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CHAPTER 1

INTRODUCTION

India launched a programme of economic policy reforms in response to a fiscal and balance of payment crisis in July 1991. The programme consisting of stabilization-cum-structural adjustment measures was put in place with a view to attain macroeconomic stability and higher rate of economic growth. While the 1980s witnessed a rather limited deregulation, the reforms of the 1990s are much wider and deeper. India’s reforms were preceded by a serious financial crisis.

In 1990-91 the central fiscal deficit was 8.3 percent of GDP. The primary deficit was 4.3 percent. An unexpected balance of payment crisis emerged in early 1991. The large current account deficit, particularly after 1984-85 was financed by substantial inflows of capital by way of commercial borrowings and deposits by non-resident Indians. The total external debt increased from US $ 20.6 million in 1980 to US $ 34.4 billion in 1984 and to US $ 70.1 billion in 1990. Debt service, as a percent of export of goods and services, increased from 9.3 percent in 1980 to 26.8 percent in 1990.

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. Inward foreign direct investment was perceived essentially as a means of acquiring industrial technology that was unavailable through licensing agreements and capital goods import. As part of the economic reforms initiated from 1991, the attitude of the government changed dramatically towards foreign investment- both direct and portfolio. Over the post-reform period, India not only permitted foreign investment in almost all sectors of the economy but also allowed foreign portfolio investment—thus practically divorcing foreign investment from the erstwhile
technology acquisition effort. The increased inflow of foreign funds into the developing countries like India is expected to act as catalyst of economic growth.

Foreign investment is a source of additional external finance augmenting fixed investment, potential output and employment. Foreign direct investment (FDI) is now widely perceived as an important resource for expediting the industrial development of developing countries in view of the fact that it flows as a bundle of capital, technology, skills and some times even market access. FDI is not a panacea for the development problem; it is a catalyst in the growth process. It enhances the efficiency of other inputs in the growth process through its well known role as a supplier of technology and know-how. Portfolio investment is a new phenomenon that came to occupy a place in the capital account only after 1992-93.

A major feature of economic reforms in India since 1991 has been a progressive liberalisation of external capital flows, especially non-debt creating ones like foreign direct investment and foreign portfolio investment. The inflow of foreign investment is likely to have macroeconomic repercussions on the Indian economy. Our study is an attempt to examine the trends and structural composition of foreign investment with particular emphasis on its impact on balance of payments, exchange rate, foreign exchange reserves, money supply and sources of external financing. The rationale for selecting this area for our study is presented in the following section which starts with a review of the existing literature.

1.1 REVIEW OF LITERATURE

Review of the existing literature is helpful in identifying the research problem and stimulates new ideas on the same. Large number of studies has been undertaken about international investment- both foreign direct investment and portfolio investment. For convenience sake, we present the studies in their chronological order.
Goldstein et al (1991)\(^1\) suggested that the right to repatriate dividends and capital might be the most important factor in attracting significant foreign equity flows. The International Finance Corporation differentiates between countries that allow foreign investors to repatriate capital and income freely and without restriction from countries that are “relatively open” which apply some restrictions on the repatriation of capital and income and countries that are “relatively closed” which apply very strict restrictions.

Williamson (1993)\(^2\) pointed out that as developing countries creditworthiness is restored, capital (bond and equity) flows are likely to become an increasingly prominent source of external finance. Although portfolio equity flows to developing countries have increased sharply in recent years, they are expected to be extremely sensitive to a country’s openness, particularly to rules concerning the repatriation of capital and income.

Chuhan and Mamingi (1993)\(^3\) investigated whether bond and equity flows were induced push or pull factors, differentiating between short and long run determinants. They concluded that equity flows are more sensitive than bond flows to global factors, while bond flows are more sensitive to country-specific factors. However, they are primarily interested in identifying the long term determinants of the large capital flows to developing countries rather than in fully modelling the dynamics of capital flows.

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Calvo and Reinhart (1993 and 1996)\textsuperscript{4} who first suggested the importance of US interest rates and to the slowdown in US industrial production over 1988-’92 in explaining portfolio flows to emerging markets. They also argue that a reversal of the global conditions could induce a fast outflow of capital from developing countries. The interest rates are likely to be the most important determinant of the dynamics of portfolio flows (especially bonds) to Asian and Latin American countries.

Sau (1994)\textsuperscript{5} presents a simple model to examine the conditions of stability with the inflow of foreign capital. He found that the equilibrium is most likely to be stable if the interest elasticity of direct foreign investment is high and that of foreign portfolio investment is low. He indicates that the experience of India is just the reverse, that is, the possibility of instability. The instability may take the form of appreciation of the rupee accompanied by falling income. With the recent liberalisation in India, the stock markets are receiving foreign portfolio investment at the rate of some four million dollars per day. FPI is attracted by higher interest rate in primary and secondary markets of stocks and bonds. It facilitates appreciation of the currency of the country.

