. Cumulative foreign investment inflows from August 1991 to March 2009 have been to the tune of $220222 million. Out of this total, the share of foreign direct investment was 64.64 per cent whereas the balance 35.35 per cent was the contribution of foreign portfolio investment. The foreign exchange reserves which fell to less than $1 billion and was hardly sufficient for meeting two weeks imports in July 1991 touched an all time record high of $313.5 billion in April 2008. The current account of India’s balance of payments which was continuously in deficit during 23 years met with a surplus during the three years 2001-04. From the brink of defaulting on its international payments in 1991, India became a net creditor to the IMF in 2004-05 and extended a financial assistance to the tune of $93.5 million.

The proponents of openness and globalization argue for further liberalisation of the economy while the critics of liberalisation point to the dangers of excessive openness. Large inflows of capital are necessary for accelerating the pace of economic growth whereas the encouragement of massive inflow of hot money can destabilize the economy. Thus what is needed is a careful balancing act in which the economy should be able to take advantage of the programme of liberalisation.

Even though strong capital inflows resulted in an overall improvement of the balance of payments and a very sharp increase in foreign exchange reserves, there are some problem areas associated with the liberalisation of capital flows. One is the recent rise in the debt creating inflows. Even though capital inflows have undergone a compositional shift from predominantly official and private debt flows to non-debt creating flows in the post reform period, there is a sharp rise in the debt-creating inflows during 2006-09. The share of debt-creating inflows which was 84.5 per cent in 1991-92 once again rose to 87.2 per cent in 2008-09.
This is mainly attributed to the steep rise in external commercial borrowings by Indian corporates which is likely to exert an upward pressure on India’s external debt.

Another area of concern is the recent appreciation in the nominal exchange rate of the rupee against the dollar. If the surge in capital inflows continues to exert an appreciating pressure on the rupee in the long run, there will be an erosion in India’s export competitiveness. At the same time if the external value of Indian rupee is not determined by the market forces, the central bank will be forced to intervene in the foreign exchange market which involves considerable costs.

Burgeoning foreign exchange reserves is another area of concern. Those who oppose the free flow of capital feel that the economy is not able to absorb the foreign exchange and thus favour the imposition of capital controls. At the same time since there is no evidence to suggest that FPI flows have fluctuated so much as to seriously impair the RBI’s foreign exchange management, there is no need for imposing capital controls. Unless a convincing case is made out for discouraging FPI inflows on a long-term basis, it would be unwise to impose restrictions on FPI. This is due to the fact that U-turns in policies regarding foreign investment may send out wrong signals to the international investing community. Besides, comfortable foreign exchange reserves provide valuable leeway in pushing reforms forward speedily to accelerate the absorption capacity of the economy which will help India to achieve and maintain her growth rate around 10 per cent.

In brief, we conclude that further liberalisation of capital inflows should be in favour of foreign direct investment rather than portfolio flows since the latter is transient in nature.