Introduction

In 1992, India opened up its economy and allowed Foreign Portfolio Investment (FPI) in its domestic stock markets. Since then, FPI has emerged as a major source of private capital inflow in this country. The objective of this study is to examine the impact of Foreign Portfolio Investment on India's economy and industry. As FPI essentially interacts with the real economy via the stock market, the effect of stock market on the country's economic development will also be examined. In the current global economic scenario, it is important to address these issues because of the following reasons:

1. First, during the late 1980s and early 1990s portfolio investment emerged as an important form of capital inflow to developing countries. The importance of portfolio investment to developing countries has come down after the East Asian crisis of 1997. However, unlike most other developing countries, India is still more dependent upon FPI than Foreign Direct Investment (FDI) as a source of foreign investment. For the period 1992 to 2001, about 54 percent of foreign investment in India came in the form of FPI. Given such high dependence of the Indian economy on FPI, it is important to assess whether and how FPI has contributed to the economic development of the country.

2. Second, the spate of financial crises since the late 1990s have repeatedly highlighted that the current global financial architecture, with its emphasis on speculative capital flows, can seriously disrupt the economic prospects of a developing country. For these countries, insulating the economy from the uncertainties of short term capital flows can impose serious fiscal costs on the economy. It can also make the management of external economy difficult by reducing the policy options available to the policymakers in developing countries. It is important to investigate these aspects of FPI in the Indian context.

Also, competition among emerging markets to attract foreign portfolio investment has led to a situation in which in order to sustain inflows of portfolio investment, it has become increasingly important for developing countries to ensure attractive returns for portfolio investors. Often this means offering increasing operational flexibility and fiscal sops to portfolio investors. This increases the cost associated with portfolio investment in a developing country. It needs to be investigated whether the benefits
brought by the foreign portfolio investors to the domestic economy are sufficient to justify the costs associated with the promotion of FPI in these countries.

3. The dependence on FPI is pushing many developing countries, including India, towards a more stock market oriented financial system. This makes it imperative to evaluate the relative merits and demerits of a stock market based financial system in a developing country. In this context, it becomes particularly important to find out how a stock market based financial system can benefit the economy and the industry of a developing country. It is also crucial to empirically investigate whether the supposedly beneficial aspects of a stock market based financial systems are actually being realized in developing countries.

Given these concerns, this study attempts to address the issue of foreign portfolio investment and its impact on economic development from an Indian perspective. This study has focused on India because it was felt that in spite of the relevance and importance of the current topic, this area has remained somewhat under-researched in the Indian context. Apart from pioneering works by Singh (1993) and Singh and Weisse (1998), only a few studies have attempted to investigate the impact of FPI on India's industry and economy [Joshi, 1995; Pal, 1998, Pp. 589-98; Samal, 1997, Pp. 2,729-32; Rao, Murthy and Ranganathan 1999]. Most of these studies are based on aggregate level data and have dealt only with specific aspects of FPI in India. This study tries to fill this void by taking a more comprehensive look at the subject.

To study the impact of FPI on India's economy and industry, first it is important to understand how FPI differs from FDI. According to the definitions adopted by the International Monetary Fund (IMF), Foreign Direct Investment takes place when a resident entity in one economy obtains a lasting interest in an enterprise resident in another. A lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise. The criterion used is that "a direct investment is established when a resident in one economy owns 10 percent or more of the ordinary shares or voting power of an incorporated enterprise, or the equivalent for an unincorporated enterprise. All subsequent transactions between affiliated enterprises, both incorporated and unincorporated, are direct investment transactions".

According to this IMF methodology, Foreign Portfolio Investment is defined as non-FDI investment by foreign investors in the tradeable financial assets of a country. This implies that a portfolio investor should not own 10 percent or more of a company’s ordinary shares and the investor should not have a significant degree of control or a lasting interest in an enterprise of another country. FPI can include foreign investors’ investment in a variety of instruments which are traded (or tradeable) in organized and other financial markets, like bonds, equities and money market instruments. The IMF also includes derivatives or secondary instruments, such as options, in the category of FPI. The channels of cross-border investments can be through securities acquired and sold by retail investors, commercial banks, and investment trusts (mutual funds, country and regional funds, pension funds and hedge funds). To emphasize the difference between FDI and FPI again, it can be pointed out that, unlike foreign direct investment, foreign portfolio investment generally does not provide the investor, management control rights of local companies.

This definition of FPI highlights the fact that portfolio investment is restricted to the financial sector of the economy. As a consequence, unlike FDI, FPI does not have a one-to-one relationship with real investment. The interaction of FPI with the real economy essentially takes place through its effect via the financial markets. Secondly, it also shows that foreign portfolio investment, by definition, is short-term and therefore, more volatile in nature. The short-term nature of portfolio investment and its lack of direct interaction with the real economy have raised the question whether apart from providing foreign capital to developing countries, FPI contributes to the development of the real sector of the economy and helps economic development.