Sen (1995)\textsuperscript{6} examined the short run balance of payments repercussions of FDI within the framework of a simple pedagogic macroeconomic model. The analytical framework used was a small open economy which produced two goods: an export product which is not consumed domestically and a composite home good which is used for both consumption and investment. The model showed that unless capital inflow is systematically higher than the value of tied imports the


balance of payments must necessarily worsen in the short run as a result of the FDI.

International Finance Corporation (1997)\(^7\) analysed the effect of economic policies on foreign direct investment. According to IFC the restrictive economic policies followed by the countries have reduced the benefits and increased the costs of FDI because of costs of regulation, economic costs of protection, inefficient project structures, encouragement of the use of transfer pricing to repatriate profits and fiscal losses from tax incentives.

A study by World Bank (1997)\(^8\) has revealed that, international capital flows have recently been marked by a sharp expansion in net and gross capital flows and a substantial increase in the participation of foreign investors and foreign financial institutions in the financial markets of developing countries.

Twomby (1998)\(^9\) analysed the patterns of foreign investment in the third world during 1914 to 1995. According to him, the twentieth century witnessed a sharp rise in the volume of private capital flows to emerging markets. In volume terms, capital flows to developing countries increased eight-fold over the period, or by 2.6 percent per year. Capital flows financed less than a tenth of investment in developing countries in the first half of the 1990s.

The study also analysed the impact of per capita income on the level of capital inflows. Per capita income has a positive, large, and statistically significant effect on the level of capital inflows in 1913, after controlling for other factors. This is a different pattern than that of the 1990s, when large amounts of


capital went to middle-income countries as well as to a few low-income countries such as China, India, and Indonesia. The only significant low-income recipients of capital inflows in the earlier episode were colonies of the European empires, such as India and Indonesia.

Kumar (1998)\(^\text{10}\) argued that the expansion in the magnitude of FDI inflows could not be attributed to the reforms alone. He found that policy liberalisation has not yet helped India improve her share in FDI outflows from major European countries or the U.S. The study reveals that the recent expansion of FDI inflows is as a result of the expansion in the global FDI flows to developing countries from about $35 billion per year on average during 1987-92 to $166 billion in 1998.

Kumar (1998)\(^\text{11}\) reviews the evolution of Indian government’s attitude towards FDI, the trends and patterns in FDI inflows during the 1990s and has considered its impact on a few parameters of development in a comparative East Asian perspective. The study concludes that the changing policy framework has affected the trends and patterns of FDI inflows received by the country. Although the magnitude of FDI inflows has increased, in the absence of policy direction the bulk of them have gone into services and soft technology consumer goods industries bringing the share of manufacturing and technology intensive among them down in sharp contrast to the East Asian countries. India’s experience with respect to fostering export-oriented industrialization with the help of FDI has also been much poorer than that of East Asian economies.

The NCAER study (1998)\(^\text{12}\) observed that private flows to developing nations are fast replacing developmental financial assistance. The study found


FDI as the single largest source of external private financing in the case of developing countries. The strategies to attract FDI flows are classified into two: one through the Export Processing Zone (providing exclusivity to FDI) route and the other through the tax holiday route. The study revealed the fact that despite establishing and operating the first EPZ in developing countries, the Indian experience in attracting FDI through this route has been a failure. This is because the policy planners prefer the tax holiday route since in terms of political acceptance the exclusivity concept of EPZ did not find favour with decision makers.

The study also analysed the intensity of interstate competition through incentives by constructing an incentive index for each state. The ranking of states, according to the incentive index indicated: (a) the prevalence of incentive based competition among states (b) the level of incentives increased over the time period and (c) there is not much correlation between the level of incentives offered and investments attracted by the states.

Rao et al (1999) studied the trends in foreign institutional investment in the Indian stock market. The study begins by drawing attention to the changes in the nature and magnitude of capital flows to developing economies in recent times. Official development assistance which dominated the capital flows in the decades immediately following the Second World War gave way to private capital transfers starting with the eighties and gathering momentum in the nineties. Capital flows more than tripled from $100.8 billion in 1990 to $ 308.1 billion in 1996. During this period private capital flows increased from $ 43.9 billion to $ 275.9 billion. All main components of private capital transfers, namely, commercial loans, FDI and FPI increased substantially.

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After briefly examining the favourable and unfavourable impact of FPI on domestic economy, the authors analyzed the importance of different types of foreign portfolio investment. The study also examined the countrywide distribution of FIIs registered with the SEBI and the shares of different categories of companies in the market value of investments. The study also examined the exposure of five India specific United States funds drawing attention to the changing sectoral importance during the period 1996-98. Based on the study the authors conclude that FII investment considerably influence stock prices in India.

Rao et al (1999)\textsuperscript{14} studied the major developments that took place in the foreign investment regime during the first seven years of liberalization. Their analysis showed that infrastructure sectors attracted the maximum amount of investment. Services accounted for one-third of the total approved investment. The high share of infrastructure and service sectors in approvals implied huge servicing burden as these cannot generate direct foreign exchange earnings on their own. The study also showed that FDI approvals are increasingly for setting up of subsidiaries. Thus very few companies with substantial foreign equity entered the Indian stock market during the post liberalization period.

Mallampally and Sauvant (1999)\textsuperscript{15} analyses the growth and significance of foreign direct investment in developing countries during 1980-1997. During 1980-97, global FDI outflows increased at an average rate of about 13 percent a year. Developing countries' share in total FDI inflows rose from 26 percent in 1980 to 37 percent in 1997 and their share in total outflows rose from 3 percent in 1980 to 14 percent in 1997. Firms based in industrial countries are still the primary source of FDI, but direct investment originating in developing countries has more


than doubled since the mid-1980s. Industrial countries as a group also attract the greater proportion of such investment, but their share is eroding as developing countries become increasingly attractive destinations for investment. According to them, what is likely to be more critical in attracting foreign direct investment into the developing countries in the future is the distinctive combination of locational advantages and, especially, created assets that a country or region can offer potential investors.

Loungani and Razin (1999)\textsuperscript{16} reviews the recent theoretical and empirical work on the impact of foreign direct investment on developing countries' investment and growth. According to them, the resilience of foreign direct investment during financial crises may lead many developing countries to regard it as the private capital inflow of choice. Recent works on foreign direct investment indicates that developing countries should be cautious about taking too uncritical an attitude toward the benefits of FDI. It can be reversed through financial transactions; it can be excessive owing to adverse selection and fire sales; its benefits can be limited by leverage; and a high share of FDI in a country's total capital inflows may reflect its institutions' weakness rather than their strength. They concluded that policy recommendations for developing countries should focus on improving the investment climate for all kinds of capital-domestic as well as foreign.

Recent empirical work indicates a strong link between the volume of FDI and domestic investment. Bosworth and Collins (1999)\textsuperscript{17} and Mody and Murshid (2001)\textsuperscript{18} found that a dollar of FDI results in an almost one-dollar increase in


\textsuperscript{18} Mody, Ashoka, and Antu Panini Marshid.2001. “Growing up with Capital Flows”. International Monetary Fund, Washington, D.C. processed.
investment. By contrast, international portfolio flows and bank loans have a much smaller impact on investment. In addition to the impact of FDI on the volume of investment, the presence of foreign firms by increasing their knowledge of and access to advanced technology, contributes to growth by improving the overall skills of the workforce and by increasing the demand for domestic firm’s products and the supply of inputs. These spillover benefits of FDI are greatest in countries with sound investment climates marked by well-developed human capital, efficient infrastructure services, sound governance and strong institutions.

Bajpai and Sachs (2000)\textsuperscript{19} in their paper have attempted to identify the issues and problems associated with India’s foreign direct investment regime. Despite India offering a large and fast growing domestic market, rule of law, low labor costs, and a well working democracy, her performance in attracting FDI flows has been far from satisfactory. The analysis shows that India does poorly on competitiveness, infrastructure, and skills and productivity of labor. They also tried to identify the other important deterrents to larger FDI inflows to India. According to them a restrictive FDI regime, high import tariffs, exit barriers for firms, stringent labor laws, poor quality infrastructure, centralized decision-making processes, and a very limited scale of export processing zones make India an unattractive investment location.

The eclectic paradigm of Dunning (2001)\textsuperscript{20} hypothesizes that firms make their international production decisions based on perceived ownership (O advantages), location (L advantages) and internalization (I advantages) related factors. When stretched from the micro to the macro, this leads to the concept of the investment development path (IDP). As a country develops, the attractiveness


of its OLI advantages change for potential investors (both inward and outward) and the country is likely to go through five relatively well-defined stages. The IDP is a useful heuristic model and attempting to find the position of a country on its IDP can lead to meaningful policy debates. In a way, the O advantages are related to the push factors of the home country, the L advantages to the pull factors of the host and the I advantages to the how of the involvement in so far as an international production decision is concerned. Although the basic structure of the model is attractive, its details have been evolving over time and may contain too many explanatory variables—many with limited predictive value. On one side, this may be too general a theory and on the other it ignores the possibility of any special advantage for a pair of countries. Countries in the neighbourhood have a role in the reduction of perceived risk and Dunning also argues that firms from developing countries are likely to perform activities in neighbouring countries that are politically and economically stable.

Chakrabarti (2001) using a monthly data-set for the period May 1993 to December 1999 found that the FII net inflows were not only correlated with the return in Indian equity market but was more likely the effect than the cause of the Indian equity market return. FIIs did not appear to be at an informational disadvantage compared to domestic investors in the Indian markets. Furthermore, the Asian crisis marked a regime shift. In the post-Asian crisis period, the return in the Indian equity market turned out to be the sole driver of the FII inflow, while for the pre-Asian crisis period, other covariates reflecting return in other competing markets were also correlated with FII net inflow.