Mainstream economists suggest that the FPI can benefit the real sector of an economy in two broad ways:

1. **As a Source of Foreign Exchange:** FPI can help a developing country by providing it a non-debt creating source of foreign exchange to bridge the foreign exchange gap.

2. **By Stimulating the Development of Domestic Equity Markets:** According to the mainstream view, FPI stimulates the development of domestic equity markets which in turn helps the domestic economy through the following channels:

   It:

   2 Here we are assuming green field FDI investment only.
Chapter 1. Introduction

- Provides an additional channel for encouraging and mobilizing domestic savings.
- Fosters the growth of the domestic financial services sector and the various forms of institutional savings.
- Provides savers with better protection than most debt instruments against inflation and currency depreciation.
- Assists in the transformation of the private sector from ownership capitalism to managerial capitalism.
- Improves the efficiency of capital by providing market measures of returns on capital and a market mechanism for management.
- Improves gearing and helps to reduce dependence on borrowing.
- Provides an incentive for high standards of accounting and disclosures which will both improve management performance and facilitate the eventual entry of domestic enterprises to the international capital market.

Plan of the Study

This study will assess whether and to what extent these supposedly beneficial aspects of FPI have actually materialized in the Indian economy. This study is organized in the following manner.

Chapter 2 of this study is divided into two parts. The first part gives an overview of foreign portfolio investment and discusses the global economic situation which propagated the surge in foreign portfolio investment to the developing countries during the 1980s. It also looks at the economic conditions in India that prompted the government to open up the economy to attract foreign portfolio investment. Next, a detailed study is undertaken to understand the profile of the Foreign Institutional Investors (FIIs), who are the main source of FPI in India.

The second part of this chapter studies the impact of foreign portfolio inflow on domestic macroeconomic variables of India. In this part of the study it is also investigated how foreign portfolio investment is affecting the macroeconomic management of this country. The impact of capital inflow on foreign exchange rates, foreign exchange reserves and domestic money supply of India are analyzed in this chapter. This chapter also discusses the volatility of FPI and its impact on domestic stock prices. Finally, it studies how the

3 WIDER (1990).
influx of foreign portfolio investment and the development and fostering of domestic stock market have influenced domestic saving rates in the Indian economy.

As suggested by the mainstream theory, one of the most important contributions of portfolio investment is that it lowers the cost of capital for the domestic corporate sector and facilitates resource mobilization. Using balance sheet data for companies, Chapter 3 of this study looks at how stock markets in India, under the influence of foreign portfolio investment, have helped resource mobilization for the corporate sector in India. In this chapter the question is addressed of how after the advent of foreign portfolio investors in India, the development of stock markets has affected the financing pattern of the Indian corporate sector.

The discussion in Chapter 2 shows that most developing countries, including India, are moving towards a more stock market oriented domestic financial system. There is a large body of literature in economics, which suggests that the relative importance of banks and stock markets in a country's financial system can have a significant influence on the investment decisions of the country's corporate sector. The first part of Chapter 4 reviews the literature on the role stock market in firm level investment decisions and investigates the relative merits of bank based capital market based financial system. The second part of this chapter empirically investigates how stock market development has affected the investment pattern of the Indian corporate sector during the decade of 1990s. In the backdrop of stock market development, this chapter will try to explain the observation that during a substantial part of the 1990s, Indian firms have investment more in financial assets than in physical assets. This chapter will also investigate the performance of the Indian corporate sector during the In 1990s using indicators for profitability, resource utilization and value addition.

Chapter 5 contains an industry specific study to ascertain the influence of the stock market development on that industry. In the Indian stock markets, share price movements indicate that the Pharmaceutical sector has emerged as one of the top performers among different industry groups. Data also reveal that FIIs invest a very high proportion of their money in stocks of the pharmaceutical sector. Chapter 5 will analyze the performance of the Pharmaceutical sector in detail to investigate first, whether a vibrant stock market has helped this sector to improve its mobilization of resources, and secondly, whether the optimism expressed by the stock market about the Pharmaceutical sector can be justified.
by the economic fundamentals of this industry. In this chapter, the performance and prospects of the Indian Pharmaceutical industry is analyzed by looking at profitability, investment growth rate, Research and Development (R&D) expenditures and present or future growth prospects of this industry. The future growth prospects of the Indian Pharmaceutical industry is also investigated in the context of the impending product patents regime in India.

Chapter 6 concludes the thesis by summarizing the main findings of the study. It also suggests policy prescriptions regarding foreign portfolio investment in the context of Indian economy.