Misra et al (2001) analysed the impact of private capital on the growth of developing countries. Capital flows have been associated with higher growth in

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some countries; they have also been associated with a higher incidence of crises. Private capital flows are generally found to have a significant impact on domestic investment, with the relationship being strongest for foreign direct investment and international bank lending and weaker for portfolio flows. But private capital flows are not likely to solve all development problems and can impose significant costs. However, when harnessed effectively, they can boost investment and spur productivity growth. Domestic policy priorities that foster more efficient investment will also attract productive foreign capital. Ultimately, domestic strength, including a robust and prudent financial sector will also protect a country from the volatility induced by capital flows. However, special safeguards, such as higher foreign exchange reserves or contingent credit lines, may be advisable in certain situations.

Shatz (2001)\textsuperscript{23} attempted an overview of Andean countries’ suitability for investment compared to other investment locations. The study discussed the key determinants of foreign direct investment worldwide and the actual pattern of foreign direct investment in the Andean countries. It also described the policy areas where the national governments of the five Andean countries (Bolivia, Colombia, Ecuador, Peru, and Venezuela) can take action to attract the type of foreign direct investment that will increase living standards and help alleviate poverty.

The study showed that for the Andean countries as a group, foreign direct investment has been high and on the rise in the 1990s. For all five countries, the percentage of FDI in GDP has been higher than the percentage for developing countries as a group from 1994 to 1998. Infrastructure-oriented FDI has contributed a large share of FDI in the 1990s. The major constraint limiting

sustained new entry of international businesses is market size. The biggest challenge is to attract export-oriented manufacturing FDI.

Kathuria’s (2002)\textsuperscript{24} econometric study of the impact of FDI on productivity of Indian industry, based on data for 487 firms in 24 industry groups, for the period 1989-90 to 1996-97 reveals that: (a) following the economic liberalization policies instituted in 1991, productive efficiency increased in the case of both foreign owned and domestically owned firms but the growth in efficiency was relatively high in the case of foreign firms; (b) only those domestic firms with a threshold level of research and development gained from the presence of foreign firms; (c) in the science oriented industries, the presence of foreign firms exerted a strong learning effect, i.e., domestic firms in this group experienced technology spillovers from the presence of foreign firms; and (d) in the non-science oriented industry groups, only those locally owned firms with an R and D base experienced spillovers from the presence of foreign firms.

Chakraborty and Basu (2002)\textsuperscript{25} explored the two-way link between FDI and growth by using a structural cointegration model with vector error correction mechanism. Using aggregate data for 1974-1996, they find that causality runs more from GDP to FDI. In the long run, FDI is positively related to GDP and openness to trade. Furthermore, FDI plays no significant role in the short-run adjustment process of GDP.

Mukherjee et al (2002)\textsuperscript{26} explored the relationship of daily FII flows to the Indian equity market for the period January 1999 to May 2002 with two types of

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variables. The first type included variables reflecting daily market return and its volatility in domestic and international equity markets, based on the BSE Sensex, S&P (Standard and Poor) 500 and the MSCI (Morgan and Stanly Capital Index) as well as measures of co-movement of returns in these markets. The second type of variables, on the other hand, were essentially macroeconomic like daily returns on the Rupee-Dollar exchange rate, short-term interest rate and index of industrial production; variables that are likely to affect foreign investors' expectation about returns in the Indian equity market. They distinguished among three kinds of daily FII flows, namely, FII flows into the country or FII purchases, FII flows out of the country or FII sales, and the net FII inflows into the country or FII net, and related these to the above mentioned variables along with their past history over different time frames, like a week or fortnight.

According to the authors, FII flows to and from the Indian market tend to be caused by return in the domestic equity market and not the other way round as commonly believed. To quote them “the regression analysis, in various stages, reveals that return in the Indian equity market is indeed an important factor that influences FII flows into the country. While, the dependence of net FII flows on daily return in the domestic equity market is suggestive of foreign investors' return-chasing behaviour, the recent history of market return and its volatility in international and domestic stock markets have some significant effect as well. However, while FII sale is significantly affected by the performance of the Indian equity market, FII purchase is not responsive to this market performance. Looking at the role of the beta's of the Indian market with respect to the S&P 500 and MSCI indices, it is concluded that foreign institutional investors do not seem to use the Indian equity market for the purpose of diversification of their investments.”
Government of India report (2002)\textsuperscript{27} addresses reasons for inadequate performance of India in the area of FDI. The identification of causes draws extensively on investor perception surveys carried out by major global consultancy firms Boston Consultancy Group and AT Kearney. Six major constraints are mentioned:

\textit{Image and Attitude.} There is a perception among investors that foreign businesses are treated with suspicion and distrust in India.

\textit{Domestic Policy}. While the FDI policy is quite straightforward and getting increasingly liberalized for most sectors, once an investor establishes his presence, ‘national’ treatment means that this investor is subject to domestic regulations, which are perceived as being excessive.

\textit{Procedures}. Although approval for investment is given quite readily, actual setting up requires a long series of further approvals from central, state and local authorities. This introduces substantial implementation lags.

\textit{Quality Infrastructure}. Foreign investors are concerned about a number of problems with the infrastructure sector- in particular electricity and transport. Irregular and undependable supply complicates problems for foreign investors.

\textit{State Government Level Obstacles}. At the level of actual investment the practices of state governments become important. State level reforms are lagging behind central government reforms to a considerable degree. State government practices in issues such as land records, utility (power, water etc) connections, providing clearances of various sorts may make an important difference in the time it takes to get a plant up and running. Differences in state practices in such matters partly explain the disproportionate flow of FDI to some states in the peninsular region of India.

Delays in Legal Practices. Despite a highly structured legal system, dispute settlement and contract enforcement are time consuming activities in India. Such apprehensions deter the rapid inflow of foreign investment.

Kim and Wei (2002)\textsuperscript{28} studied trading behaviour of portfolio investors in South Korea before and during the currency crisis. They found that investors in different categories have different trading patterns. These differences in trading behaviour are due to differences in information. The Korean branches of foreign institutions or foreign individual investors engaged less in positive feedback trading (hence less herding) than their non-resident counterparts. The authors recognize that even though the impact of foreign investors on Korean stock prices was negligible, its impact could increase in emerging markets in the days to come due to increasing liberalization of capital flows into emerging markets.

FICCI’s FDI survey (2003)\textsuperscript{29} is a study on the measures necessary for enhancing the quantum of FDI flows to India. It argues that India’s competitiveness in the FDI sector needs to be sharpened. China and the ASEAN nations have become adept in attracting FDI. Besides in liberalizing policies, China’s attractiveness has been enhanced by its entry into the WTO and the ASEAN Free Trade Area. India has considerable potential in both these areas.

The survey points out that India continues to repose faith in ‘greenfield’ investment while framing policies for second-generation reforms in FDI. With the global competition becoming fierce with the rapid development of information technology and research and development, and the speed required to strengthen market competition, greenfield investment has been losing to mergers and acquisitions because the former require longer time to set up facilities for


\textsuperscript{29} FICCI- (Federation of Indian Chamber of Commerce and Industry) (2003): “FDI Survey”, New Delhi.
commercialization and generate profits. India needs to accomplish much more to facilitate Mergers and Acquisitions.

Nagaraj (2003)\(^{30}\) documents the trends in foreign direct investment in India in the 1990s, with emphasis on the trends in the quantum and composition of the FDI inflow and compares them with those in China. While the foreign investment inflow in the 1990s represented a substantial jump over the 1980s, it was miniscule compared to China. Even though the bulk of the approved FDI was for infrastructure, the realized investment was largely in manufacture of consumer durable goods and the automotive industry. As stated by the author the analysis is indicative in nature regarding the effects of foreign investment because of the absence of statistical information- both at the aggregate and at the industry level. The study concludes by suggesting that foreign investment should be allowed mainly in manufacturing to acquire technology, and to establish international trading channels for promoting labour intensive exports.

Srivastava (2003)\(^{31}\) compares and contrasts the methods of measurement of FDI inflows to India with that prescribed by the International Monetary Fund. India is an ‘underperformer’ in attracting foreign direct investment when compared to China and the rest of East Asia. The major reason for this kind of a situation is that India excludes reinvested earnings, the proceeds of foreign equity listings and foreign subordinated loans to domestic subsidiaries, overseas commercial borrowings and equity in the form of American Depository Receipts and Global Depository Receipts acquired by the Foreign Institutional Investors through the purchase of additional shares in subsequent transactions after acquiring 10 per cent initially through the portfolio route. She also suggests ways of improving the coverage of FDI data in India.


FDI flows are generally believed to be influenced by economic indicators like market size, export intensity, institutions, etc, irrespective of the source and the destination countries. Banik et al (2004)\textsuperscript{32} uses the neighbourhood model, developed in the context of the US, to explain the FDI inflows. The study shows that the neighbourhood concepts are widely applicable in different contexts—particularly for China and India and partly in the case of the Caribbean. In the neighbourhood model, the role and importance of ‘psychic’ or ‘cultural’ distance itself changes dynamically as investments move from the original to the intermediate and the extended neighbourhoods.

Brink and Viviers (2003)\textsuperscript{33} studied the obstacles in attracting investments into Southern Africa. The emphasis of the study is the fact that Southern Africa has been isolated from international financial markets and the process of financial globalization; the only exception being South Africa and Mauritius. Recognizing the fact that ‘hot money flows’ can be potentially destabilizing—both financially and economically— the authors feel that the potential dangers can be avoided through sound policy. The study focused on the obstacles in attracting portfolio investments into South Africa and found that underdevelopment of financial markets as the major obstacle in attracting FPI. Other obstacles identified were macroeconomic instability, interest rate structures, exchange rate risk, exchange control, tax structures, inadequacy of information and underdeveloped telecom infrastructure.

Gordon and Gupta (2003)\textsuperscript{34} examined the factors determining portfolio flows. These factors were classified into global and domestic. Global factor is the


London Inter Bank Offer Rate (LIBOR) which is inversely related to portfolio flows. Among the domestic factors that affected FII flows adversely, the most important ones are lagged stock market returns, rating downgrades and rupee depreciation. Other significant determinants are the macroeconomic fundamentals of an economy.

Balasubramanyam and Mahambare (2004) in their paper reviews the determinants of FDI, analyses the efficacy of FDI in promoting development and examines the policies. An attempt is also made to compare the FDI flows into India and China. To the authors, the reasons for relatively low volumes of FDI India attracts are to be sought in the pervasive factor and product market distortions generated by the overall policy framework and not entirely due to the FDI policy regime in place. The operation of the regime in practice appears to be riddled with excessive delays and red tape, with attendant opportunities for rent-seeking. They argue that instead of adopting specific policies geared to the promotion of FDI, a level playing field for one and all may be a much better bet.

The paper also argues that for a variety of reasons China and its spectacular success in attracting FDI may not be the role model for India. Advocacy of large volumes of FDI should be tempered by the recognition that it is a superb catalyst of growth and not an initiator. Its efficacy in promoting development objectives is conditioned by the presence of co-operant factors in the host economies and it is most effective in countries which possess a threshold level of human capital and infrastructure facilities.

Hoti (2004) evaluated the significance of 30 published empirical papers in the international capital flow literature according to established statistical and

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The study compared the trends and volatilities in international capital flows for nine representative countries for the period 1977-2001. The nine developing countries, namely, Argentina, Brazil, Hungary, Indonesia, Mexico, Pakistan, Philippines, Russia and Slovenia were selected as representative of Latin America, Asia and Eastern Europe.

The study showed that Indonesia had the most variable FDI followed by Argentina, Brazil and Philippines. Russia had the least variability in FDI, followed by Slovenia, Pakistan and Mexico. The variability in FPI differed from that of FDI, with Indonesia being most variable, followed by Russia, Argentina and Pakistan. The least variability in FPI was shown by Hungary, followed by Slovenia, Philippines and Mexico. The most variable countries in total capital flows were Indonesia, Russia, Argentina and Brazil while the least variable were Hungary, Slovenia, Pakistan and Mexico.

Kumar (2005)\(^{37}\) analysed the role of liberalisation in explaining the rising inflows of FDI till 1997 and found that only a part of the increase in FDI inflows could be attributed to liberalisation, and a part of the rise was explained in terms of a sharp expansion in the global scale of FDI outflows during the 1990s. The decline in inflows since 1997 despite continued liberalisation suggested that policy liberalisation is not an adequate explanation of FDI inflows. Macroeconomic fundamentals of the host economies that emerge as the most powerful explanatory variables in the inter-country analysis of FDI inflows also explain the year-to-year fluctuations in FDI, although with a lag.

Gupta (2005)\(^{38}\) analyses the role of foreign direct investment in India since economic liberalization in 1991. She contends that the inflows of FDI so far in

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India have been disappointingly low. India’s policy towards FDI is presented in a historical perspective besides analyzing the structure and industrial breakdown of the inflows. The success of China in absorbing and utilizing FDI inflows in the post-reform period since 1978 has been contrasted with the corresponding failure of India. China’s success is mainly attributed to the successful operation of Special Economic Zones whereas inadequate infrastructure, bureaucratic delays, rigid industrial labour laws and in some cases militant trade unionism are the major obstacles in the way of attracting large inflows of FDI into India. She suggests that India should liberalise further, introduce labour market reforms in the industrial sector and invest more in the infrastructure. She concludes that, India has attracted much less FDI than it should have attracted given its potential.

Liljeblom and Loflund (2005)\textsuperscript{39} investigated the determinants of foreign equity investment flows into the Finnish stock market during its deregulation in the early 1990s. They focused on informational differences in influencing foreign equity investment. They found that stocks held by foreign investors deviated clearly from the Finnish market portfolio. They found evidence of stock induced effects as well as effects of potential informational barriers. Foreign investor’s portfolios were tilted towards low dividend yield stocks. This was the result of additional withholding tax on dividends. A preference for large cap, liquid stocks with a strong profitability record was also found. However they did not find evidence of any informational disadvantage or advantage for foreign investors.

Jha (2005)\textsuperscript{40} provides an overview of the trends and prospects of FDI inflows into India. His paper stresses the role of domestic policy reform to augment investment and emphasizes the need to improve the quality rather than the quantity of FDI. The distribution of FDI in India is also discussed. The share


of FDI directed towards the manufacturing sector has declined, whereas the services sector (including telecommunications) increased its share, between 1980 and 1997. Jha believes that quality FDI will flow to India if much faster tariff reforms and privatization are introduced. This will have to be supported by improved governance and regulatory structures. According to him, it is more important to have a high rate of saving and investment, than to have a large FDI component of investment, per se.

Krugell (2005)\textsuperscript{41} provides a theoretical and empirical analysis of the determinants of FDI in sub-Saharan Africa. Theories of the internationalization of production are used to outline the reasons why multinational enterprises undertake FDI. The empirical analysis tests for the significance of a number of hypothesized determinants of FDI, in sub-Saharan Africa. The pooled cross-country and time series estimation covers the period 1980 to 1999 for 17 countries.

The major determinants of FDI identified are broadly classified into micro-determinants and macro-determinants. Market size and growth, labour costs, host government policies, and tariffs and trade barriers are the important location specific micro-determinants. The macro-determinants are openness and exports, exchange rates, inflation rates, budget deficits, infrastructure development and political instability. The study shows that past FDI is the most important determinant of current FDI flows to sub-Saharan Africa. Africa’s small and underdeveloped economies do not attract FDI on the basis of their market size. The study also shows that foreign investors prefer an environment with low inflation and thus less uncertainty.

Naude and Krugell (2005)\textsuperscript{42} in their paper analyses the influence of human resource development as an important determinant of FDI. According to them, one of the major reasons for the slow inflow of FDI into South Africa since 1994 is the country’s inadequate human capital. Since physical and human capital work in a complementary fashion, if human capital cannot complement physical capital due to inappropriate human resource development, investment will be reduced. The authors concludes that a fundamental reason for South Africa’s slow growth, high unemployment and lack of sufficient FDI is due the fact that the supply of adequately trained labour has not kept up with the demand.

Chakraborty (2006)\textsuperscript{43} examines the time series properties of foreign capital inflows into India in the 1990s, particularly in the period that followed certain liberalisation measures in the financial sector. An analysis of the quarterly data for the period 1993 to 2003 shows that net capital inflows have been volatile, though not all components of aggregate inflows have moved in a similar fashion. The paper further analyses how capital inflows adjusted to changes in the real exchange rate and other macroeconomic variables in India since 1993. The econometric results indicate that an error-correction mechanism was operating between net inflows of capital and the real exchange rate. Macroeconomic fundamentals did not have any significant effect on the dynamic adjustment of capital inflows, and a co-integration relationship exists between the net inflows of capital, real exchange rate and interest rate differential. She argues that co-movement in these variables was due to the intervention of the Reserve Bank of India in the foreign exchange market, which helped prevent the volatility of the real exchange rate in spite of this volatility in net inflows of capital.


Mohan (2006) examined the trends in foreign institutional investment in emerging markets in general and India in particular. According to him in mature economies institutional investors have replaced banks as the primary custodian of peoples’ savings. These institutional investors are mutual funds, insurance firms, pension funds and hedge funds. These institutional investors who command huge resources are diversifying their portfolios through investments in debt and equity in emerging markets.

Huge capital flows into emerging markets via foreign institutional investors have substantially augmented the foreign exchange reserves of those economies besides boosting their stock markets. While accepting the fact that FIIs have replaced domestic mutual funds as the major investors and prime movers of the stock market, he dispels the fears that FII investment can be destabilizing. In emerging markets capital outflows became a problem only in Malaysia and Indonesia during the currency crisis of 1997. In India FII investment has been steady and positive with modest volatility so far. According to him, the real problem caused by variations in FII inflows is not stock market volatility but the difficulties posed in the management of money supply and exchange rate.

Busse and Groizard (2006) explored the linkage between income growth rates and foreign direct investment (FDI) inflows. They found mixed evidence because no robust relationship between FDI and income growth has been established. They argue that countries need a sound business environment in the form of good government regulations to be able to benefit from FDI. Using a comprehensive data set for regulations, they tested this hypothesis and found


evidence that excessive regulations restrict growth through FDI only in the most regulated economies.

Rakshit (2007)\textsuperscript{46} presented a critique of the approach and recommendations of the Government of India expert group on foreign institutional flows (2004). The expert group was set up to suggest measures for encouraging foreign institutional flows. While recognizing the fact that foreign institutional inflows have strengthened India’s balance of payments position, he cautions against unbridled encouragement of highly volatile and potentially destabilizing inflows in the absence of empirical evidence proving the beneficial impact of such flows on economic growth.

Rakshit questions the government’s policy assumption that foreign institutional inflows are always investment and growth promoting. So long as the current account is in surplus foreign institutional inflows cannot be investment and growth promoting. He concludes by recognizing that, of late, capital inflows are used for financing the investment-saving gap. He calls for further probing into the linkages between capital inflows and domestic economic activity. Furthermore, he feels that measures relating to foreign institutional investment should be considered as an integral part of a policy package encompassing all types of external capital.

Balasubramanyam and Sapsford (2007)\textsuperscript{47} compared the inflow of FDI in India and China and finds that there are differences in the volume of FDI in the two countries. The explanation for the observed differences in the volume of FDI in the two countries is that the productivity of FDI in India is higher than that in China. This paper argues that although India could do with much larger volumes


of FDI than that it attracts now, the concern that it is well below the levels of FDI in China is misplaced. Given the structure, composition and factor endowments of her economy which are significantly different from that of China, they argue that India may not need larger volumes of FDI, not on the scale that China attracts.

Cravino et al (2007)\textsuperscript{48} empirically estimated the impact of China and India on foreign investment in other economies, with special emphasis on Latin America and the Caribbean. Using bilateral outward stocks data from UNCTAD and OECD for the period 1990-2004, they found that China and India had a positive effect on the foreign capital stocks in Latin America and the Caribbean and the rest of the world. The evidence based on U.S. foreign investment data across industries also suggests that the effect of China has been positive on aggregate for all sectors, but there is little evidence that this is the case in the manufacturing sector. In contrast, India appears to have had no impact on the foreign capital stocks of Latin America and the Caribbean from the U.S. They suggests that since the emergence of China and India in the global economy has positive effects on global FDI flows, fears of global competition for FDI seems misplaced. The policymakers should focus their efforts on the fundamental determinants of FDI to attract foreign investors into their economies.

The review of literature clearly reveals the fact that the focus of majority of the studies has been to identify the determinants of foreign investment-portfolio or direct. Another set of studies evaluates the impact of policy changes on foreign investment. The studies that analyses the impact of foreign investment concentrates on variables like income, growth, investment and productivity. India China comparison is the focus of some studies. Very few studies have been made on the impact of foreign investment with particular emphasis on foreign exchange reserves, balance of payments (current account deficit) sources of external

financing and the exchange rate. In the context of the substantial increase in foreign investment into India in recent years, the impact on the said variables needs a thorough investigation. Therefore, there is a clear research gap here. Our study is expected to fill this research gap.

1.2 STATEMENT OF THE PROBLEM

India launched a programme of economic policy reforms in response to a fiscal and balance of payment crisis in July 1991. The fiscal deficit was 8.5 per cent of GDP and the current account deficit was 3.5 per cent of GDP in 1990-91. As a percentage of export earnings, the debt service burden rose to 30 per cent in 1990-91. Inflation shot up to 16.7 per cent. Simultaneously, there was a run on deposits held by non-resident Indians, and it became difficult even to roll over the existing short term debt as international creditors held back from lending to India. For the first time in its history, India was teetering on the brink of defaulting on its international payments. The government was left with no option except to turn to the IMF and World Bank to avoid default and to restore its credibility with international creditors.

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, foreign exchange markets, money supply and foreign exchange reserves. The present study is an attempt to examine and explore these issues and problems.

1.3 OBJECTIVES OF THE STUDY

The objectives of the present 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 flows, sources of financing the current account deficit, foreign exchange reserves and exchange rate.
1.4 HYPOTHESES

The study is based on the following hypotheses.

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

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

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

1.5 IMPORTANCE OF THE STUDY

The external debt crisis of 1991 brought India close to default in meeting its international payments obligations. The Government of India was following a highly restrictive policy towards foreign investment until mid 1991. As a part of the economic reforms initiated from 1991, the attitude of the government towards foreign investment-both direct and portfolio- changed dramatically. The policy reforms have enabled the country to overcome the crisis.

The increased inflow of foreign funds into the developing countries like India is expected to act as a catalyst of economic growth by affecting the level of gross capital formation. Foreign investment is seen as a way of filling the gap between domestically available supplies of foreign savings and planned investment. It is also helpful in bridging the foreign exchange gap. Developing countries like India are faced with a shortage of domestic savings to match investment opportunities or a shortage of foreign exchange to finance needed imports of capital goods and intermediate goods. Foreign direct investment may lead to capital formation by supplementing the domestic resources. The availability of foreign portfolio investment is expected to reduce the cost of capital and help the development of the capital markets. Thus foreign investment in general enhances the size of the total investment.
The Government of India initiated wide ranging reform of the policy regime beginning in July 1991. The change in the policy regime related to foreign investment resulted in unprecedented capital inflows in the post reform period. Both foreign direct investment and portfolio flows have been encouraged in the post reform period. The inflow of foreign investment is likely to have macroeconomic repercussions on the Indian economy. It is important to understand the impact of foreign investment on macroeconomic aggregates like current account balance, foreign currency assets, exchange rate, composition of capital inflows, money supply and sources of external financing. These are areas that remain seriously unexplored. The present study is an attempt to fill this research gap.

1.6 METHODOLOGY

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 and 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.

1.7 SCOPE OF THE STUDY

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.

1.8 SOURCES OF DATA

1.9 LIMITATIONS OF THE STUDY

The study relies exclusively on secondary data. The limitations and deficiencies of secondary data are the main limitations of the study. Since the study is conducted with a macroeconomic perspective, sub-regional analysis of data is not attempted in this study. The exclusion of foreign investment outflows from the purview of the study is another limitation of the study. Besides, the impact of foreign investment on the real sector of the economy is not attempted.

1.10 PLAN OF THE STUDY

The study is composed of seven chapters. Chapter one presents the review of the literature, statement of the research problem, objectives of the study, importance, methodology and analytical tools used in the study, sources of data and limitations of the study. Chapter two describes the theoretical framework of foreign investment. Chapter three focuses on foreign investment from an international perspective. An overview of foreign investment policy in India is presented in chapter four. Chapter five examines the changing patterns of foreign investment in India. The impact of foreign investment on the selected macroeconomic variables is presented in chapter six. Chapter seven summarizes the findings of the study.